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PART 1: INTRODUCTION

1.1 This bulletin provides an explanation of the controlled foreign companies (CFC) legislation contained in Part IVA of the Income Tax Act 1976. This legislation was inserted into the Income Tax Act by s.24 of the Income Tax Amendment Act (No.5) 1988. Subject to the transitional rules contained in s.245Y of the Income Tax Act, the CFC legislation took effect from 1 April 1988: s.15 of the Income Tax Amendment Act (No.5) 1988.

1.2 The objective of the CFC regime is to reduce opportunities for residents to avoid or defer New Zealand tax through the accumulation of income in foreign companies that are controlled by New Zealand residents. Before the enactment of the CFC legislation income could be accumulated free of tax in a non-resident company. Further, such income was often exempt from tax on repatriation to New Zealand by virtue of the inter-corporate dividend exemption provided by s.63 of the Income Tax Act.

1.3 Legislation enacted by the Income Tax Amendment Act (No.5) 1988 limits opportunities for accumulation of income in a foreign entity free of New Zealand tax, and for the tax-free repatriation of such income, in the following ways:

(a) The CFC legislation contained in Part IVA of the Income Tax Act provides that residents holding interests of more than 10 percent in a CFC are required to include in their assessable income their proportionate share of the income derived by the CFC.

(b) The foreign investment fund legislation contained in ss.245R to 245T provides that residents investing in foreign investment funds are required to calculate income or loss with respect to those interests. The objective of the foreign investment fund legislation is to limit opportunities for residents to accumulate income in certain foreign entities other than CFCs. These are entities located in low tax jurisdictions in circumstances where tax on income accumulated by the entity may be deferred until distribution, or can be avoided by realising the interest in the entity in the form of a tax-free capital gain.

(c) The trust taxation legislation contained in ss.226 to 231 of the Income Tax Act limits opportunities for residents to use trusts with non-resident trustees to avoid or defer New Zealand tax. This legislation is discussed in the appendix to Taxpayer Information Bulletin No.5.

(d) The dividend withholding payment legislation contained in Part XIIB of the Income Tax Act limits opportunities for deferring tax on dividends derived by resident companies from foreign companies by requiring a withholding payment to be deducted when the dividends are derived. This legislation is discussed in the appendix to Taxpayer Information Bulletin No.1.

(e) The new residence rules contained in s.241 of the Income Tax Act clarify and extend the definition of company residence. One effect of the rules is that companies which were previously used to defer and avoid New Zealand tax may be treated as being resident in New Zealand and, therefore, as being liable to tax on worldwide income. Amendments to the residence rules also make it difficult to avoid the CFC, foreign investment fund and trust regimes through manipulations of residence. The Inland Revenue Department's interpretation of the new residence rules is set out in Public Information Bulletin No.180.

1.4 The CFC legislation therefore constitutes part of a series of measures designed to ensure that residents are taxable on income derived from outside New Zealand. The legislation achieves this objective by providing that any New Zealand resident who holds an interest in a CFC may be assessable on a portion of the income derived by the CFC, notwithstanding that the income has not been distributed to the person by the CFC.

1.5 Part 2 of this bulletin contains a broad overview of the CFC legislation. The description in Part 2 is broad in nature and if a more detailed explanation is required the succeeding parts of the bulletin should be considered. Parts 3 to 19 of the bulletin follow the scheme of the legislation, providing an explanation in accordance with the order in which the sections are arranged. Part 20 contains a discussion of the relationship of the CFC regime to other parts of the Income Tax Act.

1.6 This bulletin represents the Inland Revenue Department's interpretation of the law as it stands at 1 July 1990.

PART 2: OVERVIEW OF CFC LEGISLATION

Features of the CFC regime

2.1 The CFC regime is contained in ss.245A to 245Q and ss.245V to 245Y of the Income Tax Act. Sections 245R to 245T contain the provisions establishing the foreign investment fund regime, and ss.245V to 245Y contain further provisions which apply in relation to the foreign investment fund regime. Only limited aspects of the foreign investment fund regime are discussed in this bulletin. These are the attribution of foreign investment fund income and losses in cases where a CFC holds an interest in a foreign investment fund (discussed in Part 9), and the relationship of the foreign investment fund regime to the CFC regime (discussed in Part 20).

2.2 The sections comprising the CFC regime operate as follows:

- s.245A(1) contains definitions of terms that apply for the purposes of Part IVA. Sections 245A(2) and (3) contain rules which apply for the purposes of calculating control or income interests in a foreign company and for the purposes of calculating attributed foreign income or loss.

- s.245B defines the circumstances in which persons are associated for the purposes of Part IVA. This question is relevant primarily in calculating control interests under s.245C for the purpose of determining whether a foreign company is a CFC. The associated persons rules are also relevant in determining whether a person has an income interest of 10 percent or greater in a CFC and, in some circumstances, in calculating the branch equivalent income or loss of a CFC.

- s.245C defines when a foreign company is a CFC. It also provides for the calculation of control interests in a foreign company. Control interests are relevant in determining whether a foreign company is a CFC.

- s.245D provides for the calculation of income interests in a CFC. Income interests are relevant in calculating attributed foreign income or attributed foreign losses of a person in relation to an interest in a CFC. Attributed foreign income is included in assessable income. Attributed foreign losses may be deducted from attributed foreign income subject to the limitations in ss.245M and 245N. Income interests are also relevant in calculating the foreign tax credits to which a person is entitled.

- s.245E sets out rules which are intended to limit opportunities for manipulating control or income interests in a foreign company around measurement days. As a general rule, in order to simplify compliance, s.245A(2)(e) provides that control and income interests in a foreign company are calculated only on four measurement days during the year. One result, however, is to provide opportunities for reducing or avoiding the attribution of income from a foreign company, or for increasing the attribution of losses from a foreign company, by temporary manipulations of control or income interests around measurement days. Section 245E counters such manipulations.

- s.245F provides that attribution of income and losses from CFCs is not required by non-residents and by persons who do not hold an income interest of 10 percent or greater in a CFC.

- s.245G sets out the method of calculating attributed foreign income or attributed foreign loss in relation to an income interest in a CFC.

- s.245H provides that where the aggregate income interests of residents in a CFC is more than 100 percent for an accounting period, those interests may be reduced to 100 percent.

- s.245I makes provision for changes in the accounting period of a CFC.

- s.245J provides rules for calculating the branch equivalent income or loss of a CFC. Branch equivalant income or loss of a CFC is taken into account under s.245G in calculating the attributed foreign income or losses of persons who hold income interests in CFCs.

- ss.245K and 245L set out the rules governing the allowance of credits for tax paid by CFCs.

- ss.245M and 245N set out the rules governing the treatment of attributed foreign losses.

- s.245O provides rules for calculating the branch equivalent income or loss of a CFC that becomes resident in New Zealand or of a company that ceases to be resident in New Zealand and that becomes a CFC.

- s.245P provides that income and losses are not attributed from CFCs resident in countries listed in the Fifteenth Schedule to the Income Tax Act. These are Australia, Canada, France, Japan, the United Kingdom, the United States and the Federal Republic of Germany.

- s.245Q sets out rules for determining the residence of a foreign company for the purposes of the CFC and foreign investment fund rules.

- s.245V permits the Commissioner to make default assessments in certain circumstances and provides for several methods which may be used in making a default assessment.

- s.245W requires disclosure of interests in foreign companies.

- s.245X provides that a reference in other Parts of the Income Tax Act to Part IV is deemed to include a reference to Part IVA.

- s.245Y provides transitional rules for the application of the CFC and foreign investment fund regimes.

Determining whether a foreign company is a CFC

2.3 As the legislation is structured, a company is not permanently a CFC or a non-CFC. Rather the rules operate from one accounting period to another. Section 245C(1) provides that a foreign company is a CFC in relation to an accounting period if at any time during that period there is a group of five or fewer persons resident in New Zealand whose control interest in the company in any category of control interest is equal to or greater than 50 percent. The main elements of this test are as follows:

(a) Only "foreign companies" may be CFCs. These are mainly companies that are not resident in New Zealand. However, companies resident both in New Zealand and in another country are foreign companies where New Zealand's right to tax the income of the company is limited by a double taxation agreement.

(b) A foreign company is a CFC for an accounting period if the control test is satisfied at any time during that period. However, this does not mean that interests must be calculated on every day during the foreign company's accounting period because, unless an election is made to the contrary, interests are required to be calculated only on four "measurement days" during the year. Thus, where no election has been made to calculate interests daily, the control test is applied by focusing on interests held by residents on the measurement days that apply to the CFC in question.

(c) Five categories of interest are taken into account for the purposes of the control test. These are: paid-up capital, nominal capital, voting rights, rights to distributions of income and rights to distributions of assets. A foreign company is a CFC if the control test is satisfied in relation to any one of these categories. For example, if five or fewer residents hold 50 percent or more of the voting rights in relation to a foreign company that company is a CFC even if they hold less than 50 percent of the interests in the other categories.

(d) The control interests of a person in a foreign company include direct and indirect control interests in the company held by the person and by the person's associates and nominees. An extensive definition of when persons are associated is set out in the legislation.

(e) As mentioned in paragraph (d), indirect control interests are taken into account in calculating control interests. Indirect control interests are interests in a foreign company held through a CFC. For example, if a person holds a direct control interest in a CFC, and the CFC holds a direct control interest in a foreign company, the person may hold an indirect control interest in the foreign company.

(f) Entitlements to acquire interests in foreign companies are taken into account in calculating control interests. For example, if a resident holds an option to acquire shares in a foreign company held by a non-resident, the resident will be deemed to hold those shares for the purposes of the control test. A person is deemed to be entitled to acquire an interest in a foreign company even if the entitlement is contingent, and however the entitlement arises, for example by contract, or pursuant to the constitution of a company, or by virtue of the terms of a security. Persons are also deemed to be entitled to acquire interests that they have the power to have cancelled or extinguished.

2.4 Although the test may appear complicated, it will be simple to operate in practice in most cases. For example, where a New Zealand resident holds 60 percent of the shares of a foreign company at all times during the foreign company's accounting period it will be immediately apparent that the company is a CFC. Many of the complexities built into the control test arise from the need to prevent residents from decontrolling foreign companies artificially. Consequently, where no attempt has been made to decontrol a foreign company the control test will usually operate in a straightforward manner.

Income interests

2.5 The rules for calculating the income interest held by a person in a CFC are set out in s.245D. Income interests are relevant mainly for the purposes of calculating "attributed foreign income" or "attributed foreign losses" of persons who hold interests in CFCs. Section 245G provides that any person holding an income interest in a CFC calculates attributed foreign income and attributed foreign losses with

respect to that interest by multiplying the income interest by the branch equivalent income or loss of the CFC. The concept of "branch equivalent income or loss" is discussed below at paragraph 2.11.

2.6 The income interest of a person in a CFC at any time is calculated by aggregating any direct income interest and any indirect income interests held by the person in the CFC at that time. The direct income interest of a person in a CFC at any time is the highest percentage that the person holds at that time of the paid-up capital or nominal capital of the CFC, voting rights in respect of the CFC and rights to distributions of income or assets from the CFC. For example, a person who holds 10 percent of the nominal and paid-up capital of the CFC, 15 percent of the voting rights and the right to a distribution of 15 percent of the income or assets of the CFC will have a direct income interest of 15 percent. Indirect income interests are income interests held through CFCs. For example, if A, a New Zealand resident, holds a direct income interest in CFC 1 and CFC 1 holds a direct income interest in CFC 2, A will hold an indirect income interest in CFC 2. The amount of the indirect income interest is calculated by multiplying the direct income interest that A holds in CFC 1 by the direct income interest that CFC 1 holds in CFC 2.

2.7 The concept of an income interest is narrower than that of a control interest. For example, interests held by associated persons are not aggregated in calculating income interests. Further, entitlements to acquire interests in foreign companies are taken into account in calculating income interests only in a number of narrowly defined circumstances. Thus, a person may have a control interest in a company that is greater than the person's income interest in the same company. The policy that results in this distinction is that to prevent residents decontrolling foreign companies artificially a person should be deemed to control what they may be able to control indirectly, but when it is a question of attributing income to New Zealand residents they should not be deemed to have the potential to enjoy income that belongs, or will belong, to someone else.

2.8 Unless an election is made to the contrary, income interests are calculated only on four measurement days during the year. If an election is made, income interests are calculated daily. Where income interests are calculated on measurement days, the income interest held by a person on each measurement day is deemed to have been held on each day in the quarter preceding the measurement day. Where the income interest of a person varies during an accounting period (for example, because the person has a different income interest on different measurement days), the income interest of the person for the accounting period is calculated by an averaging process set out in s.245D(5). The rules contained in s.245E are intended to reduce opportunitiesto manipulate control and income interests around measurement days temporarily.

Calculation of attributed foreign income or loss

2.9 Attributed foreign income and attributed foreign losses are calculated in accordance with s.245G. Section 65(2)(ea) requires attributed foreign income to be included in assessable income. The treatment of attributed foreign losses is governed by ss.245M and 245N. Those provisions impose limitations on the use of attributed foreign losses and allow such losses to be consolidated in the accounts of companies in the same group.

2.10 Where a person holds an income interest in a CFC, the income or loss that is attributed to the person is the person's proportionate share of the income or loss for any accounting period of the CFC that ends within the income year of the person who holds the income interest. The attributed foreign income or attributed foreign loss of a person in relation to a CFC is calculated for each accounting period of the CFC by multiplying the branch equivalent income or loss of the CFC for that period by the income interest of the person in the CFC for the accounting period.

2.11 "Branch equivalent income or loss" is calculated in accordance with s.245J as an amount equal to the assessable income or loss of the CFC that would be calculated in accordance with the Income Tax Act if the CFC were resident in New Zealand at all times during the accounting period. New Zealand and foreign source income are taken into account. Several of the provisions of the Income Tax Act are modified to ensure that they apply or are specifically precluded from applying. The branch equivalent income or loss of a CFC is calculated in the currency in which the CFC prepares its financial accounts or, if it does not prepare financial accounts, in the currency of the country in which the CFC is resident. The amount thus calculated is converted into New Zealand currency at the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the CFC's accounting period. Alternatively, branch equivalent income or loss may be calculated in New Zealand currency.

2.12 Section 245F provides that any person who is resident outside New Zealand at all times during an accounting period of a CFC is not required to calculate attributed foreign income or attributed foreign losses in relation to an income interest in the CFC. Section 245F also provides that a person is not required to calculate attributed foreign income or attributed foreign losses in relation to a CFC for an accounting period if the person does not hold an

income interest of 10 percent or greater in the CFC for that period. Income interests held by associated persons are aggregated for the purposes of this rule. For example, if A holds an income interest of 5 percent in a CFC and B, an associate of A, holds an income interst of 6 percent, A is deemed to hold an income interest of 11 percent. This is an income interest of 10 percent or greater. Therefore, A is required to calculate attributed foreign income and loss. Aggregation of interests held by associates applies only for the purposes of determining whether attribution of income and losses is required. It does not apply for the purposes of actually attributing income or losses. Thus, in the example A would be required to attribute only 5 percent of the CFC's income or losses.

Foreign tax credits

2.13 Section 245K allows any resident who derives attributed foreign income with respect to an interest in a CFC to claim a credit for income tax paid by the CFC in respect of that income. Income tax paid or payable by the CFC to both foreign countries and to New Zealand is available for crediting. The credit is utilised in accordance with the following rules:

(a) First, the credit is allowed against any income tax payable in respect of the attributed foreign income. For example, if attributed foreign income of $100 is derived and foreign tax of $40 is paid, then, assuming that the resident shareholder has an income interest of 100 percent, the $40 is credited against New Zealand tax payable on the income. At a 33 percent rate of tax the New Zealand tax would be $33. The $40 tax paid by the CFC would be credited against the New Zealand tax leaving no New Zealand tax payable. There would be an excess credit of $7.

(b) Second, any excess credit is allowable against New Zealand tax payable on attributed foreign income derived in respect of any other CFC in that income year. This rule applies only if the other CFC is resident in the same country as the CFC in respect of which the credit arose. Using the example in paragraph (a), assume that the CFC mentioned in that paragraph is resident in country X and that the shareholder holds a 100 percent income interest in CFC 2, another CFC resident in country X. If the resident derives $100 attributed foreign income from CFC 2, and CFC 2 pays tax of $20 in respect of that income, there will be $13 New Zealand tax to pay on that income after crediting the $20. This liability can be reduced further by the $7 excess credit calculated in paragraph (a) that arose in relation to the first CFC. The amount of tax to pay would therefore be reduced to $6.

(c) Third, any excess credit not utilised in accordance with paragraphs (a) and (b) may be carried forward to the next income year. In that income year the credit is allowable against tax payable on attributed foreign income derived from the CFC in relation to which the credit originally arose. This rule applies only if the CFC remains resident in the same country. The carried forward credit is also allowed against tax payable on attributed foreign income derived from any other CFC that in the income year to which the credit is carried forward is resident in the country in which the first CFC (ie the CFC in respect of which the credit arose) was resident when the credit originally arose.

(d) Fourth, if any excess credit remains after application of the above rules the excess is carried forward indefinitely until it has been utilised in accordance with the rules described in paragraph (c).

2.14 Section 245L provides for tax credits arising under s.245K to be consolidated among members of a specified group of companies (as defined in s.191(4)). The country by country limitation on the use of foreign tax credits is maintained under s.245L. Therefore, where tax paid by a CFC gives rise to an excess credit that is available to one company in a specified group, the credit can be offset against tax payable by another company in the group only in respect of attributed foreign income derived from a CFC that is resident in the same jurisdiction as the first CFC.

Attributed foreign losses

2.15 Section 245M provides that the following rules apply to attributed foreign losses incurred by a person:

(a) First, attributed foreign losses sustained in relation to a CFC are deducted from any attributed foreign income derived by the person in that income year in respect of any other CFC that is resident in the same jurisdiction as the first CFC.

(b) Second, any excess attributed foreign losses may be carried forward to the next income year. In that income year the losses are deducted from attributed foreign income derived in respect of the first CFC if it remains resident in the same jurisdiction. The carried forward attributed foreign losses may also be deducted from attributed foreign income derived in respect of any other CFC in that income year if that other CFC is resident in the jurisdiction in which the first CFC was resident when the loss arose.

(c) Any further excess attributed foreign losses are carried forward indefinitely until utilised in accordance with the rules described in paragraph (b).

2.16 Section 245N provides for the consolidation of attributed foreign losses among members of a specified group of companies (as defined in s.191(4)). As with the consolidation of foreign tax credits, attributed foreign losses may be consolidated only on a country by country basis. That is, they may be consolidated only if attributed foreign losses sustained with respect to one CFC are deducted from attributed foreign income derived with respect to another CFC that is resident in the same jurisdiction as that in which the first CFC was resident when the losses arose.

CFCs resident in countries listed in Fifteenth Schedule

2.17 Income and losses are not attributed from CFCs resident in jurisdictions listed in the Fifteenth Schedule to the Income Tax Act: s.245P. These jurisdictions are Australia, Canada, France, Japan, the United Kingdom, the United States and the Federal Republic of Germany. The exemption does not apply if the CFC utilises a tax preference listed in the Sixteenth Schedule to the Income Tax Act for the purposes of income tax calculations in the country in which it is resident. Where a listed preference is utilised, the income or loss of the CFC is calculated according to the tax rules of the country in which the CFC is resident, adjusted to the amount that would have been calculated if the preference had not been utilised. Currently, only one preference is listed: namely, an exemption for income derived from business activities carried on outside the country.

Administrative provisions

2.18 Section 245V provides that the Commissioner may make default assessments of attributed foreign income or loss where a person -

(a) has failed to disclose a control or income interest in a CFC; or

(b) has failed to disclose information requested by the Commissioner under s.17 of the Inland Revenue Department Act 1974 in relation to an interest in a CFC; or

(c) is unable to obtain sufficient information to calculate attributed foreign income or loss with respect to an interest in a CFC.

2.19 Several methods for making default assessments are listed. However, these do not limit the methods that the Commissioner may employ in making an assessment. The listed methods are:

(a) having regard to financial accounts or accounts prepared for the purposes of furnishing a tax return;

(b) applying a presumed rate of increase to the branch equivalent income or loss of the CFC or the accounts of the CFC in prior years;

(c) imputing a rate of return to the value of the interest at the beginning of the period; or

(d) treating any gain or loss on disposal of the interest in the CFC, or any change in value of the interest, as attributed foreign income or loss.

2.20 Section 245W requires disclosure of control and income interests in foreign companies except to the extent that a control interest exists by virtue of the holding of direct and indirect control interests by associated persons. Also, provision is made for the Commissioner to exempt persons or classes of persons from the obligation to disclose.

Transitional provisions

2.21 Transitional rules are set out in s.245Y. These apply with respect to CFCs that are not resident in low tax jurisdictions listed in the Seventeenth Schedule of the Income Tax Act. Where a person holds an income interest in such a CFC, income and losses are not attributed from the CFC until after 1 April 1990. The application of the CFC regime is thus phased in. In the case of CFCs resident in low tax jurisdictions listed in the Seventeenth Schedule income and losses are attributed from 1 April 1988. In the case of other CFCs there is no attribution until after 1 April 1990.

2.22 An election may be made not to apply the transitional rule. The effect of such an election is that the elector attributes income and losses from 1 April 1988 in respect of all CFCs in which the elector has an income interest, other than CFCs resident in countries listed in the Fifteenth Schedule (ie Australia, Canada, France, Japan, the United Kingdom, the United States and the Federal Republic of Germany). Such an election would likely be made in order to utilise losses incurred before 1 April 1990 by CFCs not resident in the listed low tax jurisdictions.

PART 3: INTERPRETATION

Overview

3.1 Section 245A(1) sets out definitions of terms for the purpose of Part IVA of the Income Tax Act and Part III of the Income Tax Amendment Act (No 5) 1988. Section 245A(2) contains a series of rules used in calculating control and income interests in foreign companies under s.245C and s.245D and in attributing income and losses from controlled foreign companies (CFCs) under s.245G. Section 245A(3) sets out rules for calculating income interests in CFCs where interests are held through partnerships.

Definitions: s.245A(1)

Accounting period

(a) Significance

3.2 The expression "accounting period" is relevant in the following contexts:

(i) The test of whether a foreign company is a CFC is applied in relation to the accounting period of the company: s.245C. A foreign company is a CFC if at any time during its accounting period the control test set out in s.245C is satisfied.

(ii) A person who holds an income interest in a CFC is not required to attribute income and losses from the company for any accounting period if at all times during that accounting period the person is resident outside New Zealand, or if the person's income interest for the accounting period is not an income interest of 10 percent or greater: s.245F.

(iii) A person who holds an income interest in a CFC is required to calculate the attributed foreign income or attributed foreign loss in respect of that interest for any accounting period of the CFC that falls within the person's income year: s.245G.

(iv) The branch equivalent income or loss of a CFC, which is used to calculate the attributed foreign income or attributed foreign loss of a person with an income interest in the company, is calculated for the CFC's accounting period: s.245J.

(v) Where a person has an income interest in a CFC that is resident in a country listed in the Fifteenth Schedule to the Income Tax Act, the exemption from calculating attributed foreign income or attributed foreign loss in relation to an accounting period of the CFC applies only where the company is resident in the listed country at all times during the accounting period.

(b) Definition

3.3 Section 245A(1) provides that the "accounting period" of a foreign company means its "accounting year". "Accounting year" is not defined and has its ordinary meaning: ie the period of twelve months for which the company usually prepares a set of financial accounts.
The definition of "year" in s.2 of the Income Tax Act is not relevant in this context.

3.4 The expression "accounting period" may mean a period other than twelve months where by virtue of -

(i) the formation or winding up of the foreign company (or similar circumstances); or

(ii) the foreign company changing its residence; or

(iii) the adoption, pursuant to s.245I, of a new accounting year, -

the branch equivalent income or loss of the company is permitted or required to be calculated on the basis of a period of other than twelve months. In these circumstances, the accounting period of the foreign company is the period of other than twelve months in respect of which branch equivalent income or loss is permitted or required to be calculated.

3.5 When a foreign company is formed, its annual balance date for accounting purposes may be less than twelve months from the date of formation. If this is the case the initial accounting period of the foreign company will be the period falling on and between the date of formation of the company and its annual balance date. Similarly, when a foreign company is wound up prior to its annual balance date for accounting purposes, the accounting period will be the period falling on and between the first day of the company's normal accounting period and the day on which the company is wound up. The "similar circumstances" contemplated by the language in parentheses in para (a) of the "accounting period" definition are circumstances where the company is not actually wound up but where it nevertheless ceases to exist. Where a company simply ceases to trade, but continues to exist, the cessation of trade would not constitute circumstances which are similar to the winding up of the foreign company in terms of the definition.

3.6 Paragraph (b) of the definition of "accounting period" contemplates that the branch equivalent income or loss of a foreign company may be calculated on the basis of a period of other than twelve months where there is a change in residence of the foreign company. The only situation where this will occur is where a company becomes a foreign company or where a foreign company ceases to be a foreign company. This will generally happen when a resident company ceases to be resident in New Zealand or where a non-resident company becomes resident in New Zealand. However, this will not always be the case as foreign companies may be resident in New Zealand in terms of s.241 of the Income Tax Act: see the discussion of the definition of "foreign company" in paragraphs 3.56 to 3.59. Where the residence of a foreign company changes from one foreign country to another this will not automatically result in the branch equivalent income or loss of the company being calculated on the basis of a period of other than twelve months. A change in residence of this type can only give rise to an accounting period of other than twelve months if the Commissioner considers that the change is a relevant factor in deciding whether to approve a new accounting period for the foreign company under s.245I.

3.7 Section 245O(1) provides that when a company which was not previously a foreign company becomes a foreign company an accounting period of the foreign company is deemed to commence on the day on which it became a foreign company. The deemed accounting period will end on the day on which the company's accounting period normally ends. Section 245O(2) provides that when a company ceases to be a foreign company its accounting period is deemed to end on the day prior to the day on which it ceased to be a foreign company. The branch equivalent income or loss of the foreign company is then calculated in relation to the deemed accounting periods by using a time based apportionment or by calculating the income actually derived during the period for which the company was a foreign company: s.245O(3). As the effect of s.245O is to require branch equivalent income or loss to be calculated on the basis of an accounting period of other than twelve months, that other accounting period falls within the s.245A(1) definition of "accounting period".

3.8 Paragraph (c) of the definition of "accounting period" contemplates that branch equivalent income or loss may be calculated on the basis of a period of other than twelve months where, pursuant to s.245I, a new accounting year is adopted for the foreign company. Section 245I sets out the rules for changing the accounting year of a foreign company. When a person elects to change the accounting year of a foreign company, and the Commissioner approves the change, an accounting period is deemed to have commenced on the day after the last day of the old accounting year and to have ended on the last day of the new accounting year: s.245I(1). Branch equivalent income or loss will be calculated in relation to the deemed accounting period and, consequently, the deemed accounting period will be an accounting period for the purpose of the s.245A definition of "accounting period".

Arrangement

3.9 The term "arrangement" is used in following contexts:

(a) the definition of "nominees" contained in s.245A(1). That definition is relevant for the purposes of the rules set out in s.245A(2)(a) which deem certain interests held by nominees to be held by the person for whom the nominee acts.

(b) the anti-avoidance rule set out in s.245C(9). That provision is aimed at arrangements entered into by New Zealand residents whereby control interests are held by other persons in order to prevent a company from being a CFC.

(c) the rules in s.245E that are designed to prevent manipulation of control or income interests around measurement days.

3.10 An "arrangement" is defined as meaning any contract, agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect. The language in parentheses considerably extends the definition in that transactions may constitute arrangements even though the parties have no legal rights to force each other to carry out the steps agreed to.

Attributed foreign income and attributed foreign loss

3.11 "Attributed foreign income" and "attributed foreign loss" have the meanings assigned by s.245G. The calculation of attributed foreign income and attributed foreign losses is discussed in Part 9 of this bulletin. Attributed foreign income is included in assessable income after the deduction of any attributed foreign losses that have satisfied the ring-fencing criteria in s.245M: s.65(2)(ea).

Branch equivalent income or loss

3.12 "Branch equivalent income or loss" is the income or loss calculated with respect to a CFC for an accounting period in accordance with s.245J. The calculation of branch equivalent income or loss is discussed in Part 12 of this bulletin.

Close of trading spot exchange rate

(a) Significance

3.13 The expression "close of trading spot exchange rate" is used in calculating branch equivalent income or loss in relation to a CFC under s.245J. Section 245J(3) provides that in calculating the branch equivalent income or loss of a CFC, the income or loss of the CFC is calculated in the currency in which the company prepares its financial accounts, or, if it does not prepare such accounts, in the currency of the country in which it is resident. The resulting figure is then converted into New Zealand currency using the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the company's accounting period. The proviso to s.245J(3) permits any person who is required to calculate branch equivalent income or loss to elect to make the calculation in New Zealand currency.

3.14 The expression "close of trading spot exchange rate" is also used in translating foreign taxes into New Zealand currency in calculating the entitlement to a foreign tax credit under s.245K. For the purpose of that calculation, income tax paid or payable in another currency is converted into New Zealand currency in accordance with one of two optional methods. The first is to apply the close of trading spot exchange rate on the date when the income tax was paid or became payable. The second is to apply the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the CFC's accounting period.

3.15 The definition of "close of trading spot exchange rate" was amended by s.9 of the Income Tax Amendment Act (No.2) 1989. The amendment applies from the income year commencing on 1 April 1989. Consequently, the definition prior to amendment applies only until the end of the income year commencing on 1 April 1988.

(b) Definition prior to amendment

- application

3.16 The definition of "close of trading spot exchange rate" prior to its amendment by s.9 of the Income Tax Amendment Act (No.2) 1989 applies from 1 April 1988 until the end of the 1989 income year. This means that the former definition applies where it is necessary for a person to calculate branch equivalent income or loss in relation to a CFC for the 1989 income year and in calculating the person's foreign tax credit entitlement in relation to that income year. In practical terms, this will be the case where:

(i) the accounting period of the CFC ended within the 1989 income year (but after 1 April 1988, the application date of the CFC regime) so that it may be necessary to calculate attributed foreign income or attributed foreign loss in accordance with s.245G; and

(ii) the person had an income interest of 10 percent or greater in a CFC for the accounting period so that s.245F does not preclude calculation of attributed foreign income or attributed foreign loss; and

(iii) the CFC was resident in a country or territory listed in Part A of the Seventeenth Schedule to the Income Tax Act or was a company of the type specified in Part B of that Schedule so that transitional relief provided by s.245Y is not available.

3.17 By way of example, assume that a resident who returns income to a year ending on 31 March held an income interest in a CFC resident in Hong Kong for the CFCs accounting period ending on 31 December 1988. The accounting period ends within the resident's 1989 income year. Therefore, the former close of trading spot exchange rate definition applies in calculating the branch equivalent income or loss of the CFC, and in calculating the credits available for tax paid by the CFC.

- definition

3.18 The former definition sets out three methods for determining the "close of trading spot exchange rate" of any foreign currency on a particular day. The methods are applied sequentially in that the second and third methods apply only if the preceding methods cannot be applied. The three methods for determining the close of trading spot exchange rate on a particular day are:

(a) An average of the spot rates of exchange for the purchase of New Zealand dollars using the rates quoted at 3.00 pm New Zealand time on that day (or on the preceding day if no rates were quoted on that day) by foreign exchange dealers authorised under the Reserve Bank of New Zealand Act 1964. The rates must have been quoted on a market approved by the Commissioner in determination G6, or in any determination issued in substitution for that determination.

(b) If method (a) did not apply, the "cross rate" determined as at 3.00 pm New Zealand time on that day in accordance with the method specified in para (3)(c) of determination G6, or in any corresponding paragraph of any determination issued in substitution for determination G6.

(c) If methods (a) and (b) did not apply, the method specified in para 6(3) of determination G9, or in any corresponding paragraph of any determination issued in substitution for determination G9.

- method (a)

3.19 Method (a) requires an averaging of spot rates of exchange quoted by foreign exchange dealers authorised under the Reserve Bank of New Zealand Act 1964. A "spot rate of exchange" is the exchange rate for the immediate delivery of the currencies to be exchanged. The spot rate of exchange used is the rate for the purchase, rather than sale, of New Zealand dollars.

3.20 The rate of exchange must be on a market approved by the Commissioner in determination G6, or in any determination made in substitution for determination G6. Determination G6 approved the New Zealand foreign currency market in European Currency Units and in the currencies of 24 listed countries. Determination G6 was replaced by Determination G6A on 21 November 1988. The markets approved in Determination G6A are the same as those approved in Determination G6.

3.21 If no spot rates of exchange were quoted on the day in respect of which it is necessary to establish a close of trading spot exchange rate, paragraph (a) of the former "close of trading spot exchange rate" definition provides that the rates quoted on the immediately preceding day are used.

- method (b)

3.22 Method (b) applies if no spot rates of exchange are quoted in respect of New Zealand dollars on a market approved in determination G6 (or in any determination issued in substitution for that determination) made under s.64E. In these circumstances, the close of trading spot exchange rate is the "cross rate" determined as at 3.00 pm on the day in respect of which it is necessary to establish a close of trading spot exchange rate. The "cross rate" is determined by applying the method outlined in para (3)(c) of determination G6 or in any corresponding paragraph of any determination issued in substitution for determination G6.

3.23 The reference to para (3)(c) of determination G6 is a reference to para (3)(c) of para 6 of that determination. The paragraph provides that the cross rate is calculated by reference to the rate quoted on a "multicontributor page" for the foreign currency against the United States Dollar and the rate quoted on a multicontributor page for the United States Dollar against the New Zealand Dollar. A "multicontributor page" is defined in para 5 (j) of determination G6 as a multicontributor page of information that is displayed on a screen provided by Reuters New Zealand Ltd or Telerate NZ Ltd.

3.24 Determination G6 was replaced by determination G6A on 21 November 1988. The relevant provision in determination G6A for establishing the cross rate is para 6(4)(c). That paragraph is in the same terms as para 6(3)(c) of determination G6.

- method (c)

3.25 Method (c) applies if methods (a) and (b) do not apply. It provides that the close of trading spot exchange rate is the rate determined by applying the method specified in para 6(3) of determination G9 made under s.64E.

3.26 Subparagraphs (a) and (b) of para 6(3) of determination G9 are not relevant because they specify the circumstances in which para 6(3) applies in the context of determination G9. They do not specify a method of calculating an exchange rate and para (c) of the "close of trading spot exchange rate" definition incorporates para 6(3) only in so far as it prescribes a method of calculating an exchange rate.

3.27 Subparagraph (c) of para 6(3) provides that where the method of calculating an exchange rate is dealt with in a determination made by the Commissioner under s.64E(1), the exchange rate is the price or spot rate determined in that determination. The determinations in which an exchange rate is specified will be determinations G6 and G6A, or a determination issued in substitution for those determinations. Thus, subpara (c) will not apply generally in the context of the s.245A definition of "close of trading spot exchange rate" because for the purposes of that definition recourse is only had to para 6(3) of determination G9 if the methods prescribed in determinations G6 or G6A do not apply.

3.28 Subparagraph (d) of para 6(3) applies if the exchange rate is not specified in a determination made by the Commissioner under s.64E(1) and if the amount requiring conversion into New Zealand currency is expressed in a currency for which there is an accessible and active market in New Zealand dollars, in the "base currency", or in another currency for which there is an accessible and active market. In these circumstances, the exchange rate is determined in a manner consistent with determinations made by the Commissioner for the purpose of ascertaining the price or rate for any currency. The "base currency" is defined in para 5 of determination G9 as being the currency or commodity in which rights or obligations under a financial arrangement are fixed. The base currency concept is thus not relevant in the context of the "close of trading spot

exchange rate" definition because that definition applies with respect to branch equivalent income and losses and foreign tax credits rather than with respect to financial arrangements.

3.29 For para 6(3)(d) to apply the amount must be expressed in a currency for which there is an "accessible and active" market in New Zealand dollars or in another currency for which there is an accessible and active market. For example, assume that the amount requiring conversion is expressed in the currency of country A and that there is an active and accessible market for country A currency in the currency of country B. If there is an active and accessible market for country B currency in New Zealand dollars, para 6(3)(d) may be applied to determine the exchange rate between the country A currency and New Zealand dollars. If there is no active and accessible market for country B currency in New Zealand dollars but there is such a market for country B currency in the currency of country C, and there is an active and accessible market for country C currency in New Zealand dollars, para 6(3)(d) may be applied to establish an exchange rate between the country A currency and New Zealand dollars. Thus, it may be possible to establish an exchange rate between another currency and New Zealand dollars by using a series of cross rates. In the example this would involve calculating the conversion rates from country A currency to country B currency, from country B currency to country C currency and from country C currency to New Zealand currency.

3.30 The exchange rate established under para 6(3)(d) must be determined in a manner consistent with determinations made by the Commissioner for the purpose of ascertaining the price or rate for any currency. Using a series of cross rates in the manner indicated in the preceding paragraph will be consistent with the method prescribed in determination G6A where a buy and sell rate for a spot contract is not quoted on a multicontributor page: determination G6A, para 6(5).

3.31 If the method set out in para 6(3)(d) of determination G9 cannot be used to determine an exchange rate, para 6(3)(e) of that determination applies. That paragraph provides that the exchange rate is the price or spot rate at which an arm's length dealing would be expected to take place at the time.

(b) Definition after amendment

- application

3.32 The new definition of "close of trading spot exchange rate" applies from the income year commencing on 1 April 1989. Thus, the new definition applies where it is necessary for any person to calculate the branch equivalent income or loss of a CFC for income years commencing on and after 1 April 1989, and where it is necessary to calculate foreign tax credits in relation to such income years. This will be the case if:

(i) the accounting period of the CFC ends within an income year commencing on and after 1 April 1989; and

(ii) the person has an income interest of 10 percent or greater in the CFC; and

(iii) attribution of income or losses from the CFC is required.

- definition

3.33 The definition of "close of trading spot exchange rate", as amended, prescribes three methods for determining the close of trading spot exchange rate in respect of a foreign currency. Like the former definition, the methods apply sequentially with the second and third methods apply only if the preceding methods do not apply. The methods for determining the close of trading spot exchange rate on a particular day are:

(a) The rate of a spot contract for the purchase of New Zealand dollars using the foreign currency at any time on that day. The rate must be on a market approved, and from sources of information approved, by the Commissioner in determination G6A (or in any determination issued in substitution for that determination). If no rate can be established in relation to the particular day, the rate of a spot contract on the next succeeding day (within five working days of the particular day in relation to which it is necessary to determine the close of trading spot exchange rate) on which such a rate can be established is used.

(b) If method (a) does not apply, the cross rate determined as at 3 pm New Zealand time on that day by applying the method prescribed in para 6(4)(c) of determination G6A, or in any corresponding paragraph of any determination issued in substitution for that determination.

(c) If methods (a) and (b) do not apply, the rate determined by applying the method specified in para 6(3) of determination G9, or in any corresponding paragraph of any determination issued in substitution for that determination. This method has not changed from the third method that applied under the former definition.

- method (a)

3.34 Under method (a) the close of trading spot exchange rate in relation to a particular day is calculated as the rate of a spot contract for the purchase of New Zealand dollars using the foreign currency at any time on that day. The rate is determined by taking the rate of any spot contract. This contrasts with the definition prior to amendment where an average of spot rates was taken. Also, the close of trading spot exchange rate is determined by reference to the rate of a "spot contract" for the purchase of New Zealand dollars using the foreign currency. A spot contract for the purchase of New Zealand dollars is one where delivery is within two days. This differs from the "spot rate" concept in the definition prior to amendment where delivery must be immediate.

3.35 The rate of the spot contract must be obtained from a market approved, and from the sources of information approved, by the Commissioner in determination G6A or in any determination issued in substitution for that determination. Determination G6A was replaced by determination G6B from 23 April 1990. Paragraph 6(1) of determination G6B approves the New Zealand foreign currency market in European Currency Units and in the currencies of 24 countries. Paragraph 6(2) of that determination approves two sources of information in relation to spot contracts:

(a) first, a "multicontributor page" that quotes rates for spot contracts. The expression "multicontributor page" is defined in para 5(1) of determination G6B as a multicontributor page of information that is displayed on a screen provided by Reuters New Zealand Ltd or by Telerate New Zealand Ltd.

(b) second, if the person does not have access to a multicontributor page, the advice as to the rate given to the person by an "approved foreign exchange dealer" if the rates are derived by the dealer from an approved source and are the rates at which the dealer would have performed the foreign exchange transaction. The rates are obtained by the dealer from an approved source if they are obtained from a multicontributor page. The expression "approved foreign exchange dealer" is defined in para 5(1) of determination G6B as a foreign exchange dealer that is a registered bank for the purposes of the Reserve Bank Act 1989 and is active in the market.

The approved sources of information in determination G6B differ from those in determination G6A only in that in cases where a person does not have access to a multicontributor page an exchange rate is obtained from an "approved foreign exchange dealer" while under determination G6A the rate was obtained from an "authorised foreign exchange dealer". This change reflects the provisions of the Reserve Bank Act 1989.

3.36 If a rate for a spot contract cannot be obtained on the particular day, the close of trading spot exchange rate for that day may be determined by taking the rate for a spot contract on the next succeeding day that a rate for a spot contract can be determined. However, the rate thus determined must be determined on a day not later than five working days after the day for which it is necessary to establish the close of trading spot exchange rate. If rates for a spot contract can be obtained on more than one of the five working days succeeding the day on which it is necessary to determine the rate, the rate obtained on the day closest to day in respect of which the determination is required is taken. For example, if a rate for a spot contract cannot be determined on a particular day, but a rate can be determined for the second and the third working days after the particular day, the rate which applies for the purpose of the close of trading spot exchange rate definition is that obtained on the second succeeding working day.

- method (b)

3.37 If the rate of a spot contract cannot be obtained in relation to a particular day under method (a), the close of trading spot exchange rate is determined under method (b) as the "cross rate" determined as at 3 pm New Zealand time on the particular day. The cross rate is determined by applying the method outlined in para 6(4)(c) of determination G6A, or in any corresponding paragraph of any determination issued in substitution for that determination. The corresponding paragraph in determination G6B is paragraph 6(3)(c). Determination G6B applies from 23 April 1990.

3.38 Method (b) is essentially the same as method (b) of the former "close of trading spot exchange rate" definition. The only substantive difference is that method (b), as amended, requires the determination of the rate for a "spot contract" while method (b) prior to amendment required the determination of a "spot rate of exchange". The difference is that in the former case the contract may be for New Zealand dollars deliverable within two days while in the latter case the contract must have been for immediate delivery of New Zealand dollars.

3.39 Paragraph 6(3)(c) of determination G6B provides that the cross rate is calculated by reference to the rate quoted on a multicontributor page for the foreign currency against the United States dollar and the rate quoted on a multicontributor page for the United States dollar against the New Zealand dollar. By way of example, assume that on 15 June

1990 the exchange rate between the New Zealand dollar and the United States dollar is 0.6435 (ie NZ$1 buys US$0.6435) and that the exchange rate between the United States dollar and Country X currency is 1.2500 (ie US$1 buys 1.2500 units of Country X currency). Assuming that there is no approved market in Country X currency in terms of determination G6B, the close of trading spot exchange rate is calculated as the cross rate between the Country X currency and the New Zealand dollar. The close of trading spot exchange rate is thus 0.6435 x 1.2500 = 0.8043.

- method (c)

3.40 Paragraph (c) of the "close of trading spot exchange rate" definition was not amended by the Income Tax Amendment Act (No 2) 1989. Thus, if methods (a) and (b) do not apply the close of trading spot exchange rate is determined in accordance with the method specified in para 6(3) of determination G9. Generally, this means that the close of trading spot exchange rate is:

(a) if the amount requiring conversion is expressed in a currency for which there is an active and accessible market in New Zealand dollars or in another currency, an exchange rate determined in a manner that is consistent with determinations made by the Commissioner for the purpose of ascertaining the price or rate for any currency. For example, a series of cross rates could be used if there was an active and accessible market in each of the currencies used;

(b) if it is not possible to use a method that is consistent with determinations made by the Commissioner, a price or spot rate at which an arm's length dealing would be expected to take place at the time.

3.41 Determination G9 was replaced by determination G9A from 4 December 1989. Therefore, for currency translations made after 4 December 1989 the appropriate references in paragraph (c) of the close of trading spot exchange rate definition are to paragraph 6(2) of determination G9A. The method specified in that paragraph is the same as that which applied under paragraph 6(3) of determination G9.

Control interest

3.42 The term "control interest" is defined in relation to a foreign company as having the meaning assigned to it by s.245C. Control interests are discussed in Part 5 of this bulletin.

Controlled foreign company

3.43 The term "controlled foreign company" is defined as having the meaning assigned to it by s.245C. The meaning of "controlled foreign company" is discussed in Part 5 of this bulletin. A controlled foreign company is generally referred to as a CFC in this bulletin.

Foreign company

(a) Significance and definition

3.44 The "foreign company" definition is important in the context of the controlled foreign company (CFC) regime because only foreign companies may be classified as CFCs. The definition is also important in the context of the foreign investment fund (FIF) regime because foreign companies represent the main category of entity to which that regime applies.

3.45 Section 245A(1) defines "foreign company" as meaning a "non-resident company" or a company that is resident in New Zealand but which is not liable to income tax in respect of part or all of its income pursuant to a double tax agreement because, for the purpose of the agreement, the company is treated as not being resident in New Zealand. The essential elements are thus:

(i) there must be a "company";

(ii) the company may be either a non-resident company or a resident company that is treated as not being a resident company for the purposes of a double tax agreement.

(b) "Company" definition

(i) Description

3.46 The term "company" is defined in s.2 of the Income Tax Act. A new definition was inserted by s.16(2) of the Income Tax Amendment Act (No.5) 1988 with effect from 1 April 1988.

3.47 The definition provides that "company" means a body corporate or other entity which has a legal personality or existence distinct from those of its members. A body corporate or other entity may be a company whether it is incorporated in New Zealand or elsewhere. Further, the term "company" is defined as including anything deemed to be a company for the purposes of the Income Tax Act.

(ii) Bodies corporate and other entities

3.48 Under the first limb of the "company" definition a company is:

- a body corporate; or
- any other entity which has a legal personality or existence distinct from those of its members.

3.49 A "body corporate" is a body of persons which is incorporated. A body corporate may be incorporated in New Zealand or in another country. One consequence of incorporation is that the body corporate has a legal personality that is distinct from that of its members. A body corporate thus has legal rights and is subject to legal duties which are separate from those enjoyed or borne by its members.

3.50 Whether an entity is a company on the grounds of having a separate legal personality or existence is determined by considering the following factors:

- whether the property of the entity is distinct from that of its members. If the entity's property is owned by the members jointly, that may indicate that the entity does not have a separate personality.
- whether the entity may sue and be sued in its own right. If so, this may indicate that the entity has a separate legal personality, although in some jurisdictions entities without a separate personality may sue and be sued in their own name.
- whether the members of the entity are liable for its debts. If the entity has a separate legal personality, the members will not be liable for its debts, although they may be liable to make a contribution to the entity to enable it to discharge its debts. The quantum of the contribution will depend upon whether the liability of the members is stated to be limited or unlimited.
- whether the entity has perpetual succession in that it is not affected by the death of any member or by a change of members. If the entity is dissolved on the death or retirement of a member, for example, it will not have a legal personality distinct from its members.
- whether interests in the entity are freely transferable. In the case of a body corporate there may sometimes be restrictions on the transfer of members' interests in the body. However, interests are freely transferable except to the extent that transfer is expressly limited. By contrast, partnerships, for example, have no distinct legal personality and there is no transferability of interests unless there is express agreement to allow transferability.

3.51 If the entity was created outside New Zealand, its characteristics are established in terms of the law under which it was created. The question of whether the entity has a distinct legal personality is then determined on the basis of whether it possesses the characteristics listed above.

(iii) Things that are deemed to be companies

3.52 The "company" definition encompasses "anything deemed to be a company for the purposes of [the Income Tax Act]". This would include unit trusts. These are deemed to be companies by s.211. A unit trust will be a company whether it is established in or outside New Zealand. In determining whether an entity established under foreign law is a unit trust, it is necessary to identify the characteristics of the entity and then to apply the criteria set out in s.211. That section defines a "unit trust" as a scheme or arrangement that is made for the purpose or has the effect of providing facilities for participation by subscribers, purchasers or contributors as beneficiaries under a trust in income and gains arising from the investments that are subject to the trust.

(c) Non-resident companies

3.53 The "foreign company" definition includes any company that is a "non-resident company". Section 245A(1) provides that the term "non-resident company" has the meaning assigned to it by s.245Q. Section 245Q(1) provides that a company is a non-resident company if it is not resident in New Zealand for the purposes of the Income Tax Act. Section 241(6) provides that a company is resident in New Zealand for the purposes of the Income Tax Act if -

(a) it is incorporated in New Zealand;

(b) it has its head office in New Zealand;

(c) it has its centre of management in New Zealand;

(d) control by the company by its directors, acting in their capacity as directors, is exercised in New Zealand, whether or not decision making by directors is confined to New Zealand.

3.54 The Inland Revenue Department's interpretation of these tests of residence is set out in Public Information Bulletin No.180, published in June 1989.

3.55 The tests of company residence set out in s.241(6) were enacted by s.23 of the Income Tax Amendment Act (No 5) 1988. Subsection (4) of section 23 provides that s.241(6) applies from the income year commencing on 1 April 1989. However,

the proviso to s.23(4) provides that for the purpose of s.245Q of the Income Tax Act, s.241(6) applies from the income year commencing on 1 April 1988. Thus, for the purpose of determining whether a company is a non-resident company in terms of s.245Q(1), the new company residence rules contained in s.241(6) apply from the income year commencing on 1 April 1988. This earlier application of s.241(6) for the purposes of s.245Q is intended to ensure that the new company residence rules apply to the CFC and foreign investment fund regimes from the commencement of those regimes.

(d) Resident companies not subject to tax on all or part of their income

3.56 Paragraph (b) of the "foreign company" definition provides that certain companies that are resident in New Zealand are foreign companies. These are resident companies that are not subject to tax in respect of part or all of their income by virtue of an arrangement to which effect is given by an Order in Council made under s.294 where the companies are not treated as being resident in New Zealand for the purposes of the arrangement.

3.57 The arrangements referred to are double taxation agreements entered into between New Zealand and other countries. These agreements are given effect to for the purposes of New Zealand domestic law by an Order in Council promulgated under s.294. Double taxation agreements generally contain a provision for determining the residence of a person, including a company, for the purposes of the agreement. If a person is resident in both of the state parties to the agreement the residence provision will allocate residence to one of the parties for the purposes of the agreement. In the case of companies, residence is commonly allocated on the basis of the place of "effective management", "administrative or practical management" or by mutual agreement between the parties.

3.58 Where the residence of a company that is resident in New Zealand and in another country with which New Zealand has a double taxation agreement is allocated to the other country for the purposes of the agreement, the effect may be that New Zealand may not be able to tax the company on its entire income. If this is the case, a tax planning opportunity could arise whereby companies resident in New Zealand and in a country with which New Zealand has a double taxation agreement were used to accumulate income free of New Zealand tax. To limit opportunities for this strategy to be used to defeat the CFC and foreign investment fund regimes, companies that are resident in both New Zealand and a country with which New Zealand has a double taxation agreement are treated as foreign companies where the company is treated as being resident in the other country for the purposes of the agreement and where pursuant to the agreement New Zealand's ability to tax all or part of the company's income is limited.

3.59 This would be the case, for example, if a company incorporated in New Zealand had its place of effective management in Switzerland. The company would be resident in New Zealand by virtue of s.241(6) of the Income Tax Act. The company would also be resident in Switzerland as Swiss taxation law treats a company as being resident in Switzerland if it has its place of effective management there. For the purposes of the double taxation agreement between New Zealand and Switzerland the company would be resident in Switzerland because it has its place of effective management there: Article 4(3). The double taxation agreement would thus operate to limit New Zealand's right to tax the income derived by the company, and the company would therefore be a foreign company for the purposes of Part IVA of the Income Tax Act.

Foreign investment fund

3.60 Section 245A(1) provides that the term "foreign investment fund" has the meaning assigned to it by s.245R. The expressions "foreign investment fund income" and "foreign investment fund loss" also have the meanings assigned by s.245R. These terms are relevant mainly for the purpose of the foreign investment fund regime contained in ss.245R to 245T. The foreign investment fund regime is not discussed in this bulletin.

Group of persons

3.61 The term "group of persons" is defined as including one person. This definition is relevant in determining whether a foreign company is a CFC in terms of s.245C. Broadly, that section provides that a foreign company is a CFC in relation to its accounting period if at any time during that accounting period there is a "group of five or fewer persons" resident in New Zealand whose control interests in any of the categories specified in s.245C(4) are equal to or greater than 50 percent. The effect of the "group of persons" definition in this context is that a foreign company may be a CFC because one person holds a control interest of 50 percent or more. In those circumstances that person will be the "group of persons" for the purposes of s.245C.

Income interest

3.62 The term "income interest" is defined as having the meaning attributed to it by s.245D. Income interests are used to attribute income and

losses from controlled foreign companies. The meaning attributed to the term "income interest" by s.245D is discussed in Part 6 of this bulletin.

Income interest of 10 percent or greater

3.63 The significance of the "income interest of 10 percent or greater" definition is that, pursuant to s.245F(1)(b), persons who do not have an income interest of 10 percent or greater in a CFC are not required to calculate attributed foreign income or attributed foreign losses with respect to their interest in the CFC.

3.64 The expression "income interest of 10 percent or greater" is defined as meaning:

(a) an income interest calculated under s.245D which is equal to or greater than 10 percent;

(b) an income interest equal to or greater than 10 percent after the application of s.245F(2);

(c) an income interest in respect of which a person is required by s.245H(2) to calculate attributed foreign income or attributed foreign losses.

3.65 The calculation of income interests under s.245D is discussed in Part 6 of this bulletin. The application of s.245F(2) is discussed in Part 8 of this bulletin. The application of s.245H(2) is discussed Part 10 of this bulletin.

Income Tax

3.66 The term "income tax" is relevant for the purposes of the foreign tax credit provisions contained in s.245K. Under that provision a credit is allowed against New Zealand tax payable on attributed foreign income for income tax paid or payable by the CFC in respect of that income in New Zealand or in any other country. The "income tax" definition is also relevant for the purposes of the foreign investment fund regime. Section 245R(2)(f) provides that rights in relation to a foreign entity do not constitute an interest in a foreign investment fund if the aggregate of the income tax, capital gains tax and withholding taxes paid by or on behalf of the foreign entity exceeds 20 percent of the aggregate of its income and capital profits.

3.67 "Income tax" is defined as having the meaning assigned by s.293(1). That meaning is discussed in Part 13 of this bulletin.

Interest in a foreign investment fund

3.68 The definition of "interest in a foreign investment fund" is relevant in relation to the foreign investment fund regime. That regime is not discussed in this bulletin.

Measurement day

3.69 The definition of "measurement day" is relevant in relation to the rule set out in s.245A(2)(e) that control and income interests held by persons on measurement days are deemed to have been held at all times during the quarter preceding the measurement day. This rule facilitates calculation of control and income interests by requiring quarterly, rather than daily, measurement. Section 245A(2)(e) is discussed below in paragraphs 3.116 to 3.141 of this bulletin.

3.70 "Measurement day" is defined as meaning 31 March, 30 June, 30 September, and 31 December. Days falling before 30 June 1988 are specifically excluded from the "measurement day" definition. This reflects the fact that the CFC regime did not apply until 1 April 1988.

Nominees

3.71 The definition of "nominee" is relevant in relation to the rules set out in s.245A(2)(a) that attribute to persons control and income interests held by nominees. The "nominee" definition is discussed below in the context of the discussion of s.245A(2)(a).

Non-resident company

3.72 The "non-resident company" definition is discussed above with the definition of "foreign company".

Relative

3.73 The definition of "relative" is relevant in relation to the associated persons rules set out in s.245B, and is discussed in Part 4 of this bulletin.

Interests held by nominees: s.245A(2)(a)

Description of rule

3.74 Section 245A(2)(a) sets out rules which apply where an interest in a foreign company is held by a nominee or where a nominee is entitled to acquire an interest in a foreign company. It provides that:

(a) a person is deemed to hold anything that a nominee holds on the person's behalf;

(b) a person is deemed to be entitled to acquire anything that a nominee is entitled to acquire on behalf of the person;

(c) a person is deemed to exercise anything that a nominee exercises on behalf of the person.

As the person for whom the nominee is a nominee is deemed to hold or to be entitled to acquire the interests held by the nominee, or to exercise anything exercised by the nominee, it is provided that the nominee is deemed not to hold or to be entitled to acquire those interests or to exercise those things.

Nominee definition

3.75 The term "nominees" is defined in s.245A(1). The definition provides that a nominee in relation to a person (the first person) and in relation to any rights or powers is any other person where that other person:

(a) possesses the rights or powers on behalf of the first person; or

(b) may be required to exercise or refrain from exercising the rights or powers at the direction of the first person.

Trustees, other than bare trustees, are specifically excluded from the definition.

3.76 The "other person" referred to in the "nominees" definition is a nominee whether that other person possesses rights and powers on behalf of the first person or is required to exercise or to refrain from exercising those rights or powers pursuant to an arrangement between the first person and any other person "or otherwise". The use of the words "or otherwise" indicates that it is not necessary in order for the "nominee" definition to apply that there be an arrangement between the first person and any other person.

3.77 A person is a nominee if the person possesses rights and powers on behalf of the first person. A person is also a nominee if the person may be required to exercise or refrain from exercising rights and powers at the direction of the first person. In the second situation the person may possess rights and powers in the person's own right but the exercise of the rights and powers may be subject to the direction of the first person.

3.78 The "nominees" definition is broad enough to encompass nominees of nominees. For example, C will be a nominee of A if B is a nominee of A and C is a nominee of B. In these circumstances, C will possess any rights or powers it holds on behalf of A or it may be required by A to exercise or refrain from exercising those rights or powers through the medium of B.

3.79 Trustees are not nominees unless they are bare trustees. The term "bare trustee" is not defined. However, a bare trustee is a person who holds property in trust for the absolute benefit and at the absolute disposal of other persons who are of full legal capacity where the trustee has no present beneficial interest in the property and no duties to perform in respect of the property except to transfer it to persons entitled to hold it: 48 *Halsbury's Laws of England* (4 ed) para 641. When required to do so the bare trustee is bound to convey the property to the person entitled to it. By way of example, a trustee would not be a bare trustee if the trustee had a discretion to apply trust property among a class of beneficiaries. In the case of such a trust the beneficiaries of the trust would not be deemed to hold interests held by the trustees by virtue of the nominee rules. However, the trustees and beneficiaries may still be associated in terms of s.245B. If this is the case, the beneficiaries will be deemed by virtue of s.245C(3) to hold direct and indirect control interests held by the trustees in any foreign company.

Application of s.245A(2)(a)

3.80 Section 245A(2)(a)(i) provides that a person is deemed to hold anything which a nominee of that person holds on behalf of that person. The reference to "anything" held by the nominee ties in with the language used in s.245C(4) and s.245D(2) to describe direct control interests and direct income interests respectively. Those provisions list five "things" which are taken into account in determining control interests and income interests held in foreign companies: ie paid-up capital, nominal capital, voting rights, rights to distributions of income, and rights to distributions of assets. Thus, if a nominee of a person has an interest in a company that carries with it 5 percent of the total voting rights in relation to the company, the person is deemed to hold that interest and the nominee is deemed not to hold it.

3.81 Section 245A(2)(a)(ii) provides that a person is deemed to be entitled to acquire anything which any nominee of the person is entitled to acquire on the person's behalf. The circumstances in which a person is deemed to be entitled to acquire an interest in a company are set out in s.245A(2)(b). That provision is discussed in paragraphs 3.85 to 3.104 of this bulletin. By way of example, where a nominee holds an option to acquire shares in a foreign company, the person for whom the nominee acts would be deemed to hold that option.

3.82 Section 245A(2)(a) applies in relation to anything held by a nominee which is entitled to be acquired by a nominee, or which the nominee exercises on behalf of "the person". Thus, if a nominee is acting on behalf of several persons, or holds or is entitled to acquire interests in a capacity other than as nominee, only interests held by the nominee, or which the nominee is entitled to acquire, on behalf of the person are deemed to be held by the person.

Nominees and associates

3.83 There is different treatment under the CFC regime of interests held by nominees and interests held by associates. Interests held by nominees are deemed to be held by the person on whose behalf they are held for the purposes of calculating control interests and income interests. In contrast, interests held by associates are attributed to a person for the purposes of calculating control interests but, other than for the purpose of determining whether the 10 percent income interest threshold is met, not for the purposes of calculating income interests.

3.84 The rules which establish when persons are associated are set out in s.245B. Those rules are discussed in Part 4 of this bulletin. A person who is associated with another person in terms of s.245B may also be a nominee of the person in terms of the "nominees" definition. For example, a relative of a person (as defined in s.245A(1)) may act as a nominee for the person. In these circumstances the nominee rules contained in s.245A(2)(a) will apply.

Entitlement to acquire: s.245A(2)(b)

Description of rule and significance

3.85 Section 245A(2)(b) provides that a person is deemed to be entitled to acquire anything that the person is entitled to acquire, or that the person is entitled to require the cancellation or extinguishment of, absolutely or contingently. The rule applies where the entitlement arises pursuant to the constitution of a company, by virtue of the exercise of any options or convertible notes or by virtue of any arrangement of a substantially similar nature or otherwise. An exception to this rule is set out in the proviso to s.245A(2)(b). It provides that a person is not deemed to be entitled to acquire anything where the person's rights or powers in relation to the thing arise solely by virtue of the person being the holder of a security arrangement as defined in s.64B(1) of the Income Tax Act. For the exception to apply the security arrangement must have been acquired in a transaction entered into on an arm's length basis, and the terms of the arrangement must be in accordance with generally accepted commercial practice.

3.86 The rules set out in s.245A(2)(b) are relevant in relation to the calculation of control interests in foreign companies under s.245C and the calculation of income interests under s.245D(4). Entitlements to acquire interests in companies, or to require the extinguishment or cancellation of interests in companies, are taken into account in determining whether a foreign company is a CFC because they constitute a means of controlling, or potentially controlling, a company. However, entitlements to acquire are not generally taken into account in calculating income interests in a CFC because an entitlement to income does not arise from the right to acquire an interest, or to require the extinguishment or cancellation of an interest, in a company. Entitlements to acquire interests are taken into account in calculating income interests in the limited situation where the person entitled to acquire the interest gains a deferral advantage from holding the entitlement to acquire. The circumstances in which this occurs are set out in s.245D(4). That provision is discussed in Part 6 of this bulletin.

Entitled to acquire or to require cancellation or extinguishment

(a) Entitlement to acquire "anything"

3.87 Section 245A(2)(b) provides that a person is deemed to be entitled to acquire "anything" that the person is entitled to acquire or which the person is entitled to require the cancellation or extinguishment of. The reference to "anything" ties in with the language used in s.245C(4) and s.245D(2) to describe the five categories of interest (referred to in the legislation as "things") which are taken into account in calculating control interests and income interests. Those "things" are the paid-up and nominal capital of the company, the rights to vote or participate in decision making concerning the company, the rights to distributions of income and the rights to distributions of assets.

(b) Cancellation or extinguishment

3.88 The language in the first set of parentheses in s.245A(2)(b) provides that a person is deemed to be entitled to acquire anything which the person is entitled to require the cancellation or extinguishment of. For example, assume that A, a New Zealand resident, holds shares in a foreign company which carry with them 35 percent of the voting rights in relation to the company and that B, a non-resident, holds an interest in the company which carries with it 40 percent of the voting rights. Assume further that A can require the company to cancel the shares issued to B. In these circumstances, A would be deemed to be entitled to acquire the interest held by B. Consequently, the foreign company would be a

CFC because A would have a control interest in the voting rights category of 75 percent.

3.89 The entitlement to require the cancellation or extinguishment of an interest may be in the form of an entitlement to require the issuer to acquire the interest or it may be in any other form. Thus, a person would have an entitlement to acquire an interest in a company that the person could require the company to redeem. The provision applies where the person can require the cancellation or extinguishment of any of the things listed in s.245C(4) or s.245D(2). Thus, where the things listed in s.245C(4) or s.245D(2) are attached to, say, shares a person will be entitled to acquire any of the things attaching to the shares which the person can require the cancellation or extinguishment of.

3.90 For example, a person may be able to require a company to alter rights attaching to the shares issued to another person so as to cancel rights to distributions of income attaching to those shares, while at the same time not cancelling the shares themselves. In these circumstances, the person will be deemed to be entitled to acquire those rights to distributions of income. This would also be the case if there was a right to require the partial extinguishment or cancellation of a thing. For example, if the person could require the company to cancel half of the voting rights held by another person the person would be deemed to be entitled to acquire that half.

(c) Options

3.91 One of the circumstances in which section 245A(2)(b) applies is where a person is entitled to acquire an interest in a company on the exercise of an option. For example, if A holds 20 percent of the voting rights of a company, and B holds an option to acquire those rights, B would be deemed to be entitled to acquire the voting rights. Consequently, by virtue of holding the option, B would have a 20 percent control interest in the voting rights category of interest.

(d) Convertible notes

3.92 Section 245A(2)(b) also applies where a person is entitled to acquire anything on the conversion of any "convertible notes" as defined in s.196(1). Broadly, s.196(1) provides that a convertible note is a debenture, bond, certificate, document, note, or writing issued by a company relating to a loan to the company where the amount of the loan is convertible into shares in the capital of the company or where the holder has a right to subscribe for shares in the capital of the company or any other company. Thus, if a person held a debt instrument issued by a company and the instrument was convertible into shares in the company the person would be deemed to be entitled to acquire the shares. More precisely, the person would be deemed to be entitled to acquire the "things" that are incidental to the shares: ie the percentage of the paid-up and nominal capital of the company that the shares constituted, the voting rights attaching to the shares, and the rights to distributions of income and assets attaching to the shares.

3.93 The conversion of the convertible note into shares in the capital of the company may be mandatory or it may be at the option of the company or of the holder of the note. Also, the provision relating to convertibility may be in a trust deed "or otherwise". Thus, for example, a debenture would be a convertible note if the trust deed under which it was issued provided that the debenture converted, or was convertible, into shares in the company at maturity. Similarly, a debt instrument issued by a company may have warrants attached that entitle the holder of the instrument to a certain number of shares in the capital of the company at maturity. The instrument would be a convertible note irrespective of whether the warrants must be exercised.

3.94 The "convertible note" definition applies where the debt instrument is convertible into shares in the capital of the company or where the holder of the instrument has a right to subscribe for shares in the capital of the company or in the capital of any other company. For example, if a person holds a debt instrument issued by company A, and the instrument provides that the person has the right to subscribe for shares in company B, the person will be deemed to be entitled to acquire the shares in company B.

(e) Constitution of the company

3.95 One of the circumstances in which section 245A(2)(b) applies is where pursuant to the constitution of any company there is an entitlement to acquire or require the cancellation or extinguishment of anything. Thus, the constitution of a company might provide that the holders of a special class of share can require the company to redeem, or to alter rights attaching to, shares in other classes. In these circumstances any person who holds shares in the special class will be deemed to be entitled to acquire the shares in the other class, or to be entitled to acquire any rights attaching to the shares in the other class.

3.96 For example, assume that the shares of a company are divided into class A voting shares and class B voting shares. Assume further that the constitution of the company provides that holders of the class A shares can require the company to cancel the voting rights attaching to the class B shares. In these

circumstances, holders of the class A shares will be deemed to be entitled to acquire the voting rights attaching to the class B shares.

(f) Arrangements

3.97 The final situation in which section 245A(2)(b) applies is where a person is entitled to acquire, or to require the cancellation or extinguishment of, anything by virtue of any arrangement. The provision applies whether the arrangement is "of a substantially similar nature or otherwise" to any of the other methods of being entitled to acquire an interest in a company mentioned in s.245A(2)(b). That is, it applies whether or not the arrangement is similar to an option, a provision in a company's constitution or a convertible note.

3.98 A person would be entitled to acquire things listed in s.245C(4) pursuant to an arrangement if, for example, bearer shares were issued by a company to another person and there was an arrangement whereby the person had access to the bearer shares when required. Thus, if the bearer shares entitled the holder to 20 percent of the voting rights of the company the person would be deemed to be entitled to acquire 20 percent of voting rights. In this type of case the person normally holding the bearer shares may be a nominee of the person who has access to the shares. If this is the case the nominee rules in s.245A(2)(a) would apply.

(g) Absolutely or contingently

3.99 The entitlement to acquire anything, or to require the cancellation or extinguishment of anything, may be absolute or contingent. A person will be entitled to acquire, or to require the extinguishment of, anything contingently if the entitlement to acquire is contingent upon the happening of an event or arises at specified times only. Also, an entitlement to acquire or to require an extinguishment will be contingent if it is dependent upon the agreement of another person. For example, if the constitution of a company provided that class A shareholders could require the cancellation of voting rights attaching to class B shares if all class A shareholders agreed, the class A shareholders would have a contingent right to require the cancellation of the voting rights.

(h) Options over options and options over convertible notes

3.100 The language in s.245A(2)(b) is broad enough to apply where a person has an option over an option or an option over a convertible note. Assume, for example, that B holds an option to acquire an interest held by C in a company and that A holds an option to acquire B's option. On these facts A will be entitled to acquire the things which constitute C's interest in the company. This is because A will be entitled to acquire those things by virtue of the exercise of "any options" or "by virtue of any arrangement" in terms of s.245A(2)(b). Similarly, if B holds a convertible note issued by a company and A holds an option over the convertible note, A will be entitled to acquire the things that are obtained on conversion of the convertible note.

(i) Operation of s.245A(2)(b) where CFC entitled to acquire interest

3.101 Section 245A(2)(b) applies where any "person" is entitled to acquire, or is entitled to require the cancellation or extinguishment of, an interest in a foreign company. In this context, the word "person" includes a CFC. Thus, if a CFC held an option to acquire an interest in a foreign company the CFC would be entitled to acquire that interest in terms of s.245A(2)(b). Consequently, by virtue of s.245C(4) the CFC would hold direct control interests in the foreign company. These direct control interests would be allocated back to residents holding control interests in the CFC in accordance with s.245C(5), and would constitute indirect control interests held by those residents in the foreign company.

3.102 Where a CFC is entitled to acquire an interest in another CFC those interests may be taken into account in calculating the direct income interest of the first CFC in the other CFC. This will be the case where s.245D(4) applies to the entitlement to acquire the interest. That provision is discussed in Part 6 of this bulletin. If the entitlement to acquire is taken into account in calculating the direct income interest of the first CFC in the other CFC, that direct income interest will be taken into account in calculating the indirect income interests in the other CFC of residents who hold an income interest in the first CFC. The calculation of indirect income interests is discussed in paragraphs 6.16 and 6.17 of this bulletin.

Proviso to s.245A(2)(b)

3.103 The proviso to s.245A(2)(b) sets out an exception to the entitlement to acquire rules. It provides that a person is not deemed to be entitled to acquire anything where the rights or powers of the person in relation to the thing arise solely by virtue of the person being the holder of a "security arrangement" as defined in s.64B(1). The exception applies only if the security arrangement was acquired in a transaction entered into on an arm's length basis and if the terms of the security arrangement are in accordance with generally accepted commercial practice.

3.104 The objective of this provision is to ensure that a lender is not treated as being entitled to acquire an interest in a company where, in a normal commercial transaction, the lender takes security for a loan over an interest held in a company by the borrower. For example, if A lends money to B to buy shares in C and the shares are used as security for the loan A is treated as not being entitled to acquire the shares. This is the case provided that the security arrangement was obtained by A in an arm's length transaction and if the terms of the arrangement are in accordance with generally accepted commercial practice. The generally accepted commercial practice criterion is satisfied if the holder of the security arrangement can acquire the things secured by the arrangement in circumstances in which holders of such security arrangements would normally be entitled to acquire those things.

Section 192 and 195 debentures

Application

3.105 Section 245A(2)(c) provides that in determining whether rights to distributions exist, interest payable on debentures to which s.192 and s.195 would apply are treated as a distribution of income.

3.106 In calculating control interests and income interests in foreign companies five categories of interest are taken into account. One of those categories is the percentage of the income of the foreign company that the person would be entitled to receive if all of the company's income were distributed at the end of its accounting period. Thus, if a person holds a s.192 debenture or a s.195 debenture issued by a foreign company, the interest payable on the debenture is taken into account in calculating the percentage of the foreign company's income that the person would be entitled to receive if all of the company's income were distributed at the end of its accounting period.

3.107 Section 245A(2)(c) applies where interest is payable on debentures to which s.192 or s.195 "would" apply. The use of "would" means that s.245A(2)(c) may apply where s.192 or s.195 do not actually apply because, for example, the debenture in question has been issued by one foreign company to another foreign company. If the debenture issued by the foreign company was issued to a CFC, it will be necessary to determine whether the issuing foreign company is itself a CFC and, if so, to calculate the CFC's direct income interest in the issuing foreign company. By virtue of s.245A(2)(c), the control interest and the income interest of the CFC in the issuing foreign company will be determined by treating interest payable on the debenture as a distribution of income.

Sections 192 and 195

3.108 Section 192 applies where the rate of interest payable on a debenture issued by a company is determinable from time to time by reference to the dividend payable by the company or by reference to the company's profits. Section 192 does not apply where the Commissioner is satisfied that under the terms of the debenture the rate of interest payable is determined by a fixed relationship to economic, commodity, industrial, or financial indices or to banking rates or general commercial rates. Section 192, and thus s.245A(2)(c), would therefore not apply if a foreign company issued a debenture to a person where the interest rate floats but bears a fixed relationship to an economic, commodity, industrial or financial index, or to banking or general commercial rates. A common international example would be a debenture where the interest rate bears a fixed relationship to the London Interbank Offer Rate (LIBOR).

3.109 Section 195 applies if a company issues debentures to its shareholders, or to any class of its shareholders, where the amount of the debenture or debentures issued to each shareholder has been determined by reference to the shares in the company, or in any other company, held by the shareholder at the time that the debentures were issued or at any earlier time. Debentures are issued by reference to shares in a company held by a shareholder if they are issued by reference to the number of shares, or to the nominal or paid-up capital, held by the shareholder or if they are issued in any other manner by reference to the shares held by the shareholder. Section 195 does not apply to any debenture that is a "convertible note" as defined in s.196. The treatment of convertible notes in calculating control interests and income interests in foreign companies is governed by s.245A(2)(b).

Stapled Stock

Application of s.245A(2)(d)

3.110 Section 245A(2)(d) applies to "stapled stock" arrangements whereby interests in one company can be disposed of only in conjunction with the disposal of interests in another company. It applies where persons resident in New Zealand hold control interests or income interests in a foreign company (referred to as "the stapled company") which may be disposed of only in conjunction with interests in another company. In these circumstances, the control interests or income interests held by the persons in the stapled company are deemed to be held by the other company and not by the persons holding the interests.

3.111 The objective of s.245A(2)(d) is to limit opportunities for avoiding the control test contained in s.245C through the employment of stapled stock schemes. Examples 1 and 2 below illustrate how stapled stock schemes might operate to avoid the control test and how s.245A(2)(d) operates to frustrate such schemes.

Disposal of interests in foreign company

3.112 Section 245A(2)(d) applies where interests in a foreign company "may or may ordinarily" be disposed of only in conjunction with the disposal of interests in another company. Thus, the provision operates in two situations: first, where the interests in the foreign company may only be disposed of in conjunction with the interests in the other company; and second, where the interests in the foreign company ordinarily may be disposed of only in conjunction with the interests in the other company although in some circumstances they may be disposed of individually.

Other company

3.113 Section 245A(2)(d) applies where the interests in the foreign company may be disposed of in conjunction with the disposal of interests in another company, "such other company being either resident in New Zealand or a controlled foreign company". Example 1 below illustrates the application of s.245A(2)(d) where the other company is resident in New Zealand. Example 2 below illustrates the application of s.245A(2)(d) where the other company is a CFC.

Control interests and income interests

3.114 Section 245A(2)(d) applies where "control interests or income interests" held by persons in a CFC may ordinarily be disposed of in conjunction with interests in another company, that other company being resident in New Zealand or a CFC. In these circumstances, the control interests or income interests are deemed to be held by the other company and not by the persons. The control interests held by the persons are therefore concentrated in the hands of the other company, thus making it more likely that the foreign company is a CFC. Further, as the income interests are also deemed to be held by the other company there is no possible attribution of income to the persons under the CFC or foreign investment fund regimes. Instead, if the other company is resident in New Zealand, the other company may be required to attribute income. Or, if the other company is a CFC, persons resident in New Zealand who hold an income interest of 10 percent or greater may be required to attribute income in respect of the foreign company.

Application for the purposes of Part IVA

3.115 The rules contained in s.245A(2) apply for the purposes of Part IVA of the Income Tax Act (the Act) only. In the context of s.245A(2)(d) this means that although the control interests and income interests in the foreign company held by the persons resident in New Zealand are deemed to be held by the other company, those persons still hold those interests for the purposes of other parts of the Act. Thus, for example, dividends received by the persons in respect of their interests in the foreign company will be assessable in their hands in accordance with Part IV of the Act or, in the case of persons that are companies, subject to the dividend withholding payment regime contained in Part XIIB of the Act.

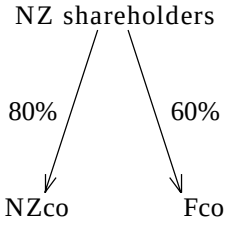
Examples

- Example 1

Facts: (i) NZco is a widely held New Zealand resident company. In total NZco has one thousand shareholders who are resident in New Zealand. In aggregate, the control interests of these shareholders in NZco is 80 percent in each of the categories of control interest listed in s.245C(4).

(ii) The New Zealand resident shareholders of NZco also hold shares in a foreign company, Fco. In aggregate, the control interests of the New Zealand resident shareholders are 60 percent in each category of control interest. However, there is no group of five or fewer New Zealand residents who hold control interests in Fco in any category of control interest of 50 percent or more.

(iii) The shares held by the New Zealand resident shareholders in Fco may be disposed of only in conjunction with the shares that they hold in NZco. The shareholding in Fco and NZco is illustrated as follows:



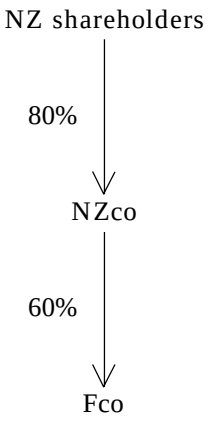
Result: (i) Unless s.245A(2)(d) is applied, Fco is not a CFC because there is no group of five or fewer New Zealand residents whose control interests in any category of control interest aggregate to 50 percent or more.

(ii) In terms of s.245A(2)(d), persons resident in New Zealand hold control interests in a foreign company, Fco, which may be disposed of only in conjunction with the disposal of interests in another company, NZco. That other company is resident in New Zealand. Therefore, s.245A(2)(d) applies.

(iii) By virtue of s.245A(2)(d), the control interests in Fco held by the New Zealand resident shareholders whose interests in Fco may be disposed of only in conjunction with their interests in NZco are deemed to be held by NZco. Thus, NZco is deemed to hold control interests in Fco of 60 percent in each category of interest. Fco is therefore a CFC as defined in s.245C(1).

(iv) Section 245A(2)(d) provides also that the income interests held by the New Zealand resident shareholders in Fco are deemed to be held by NZco. Thus, NZco is deemed to have an income interest of 60 percent in Fco.

(v) The effect of s.245A(2)(d) is illustrated as follows:

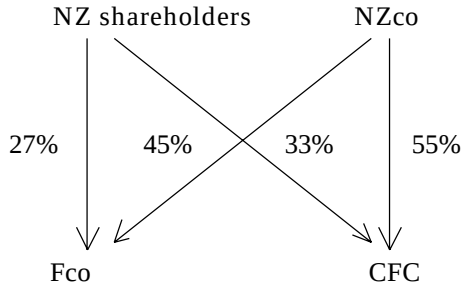


- Example 2

Facts: (i) Fco is a widely held foreign company. One thousand New Zealand resident shareholders hold aggregate control interests of 27 percent in Fco in each category of control interest listed in s.245C(4). A New Zealand resident company, NZco, holds control interests in Fco of 33 percent in each category of control interest. There is no group of five or fewer New Zealand residents whose control interests in Fco aggregate to 50 percent or more in any category of control interest. The remaining 40 percent of the control interests in each category is held by persons who are not resident in New Zealand.

(ii) The New Zealand resident shareholders who hold shares in Fco also hold shares in CFC, a controlled foreign company. In aggregate, the New Zealand resident shareholders hold control interests in CFC in each category of control interest of 45 percent. The remaining 55 percent of the control interests in each category are held by NZco.

(iii) The New Zealand resident shareholders other than NZco who hold shares in Fco and CFC can dispose of their shares in Fco only in conjunction with their shares in CFC. The shareholdings are illustrated as follows:



Result: (i) Fco would not be a controlled foreign company if s.245A(2)(d) were not applied because there is no group of five or fewer New Zealand residents whose control interests in any category aggregate to 50 percent or more.

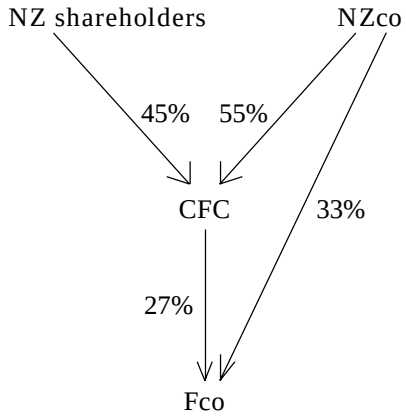
(ii) The interests held by the New Zealand resident shareholders in Fco may be disposed of only in conjunction with the interests which they hold in CFC. CFC is a controlled foreign company. Therefore, s.245A(2)(d) applies.

(iii) By s.245A(2)(d), the aggregate 27 percent control interests held by the New Zealand resident shareholders in Fco is deemed to be held by CFC. The effect of this treatment is that Fco is a controlled foreign company because under the indirect control interest rules set out in s.245C(5) the control interests held by CFC in Fco are allocated back to NZco. NZco thus holds indirect control interests in Fco of 27 percent in each category of control interest and direct control interests of 33 percent in each category. NZco therefore holds control interests in Fco of 60 percent.

(iv) The income interests held by the New Zealand resident shareholders in Fco are also deemed to be held by CFC. Thus, pursuant to s.245D NZco has an income interest in Fco calculated by multiplying NZco's direct income interest in

CFC by CFC's direct income interest in Fco: ie 55% x 27% = 14.85%. Adding this to the direct income interest held by NZco in Fco, NZco holds an income interest of 47.85% in Fco. The New Zealand shareholders would also hold indirect income interests in Fco. However, these would probably be below the 10 percent income interest threshold for attribution of income from a CFC required by s.245F.

(v) The effect of s.245A(2)(d) is illustrated as follows:



Measurement days

Application of s.245A(2)(e)

3.116 Section 245A(2)(e) sets out rules governing the frequency with which it is necessary to calculate control interests and income interests in foreign companies. The effect of s.245A(2)(e) is that, as a general rule, control interests and income interests are calculated on four "measurement days" only. The control interest or income interest held on each measurement day is then deemed to have been held for the quarter preceding the measurement day. If a person does not hold a control interest or income interest in a foreign company on a measurement day, the person is deemed not to hold any control interest or income interest for the quarter preceding the measurement day.

3.117 An exception to the general rule that control interests and income interests are calculated only on measurement days is set out in the proviso to s.245A(2)(e). In terms of that proviso, any person who holds a control interest or income interest in a foreign company may elect not to apply s.245A(2)(e) in relation to the income and control interest. If an election is made, control interests and income interests are calculated on a daily basis.

3.118 Measurement of control interests and income interests is generally required on a quarterly, rather than daily, basis to ease compliance costs which might be incurred if daily measurement were required: *Report of the Consultative Committee on International Tax Reform and Full Imputation* Part 2, July 1988 para 3.3. Also, measurement is required on four days each year, rather than on one day only, to reduce opportunities for avoiding the CFC regime by manipulating interests around a single measurement day. Any scope for manipulating interests around the four measurement days is reduced by the rules contained in s.245E. Section 245E is discussed in Part 7 of this bulletin.

Effect of s.245A(2)(e)

(a) Control or income interests held on measurement day

3.119 Section 245A(2)(e)(i) applies where a person has a control interest or income interest in a foreign company on a particular measurement day. In those circumstances, the person is deemed to hold that control interest or income interest at all times from, but excluding, the immediately preceding measurement day up to, and including, the particular measurement day. The term "measurement day" is defined in s.245A(1) in relation to any calendar year as meaning each of 31 March, 30 June, 30 September and 31 December.

3.120 The CFC regime applied from 1 April 1988. Therefore, in the case of the 30 June 1988 measurement day a person who held a control interest or income interest on 30 June 1988 is deemed to hold that control interest or income interest from, but excluding, 31 March 1988 up to, and including, 30 June 1988.

(b) Control or income interests not held on measurement day

3.121 Section 245A(2)(e)(ii) applies where a person does not hold a control interest or income interest in a foreign company on a particular measurement day. In those circumstances, the person is deemed not to hold a control interest or income interest in the foreign company at any time from, but excluding, the immediately preceding measurement day up to, and including, the particular measurement day. Section 245A(2)(e)(ii) also contains a special rule for the 30 June 1988 measurement day whereby any person not holding a control interest or income interest in a foreign company on 30 June 1988 is deemed not to hold a control interest in the company from, but excluding, 31 March 1988 until, and including, 30 June 1988. This special rule is necessary because 31 March 1988 was not a "measurement day" as defined.

(c) Control interests in different categories

3.122 By s.245C(3), a person holds control interests in a foreign company in each of the categories of control interest listed in s.245C(4) which the person holds or is entitled to acquire. Five categories of interest are listed in that provision. A person may hold control interests in a company in all five categories or in less than five categories. Sections 245A(2)(e)(i) and (ii) apply individually to each category of control interest held by the person. For example, assume that on a measurement day a person holds control interests in the nominal capital, paid-up capital and rights to distributions of income categories, but not in the voting rights or rights to distributions of net assets categories. In these circumstances, s.245A(2)(e)(i) applies to the control interests held by the person in the nominal capital, paid-up capital and rights to distributions of income categories and s.245A(2)(e)(ii) applies to the other two categories of interest.

(d) Application of s.245A(2)(e) in context of s.245C and s.245D

3.123 The rules for determining whether a foreign company is a CFC are set out in s.245C. Section 245C(1) provides that a foreign company is a CFC in relation to its accounting period if "at any time" during that period there is a group of five or fewer persons resident in New Zealand whose control interests in any of the categories listed in s.245C(4) are equal to or greater than 50 percent. Thus, a foreign company is a CFC in relation to any of its accounting periods if on any day during such period the control test in s.245C(1) is satisfied. Where all persons holding interests in the foreign company are using the measurement day basis of calculating control interests, rather than the daily basis set out in the proviso to s.245A(2)(e), the control interest is effectively applied only on measurement days which are relevant to the foreign company's accounting period. That is, the reference to "any time" in s.245C(1) (and in the other provisions of s.245C) will effectively be to the measurement days which establish the interests of persons in the foreign company for the accounting period in question.

3.124 The rules for calculating income interests in CFCs are set out in s.245D. Section 245D(1) provides that the income interest of a person in a CFC "at any time" is calculated by aggregating at that time the direct and indirect income interests held by the person in the CFC. Where the income interest of a person in a CFC varies during an accounting period of the CFC the person's income interest in respect of the accounting period is averaged under the formula set out in s.245D(5). Thus, the income interest of a person who calculates an income interest on a measurement day basis is the income interest of the person on the measurement days or, if the person does not have the same income interest on any or all of the measurement days, the income interest calculated by applying the formula in s.245D(5).

Subject to s.245E

3.125 The introductory language of s.245A(2)(e) provides that s.245A(2)(e) applies subject to s.245E. Section 245E sets out rules which apply where the control interests or income interests of a person vary temporarily around a measurement day. Those rules are discussed in Part 7 of this Bulletin.

3.126 As s.245A(2)(e) applies subject to s.245E, the control interest or income interest that the person holds on a measurement day is the control interest or income interest that the person is deemed to hold on that day by virtue of s.245E, if that provision applies. Thus, if on a measurement day a person actually holds control interests of 45 percent in a foreign company, but by virtue of s.245E the person is deemed to hold control interests of 55 percent, s.245A(2)(e) is applied on the basis of the person holding control interests of 55 percent on the measurement day. Consequently, the person will be deemed to hold control interests of 55 percent on each day in the quarter preceding the measurement day rather than 45 percent.

Proviso to s.245A(2)(e)

(a) Description of proviso

3.127 The proviso to s.245A(2)(e) sets out an exception to the rule that control interests and income interests held on a measurement day (or not held on a measurement day) are deemed to be held (or deemed not to be held) at all times during the quarter preceding the measurement day. It provides that any person who has an income interest or a control interest in a foreign company may elect, in the manner prescribed by the Commissioner, not to apply s.245A(2)(e). Elections are made individually by persons who hold control or income interests in a foreign company. If one such person makes an election there is no requirement for other persons holding interests in the company to make an election.

(b) Effective date of election

3.128 An election is made by a person in terms of the proviso for the purposes of the person's liability to income tax in income years commencing with the income year during which the election is made. Thus, the election applies in relation to the accounting period of the foreign company in respect of which the election was made that ends within the

income year in which the election is made and in relation to subsequent accounting periods. An election under the proviso, once made, is irrevocable. By way of example, if a person makes an election in the income year ending 31 March 1991 and the accounting period of the foreign company in relation to which the election was made ends on 30 June 1990, the election applies for the accounting period of the foreign company ending on 30 June 1990 and for all subsequent accounting periods.

(c) Application of control test and calculation of income interests

3.129 If no person with an interest in a foreign company makes an election in terms of the proviso to s.245A(2)(e), the control test is effectively applied only on the four measurement days because interests will be deemed to remain constant between measurement days. Where one or more persons with an interest in a foreign company makes an election in terms of the proviso, it may be necessary to apply the control test contained in s.245C(1) on a daily basis to determine whether a foreign company is a CFC. Applying the control test on this basis, a foreign company will be a CFC if the control test is satisfied at any point in time during the foreign company's accounting period.

3.130 Where some persons holding control interests in a foreign company have made an election in terms of the proviso while others have not, the interests of the persons who have not made an election will remain constant between measurement days. However, it may be necessary to apply the control test on a daily basis because the control interests of the persons who have made an election in terms of the proviso are calculated on a daily basis. This is illustrated by example 4 below.

3.131 Where a person makes an election under the proviso to s.245A(2)(e), the person's income interest in relation to an accounting period of a CFC will be calculated on each day within the period. If the person's income interest varies during the accounting period, the formula in s.245D(5) is applied in relation to each period during which the income interest remained unvaried.

(d) Elections in relation to indirect interests

3.132 If a person holds control interests in a CFC and the CFC holds control interests in another foreign company ("qualified control interests" in terms of the legislation), the person may hold indirect control interests in the foreign company: s.245C(5). The indirect control interests, together with any direct control interests held by the person, and any direct and indirect control interests held by associated persons, will constitute the person's control interests in the foreign company. Thus, if a person makes an election that s.245A(2)(e) not apply in relation to the person's control interests in the foreign company, the election is to calculate the person's control interests in the CFC and the CFC's qualified control interests in the foreign company on a daily basis.

3.133 If in the above example the person makes an election in relation to the foreign company but not in relation to the CFC, the person's control interests in the CFC are calculated on a daily basis for the purposes of calculating the person's control interests in the foreign company. However, in determining the person's control interests in the CFC for all other purposes the measurement day basis is used. Also, if the person makes an election in relation to the CFC but not in relation to the foreign company, the person's control interests in the CFC are calculated on a measurement day basis in determining the person's control interests in the foreign company, although for all other purposes the control interests will be calculated on a daily basis. Thus, separate elections must be made for each foreign company.

3.134 As with control interests, if a person holds indirect income interests in a CFC it is necessary to make separate elections under the proviso to s.245A(2)(e) in relation to each CFC in the chain. For example, assume that a person has a direct income interest in CFC 1 and an indirect income interest in CFC 2 through CFC 1. If the person makes an election in relation to CFC 1 but not in relation to CFC 2, the person's income interest in relation to CFC 2 is calculated on a measurement day basis. Thus, for the purposes of calculating the person's income interest in CFC 2 the person's direct income interest in CFC 1 and CFC 1's direct income interest in CFC 2 are calculated on a measurement day basis. However, for the purpose of calculating the person's income interest in CFC 1 the daily basis of measurement is used.

(e) Interests held by associated persons and nominees

3.135 Control interests incorporate direct and indirect control interests held by persons and their associates. Consequently, if a person makes an election in relation to control interests in a foreign company under the proviso to s.245A(2)(e) the person will also be required to calculate the direct and indirect interests of associated persons in the foreign company on a daily basis.

3.136 However, any of the persons associated with the elector who are resident in New Zealand will be required to calculate their interests in the foreign company only on measurement days unless they

make an election under the proviso. Further, in calculating their control interests in the foreign company the persons associated with the elector will be required to calculate the elector's interests in the foreign company on a measurement day basis, even though the elector calculates control interests daily. For example, if A and B are associated and A makes an election to calculate control interests in a CFC on a daily basis, A will be required to calculate the direct and indirect control interests of A and B on a daily basis. However, if B does not make an election B will continue to calculate direct and indirect control interests on a measurement day basis.

3.137 Section 245F(2) provides that for the purposes of determining whether the income interest of any person in a CFC is an income interest of 10 percent or greater, the person is deemed to hold all the income interests held by persons associated with that person. Any person who makes an election in relation to income interests in a foreign company under the proviso to s.245A(2)(e) is required to calculate the income interests of any associates in the foreign company on a daily basis for the purpose of applying s.245F(2). However, the associated persons continue to calculate their income interests on a measurement day basis unless they make an election under the proviso. Further, when the associated persons themselves apply s.245F(2) they calculate the income interest of the elector on a measurement day basis.

3.138 Section 245A(2)(a) provides that a person is deemed to hold or to be entitled to acquire anything that a nominee of the person holds or is entitled to acquire. Thus, where a person makes an election under the proviso to s.245A(2)(e) the election will apply with respect to interests which a nominee of the person holds or is entitled to acquire.

(f) Elections in relation to control interests or income interests

3.139 An election may be made under the proviso to s.245A(2)(e) by any person who has an income interest or a control interest in a foreign company. The election, if made, is that s.245A(2)(e) not apply in relation to "such income interest or control interest". The reference to an election being made in relation to an income interest "or" a control interest contemplates that an election may be made in relation to an income interest in foreign company only or in relation to a control interest in a foreign company only. Thus, it is not necessary to make an election in relation to both income interests and control interests in a foreign company.

(g) Election irrevocable and application of s.245E

3.140 An election under the proviso to s.245A(2)(e) is irrevocable. An election thus has effect in relation to the income year in which it is made and in relation to succeeding income years in which the person holds an income interest or control interest in the foreign company.

3.141 If an election is made with respect to an income interest or control interest in a foreign company, s.245E does not apply to that income interest or control interest. The objective of s.245E is to limit opportunities for manipulating interests in foreign companies around measurement days. This objective is not relevant if interests in a foreign company are not calculated on a measurement day basis.

Examples

- Example 3

Facts: (i) Fco is a foreign company resident in country X in terms of s.245Q of the Income Tax Act. Fco's accounting period ends on 31 December.

(ii) NZco, a New Zealand resident company, gradually acquires 55 percent control interests in each category in Fco during the 1990 calendar year. NZco's control interests in each category in Fco at various points during the 1990 calendar year are as follows:

Date	Control interests (%)
8/6/1990	8
22/6/1990	20
12/7/1990	35
27/7/1990	55

To simplify the example it is assumed that NZco held no control interests in Fco before 8 June 1990 and that NZco's holdings in Fco between the dates specified in the table do not vary.

(iii) NZco's income year ends on 31 March 1991. On 1 March 1991 NZco elects under the proviso to s.245A(2)(e) that s.245A(2)(e) not apply in relation to NZco's control interests and income interests in Fco.

Result: (i) The effect of the election is that NZco's control interests and income interest in Fco are calculated on a daily basis. Fco is a CFC in relation to its accounting period ending on 31 December 1990 because NZco has control interests of 55 percent in Fco on at least one day in the accounting period ending on 31 December 1990 (eg 28 July 1990).

(ii) NZco's income interest in Fco is calculated by applying the formula in s.245D(5). The variations in NZco's control and income interests in Fco are as follows:

Period	No. days	Control interest %	Income interest %
1/1/90 - 7/6/90	158	-	-
8/6/90 - 21/6/90	14	8	8
22/6/90 - 11/7/90	20	20	20
12/7/90 - 27/7/90	16	35	35
28/7/90 - 31/12/90	157	55	55

NZco's income interest in Fco for the accounting period ending on 31 December 1990 is therefore calculated as:

- period from 8/6/90 to 21/6/90

$8\% \times \frac{14}{365} = 0.31\%$

- period from 22/6/90 to 11/7/90

$20\% \times \frac{20}{365} = 1.10\%$

- period from 12/7/90 to 27/7/90

$35\% \times \frac{16}{365} = 1.53\%$

- period from 28/7/90 to 31/12/90

$55\% \times \frac{157}{365} = 23.66\%$

- income interest for accounting period

0.31% + 1.10% + 1.53% + 23.66% = 26.60%

(iii) If an election had not been made under the proviso to s.245A(2)(e), NZco's income interest in Fco would have been calculated on a measurement day basis. NZco's income interest in Fco on the four measurement days falling within the accounting period ending on 31 December 1990 is as follows:

Measurement day	Control interest %	Income interest %
31/3/1990	-	-
30/6/1990	20	20
30/9/1990	55	55
31/12/1990	55	55

Applying the formula in s.245D(5), NZco's income interest would be calculated as:

- period from 1/4/90 to 30/6/90

$20\% \times \frac{91}{365} = 4.99\%$

- period from 1/7/90 to 31/12/90

$55\% \times \frac{184}{365} = 27.73\%$

- income interest for accounting period

4.99% + 27.73% = 32.72%

- Example 4

Facts: (i) Fco is a foreign company which is resident in country X in terms of s.245Q. Fco's accounting period ends on 31 December.

(ii) A and B are New Zealand resident individuals. On 30 July 1990 A acquires control interests of 35 percent in Fco in each category of control interest. On 18 September 1990 B acquires control interests of 20 percent in Fco in each category. A's and B's income years end on 31 March.

(iii) On 1 March 1991 B elects under the proviso to s.245A(2)(e) that s.245A(2)(e) not apply in calculating B's control interests and income interest in Fco. A makes no election.

Result: (i) Fco is a CFC in relation to its accounting period ending on 31 December 1990 because on at least one day during that period (eg 18 September 1990) there is a group of five or fewer New Zealand residents (A and B) whose control interests in any category are 50 percent or more. A holds control interests in each category of 35 percent on 18 September 1990 because A holds control interests of 35 percent in each category on the 30 September 1990 measurement day and, by virtue of s.245A(2)(e), is deemed to hold those interests from 1 July 1990 to 30 September 1990. The s.245C(1) control test is satisfied on 18 September 1990 because B acquires control interests in each category of 20 percent on that day. (If B had not made an election Fco would have become a controlled foreign company on 1 July 1990 because A and B would have held aggregate control interests of 55 percent on 30 September 1990 and would have been deemed to have held those interests from 1 July to 30 September).

(ii) A's income interest in Fco is calculated on a measurement day basis. By virtue of s.245A(2)(e) A is deemed to hold an income interest in Fco of 35 percent from 1 July 1990 to 30 September 1990 and from 1 October 1990 to 31 December 1990. This income interest is calculated in accordance with the formula in s.245D(5) as follows:

$35\% \times \frac{184}{365} = 17.64\%$

(iii) B's income interest in Fco is calculated on a daily basis as:

$$20\% \times \frac{105}{365} = 5.75\%$$

(The numerator in the fraction is 105 because there are 105 days falling on and between 18 September 1990 and 31 December 1990).

(iv) If B had not made an election under the proviso to s.245A(2)(e), Fco would have been a CFC from 1 July 1990. In these circumstances A's and B's income interests in relation to Fco's accounting period ending on 31 December 1990 would have been calculated as -

A's income interest (calculated as above):

$$35\% \times \frac{184}{365} = 17.64\%$$

B's income interest:

$$20\% \times \frac{184}{365} = 10.08\%$$

- Example 5

Facts: (i) Fco 1 and Fco 2 are foreign companies that are resident in country X in terms of s.245Q. The accounting periods of Fco 1 and Fco 2 both end on 31 December.

(ii) NZco is a New Zealand resident company. NZco holds control interests in Fco 1 during the calendar year ending 31 December 1990, and Fco 1 holds control interests in Fco 2 (referred to in s.245C as "qualified control interests") during that year. NZco gradually disposes of its interests in Fco 1 during the year.NZco's control interests in Fco 1 in each category at particular points during the year are:

Date	Control interests %
12/4/1990	60
13/4/1990	53
23/7/1990	53
24/7/1990	40
9/10/1990	40
10/10/1990	0

(iii) It is assumed that NZco held control interests in Fco 1 of 60 percent at all times during the year prior to 12 April and that NZco's control interests in Fco 1 do not vary between the dates specified in the table. It is also assumed that no other New Zealand resident holds an interest in Fco 1 or Fco 2 at any relevant time.

(iv) Throughout the accounting period of Fco 1 ending on 31 December 1990, Fco 1 holds control interests in each category in Fco 2 of 55 percent.

(v) NZco does not make an election under the proviso to s.245A(2)(e) in relation to either Fco 1 or Fco 2.

Result: (i) As no election has been made under the proviso to s.245A(2)(e), NZco calculates its control interests and income interests in Fco 1 and Fco 2 on a measurement day basis.

(ii) On the measurement days falling within the accounting periods of Fco 1 and Fco 2 which end on 31 December 1990 NZco holds direct control interests in Fco 1 in each category of interest, and Fco 1 holds qualified control interests in Fco 2 in each category of interest, as indicated in the following table. The table also indicates the control interests held by NZco in Fco 2.

	Control Interests		
Measurement Day	NZco in Fco 1 %	Fco in Fco 2 %	NZco in Fco 2 %
31/3/1990	60	55	55
30/6/1990	53	55	55
30/9/1990	40	55	0
31/12/1990	0	55	0

(iii) Fco 1 is a CFC because NZco holds control interests of more than 50 percent in Fco 1 on at least one measurement day in the accounting period ending 31 December 1990. Fco 2 is also a CFC because the qualified control interests held by Fco 1 in Fco 2 from 1 January 1990 to 30 June 1990 are deemed to be held by NZco: s.245C(5). NZco thus has control interests of 55 percent in Fco 2 during that period.

(iv) NZco's income interest in Fco 1 is calculated as follows:

(a) period from 1/1/1990 to 31/3/1990

$$60\% \times \frac{90}{365} = 14.79\%$$

(b) period from 1/4/1990 to 30/6/1990

$$53\% \times \frac{91}{365} = 13.21\%$$

(c) period from 1/7/1990 to 30/9/1990

$$40\% \times \frac{92}{365} = 10.08\%$$

(d) period from 1/10/1990 to 31/12/1990

$$0 \times \frac{92}{365} = 0$$

(e) income interest in respect of accounting period ending on 31/12/1990:

14.79% + 13.21% + 10.08% = 38.08%

(v) NZco's income interest in Fco 2 is calculated as follows:

(a) period from 1/1/1990 to 31/3/1990

$$(60\% \times 55\%) \times \frac{90}{365} = 8.13\%$$

(b) period from 1/4/1990 to 30/6/1990

$$(53\% \times 55\%) \times \frac{91}{365} = 7.27\%$$

(c) period from 1/7/1990 to 31/12/1990

$$0 \times \frac{184}{365} = 0$$

(d) income interest for accounting period ending 31/12/1990:

8.13% + 7.27% = 15.40%

(vi) NZco's income interest in Fco 2 is zero from 1 July 1990 to 31 December 1990 because Fco 1 is not a CFC on the 30 September 1990 and 31 December 1990 measurement days. Thus, NZco does not hold an income interest in Fco 2 from 1 July 1990 to 31 December 1990 because a person can hold an indirect income interest in a foreign company at a particular time only if the foreign company through which the interest is held is a CFC at that time.

Accounting period treated as income year: s.245A(2)(f)

Application of s.245A(2)(f)

3.142 Section 245A(2)(f) applies where a person furnishes a return of income under s.15 of the Income Tax Act for an accounting year ending with an annual balance date other than 31 March. In these circumstances, unless the context otherwise requires, any reference to an income year in Part IVA is deemed to be a reference to the accounting year corresponding with that income year.

3.143 Section 15 provides that instead of furnishing a return of income for any year ending with 31 March any taxpayer may, with the consent of the Commissioner, elect to furnish a return for the year ending with the date of the annual balance of the taxpayer's accounts. If an election is made, and is accepted by the Commissioner, the income derived during the year ending with the annual balance of the taxpayer's accounts is deemed to have been derived during the year ending with the 31 March nearest to that date. Thus, if the taxpayer returns income to an annual balance date ending between 1 April and 30 September the income derived up to the balance date is deemed to have been derived in the income year ending on the preceding 31 March. Alternatively, if the taxpayer returns income to an annual balance date ending on or after 1 October and before 31 March the income is deemed to have been derived in the income year ending on the succeeding 31 March.

3.144 For the purposes of Part IVA the significance of s.15 is that where that section applies the year ending with the annual balance of the taxpayer's accounts is treated as the taxpayer's income year for the purposes of Part IVA. This treatment is relevant in relation to two provisions: s.245G and s.245R.

Section 245G: calculation of attributed foreign income and loss

3.145 Section 245G sets out the rules for calculating attributed foreign income or attributed foreign losses with respect to income interests in CFCs. Section 245G(1) provides that attributed foreign income or attributed foreign loss is calculated for any income year of a person in relation to any income interest in a CFC where the last day of the accounting period of the CFC falls within the person's income year. Section 15 does not change the taxpayer's income year, but only determines the income year in which income derived to the taxpayer's annual balance date is deemed to have been derived. Therefore, if not for s.245A(2)(f) in cases where a taxpayer returned income to an annual balance date of other than 31 March, s.245G(1) would be applied only in relation to accounting periods of CFCs that ended within the taxpayer's income year ending 31 March and not in relation to those periods that ended after the end of the income year but before the taxpayer's annual balance date.

3.146 For example, assume that a taxpayer who returns income to an annual balance date of 31 August holds an income interest in a CFC and that the accounting period of the CFC ends on 30 June. In relation to the period ending with the balance date of 31 August 1991, the effect of s.15 would be that income derived up to 31 August would be deemed to have been derived in the income year ending on 31 March 1991. However, the taxpayer would not have derived attributed foreign income in respect of the accounting period of the CFC that ended on 30 June

1991 because 30 June 1991 falls within the income year that ends on 31 March 1992. Thus, if not for s.245A(2)(f) the taxpayer would not be required to calculate attributed foreign income in respect of the accounting period of the CFC that ended on 30 June 1991 until 31 March 1992.

3.147 The effect of s.245A(2)(f) in this example is to deem the taxpayer's income year to end on 31 August 1991 for the purposes of Part IVA. Thus, in applying s.245G(1) the final day of the CFC's accounting period, 30 June 1991, will fall within the taxpayer's deemed income year ending on 31 August 1991. Consequently, the attributed foreign income or attributed foreign losses calculated with respect to the accounting period of the CFC ending on 30 June 1991 will be taken into account in the taxpayer's assessable income for the period up to 31 August 1991. Section 245A(2)(f) has effect for the purposes of Part IVA of the Income Tax Act only. Therefore, by virtue of s.15 the attributed foreign income or attributed foreign loss that is derived in respect of the period ending 31 August 1991 is deemed to have been derived in the income year ending on 31 March 1991.

Section 245R: foreign investment fund income and loss

3.148 Section 245R requires residents who hold interests in foreign investment funds to calculate foreign investment fund income or foreign investment fund losses with respect to those interests. Foreign investment fund income and losses are calculated as the difference between the market value of the interest in the foreign investment fund at the end of the income year and consideration derived in respect of the interest during the year, and the market value of the interest at the beginning of the income year and consideration paid with respect to the interest during the year. Where pursuant to s.15 a taxpayer furnishes a return of income for an accounting year ending with a balance date other than 31 March, the effect of s.245A(2)(f) is that interests in foreign investment funds held by the taxpayer are valued on those balance dates. Also, the consideration derived and paid by the taxpayer that is taken into account is that derived or paid with respect to the interest in the foreign investment fund during the taxpayer's accounting year.

Partnerships and calculation of income interests: s.245A(3)

Application

3.149 Section 245A(3) sets out rules that apply in calculating income interests under 245D where interests in a foreign company are held, or are entitled to be acquired, by a partnership. It provides that for the purposes of s.245D a partner of a partnership is deemed:

(a) to hold anything held by the partnership in proportion to the person's interest in the partnership;

(b) to be entitled to acquire anything that the partnership is entitled to acquire in proportion to the person's interest in the partnership;

(c) to exercise anything that the partnership may exercise in proportion to the person's interest in the partnership.

3.150 Section 245A(3) applies only for the purpose of s.245D. Section 245A(3) does not apply in calculating control interests under s.245C because partners and partnerships are associated persons under s.245B and interests held by associated persons are aggregated in calculating control interests. Consequently, it is not necessary to apply rules of the type contained in s.245A(3) in order to determine whether a foreign company is a CFC.

3.151 Interests held in foreign companies by partnerships would generally not be held by the partners individually because in the absence of an agreement to the contrary partnership property is held jointly or in common by all the partners constituting the partnership. Individual partners might therefore not hold income interests in CFCs or interests in foreign investment funds if not for the rules set out in s.245A(3). Section 245A(3) ensures that income interests in CFCs or interests in foreign investment funds held through partnerships can be calculated by looking through the partnership and attributing the interests held by the partnership to the individual partners on a proportionate basis.

Partnership

3.152 Section 245A(3) applies where a person has an interest in a "partnership". The question of whether a relationship constitutes a partnership for the purposes of s.245A(3) is determined in accordance with New Zealand law. In cases where the relationship is governed by foreign law the status of the relationship under foreign law is not relevant in determining whether there is a partnership for the purposes of s.245A(3). In terms of New Zealand law, a relationship between persons constitutes a partnership where they carry on business with a view to making a profit.

3.153 In circumstances where persons hold interests in a foreign company in common, but do not carry on a business, there may be no partnership. If there is no partnership, s.245A(3) will not apply.

However, in circumstances where activities carried on in common constitute a business s.245A(3) will apply with respect to interests in foreign companies held by the partnership even if the holding of the interests does not itself constitute a business.

Section 245A(3) and the controlled foreign company regime

3.154 Where a person is a partner in a partnership which holds any of the interests in a CFC listed in s.245D(2), s.245A(3)(a) deems those things to be held by the partner in proportion to the partner's interest in the partnership. For example, assume that the partnership assets of a partnership formed by A and B include an an interest in a CFC which constitutes 30 percent of the paid-up capital of the company and which entitles the partnership to a distribution of 30 percent of the company's income. In these circumstances, A and B would be deemed to hold the 30 percent portion of the company's paid-up capital and the 30 percent rights to income held by the partnership. The amount of each interest deemed to be held by A and B individually would be proportional to their interest in the partnership.

3.155 Section 245A(3)(a) will also operate where a CFC is a member of a partnership that holds any of the interests listed in s.245D(2) in another CFC. In those circumstances, the CFC will be deemed to hold the things held by the partnership on a basis which is proportional to its interest in the partnership. Section 245D(3) will then be applied in calculating the indirect income interest of any person with an income interest in the CFC on the basis that the CFC holds a direct income interest in the other CFC.

3.156 Entitlements to acquire interests in CFCs are not generally taken into account in calculating income interests. However, s.245D(4) provides an exception to this rule in some circumstances (broadly, where a tax deferral advantage may be obtained through the use of options). Where a partnership is entitled to acquire an interest in a CFC, and the entitlement is one to which s.245D(4) applies, the effect of s.245A(3)(b) is that the partners in the partnership are deemed to be entitled to acquire the interest that the partnership is entitled to acquire.

3.157 The attribution of interests held by partnerships to partners for the purpose of calculating income interests means that attributed foreign income and attributed foreign losses are not calculated at the partnership level and then allocated to partners in accordance with their entitlement to share in the profits of the partnership. Rather, they are calculated at the partner level.

3.158 Section 245A(3) applies only for the purposes of calculating income interests. Whether a person is required to calculate attributed foreign income or attributed foreign losses in respect of an income interest is determined under the other provisions of Part IVA. For, example, if a partner of a partnership that holds interests in a CFC is resident outside New Zealand at all times during the accounting period of the company, s.245F(1) provides that the partner is not required to calculate attributed foreign income or attributed foreign losses in respect of the partner's income interest in the company. However, if in terms of s.245B the non-resident partner is associated with a person resident in New Zealand, the partner's income interest will be taken into account in determining whether the resident associate has an income interest of 10 percent or greater: s.245F(2).

Interest in a partnership

3.159 For the purposes of s.245A(3) a person has an interest in a partnership if the person is a partner or if the person is an assignee of a share in the partnership.

3.160 A person's interest in a partnership is calculated by reference to the person's entitlement to share in the capital and profits of the partnership activities. If the partnership is governed by New Zealand law all partners are entitled to share equally in the capital and profits of the partnership business unless there is an express or implied agreement to the contrary: s.27 Partnership Act 1908. Also, any assignee of a partner is entitled to receive the share of profits to which the assigning partner would otherwise have been entitled and, on dissolution of the partnership, to receive the share of the partnership assets to which the assigning partner would have been entitled: s.34 Partnership Act 1908. Where there is an agreement to share the capital and profits of the partnership unequally, a partner's or assignee's interest in the partnership will be determined in accordance with that agreement. If the partnership is not governed by New Zealand law, the interest of a partner or assignee in the partnership is determined in accordance with the entitlement to capital or income that the partner or assignee has under the law that governs the partnership.

PART 4: ASSOCIATED PERSONS

Overview of s.245B

4.1 Broadly, s.245B provides that the following persons are associated:

(a) any two companies that consist substantially of the same shareholders or that are under the control of the same person or persons, and any two companies where any group of persons holds income interests in those companies which aggregate to 50 percent or more;

(b) any company and any person (other than a company) who holds an income interest in the company of 50 percent or more;

(c) any company and any person where the person is associated with another person who is associated with the company;

(d) any two persons who are relatives;

(e) a partnership and any person who is a partner in the partnership;

(f) a partnership and any person where the person is associated with a partner in the partnership;

(g) a trustee of a trust and a person who has benefited or who will benefit under the trust and a trustee and a person who may benefit under the trust if the person is associated with a settlor of the trust;

(h) two trustees of trusts that have at least one settlor in common;

(i) a trustee and a settlor of a trust;

(j) any two persons who habitually act in concert in respect of any of the things listed in s.245C(4).

Application of associated persons rules

4.2 The associated persons rules apply primarily in two contexts: first, in calculating control interests for the purposes of s.245C; and second, in determining whether a person has an income interest of 10 percent or greater in a CFC.

4.3 Control interests held by associated persons are aggregated for the purpose of determining whether a foreign company is a CFC. This ensures that the control test cannot be defeated by fragmenting control interests among associated persons. If control interests of associates were not aggregated the control test could be defeated by fragmenting control interests among resident and non-resident associates, thus ensuring that residents did not hold control interests of 50 percent or more. Alternatively, the interests could be split among resident associates so that there was no group of five or fewer residents whose control interests aggregated to 50 percent or more.

4.4 Income interests of associated persons are not aggregated except for the purpose of determining whether a person has an income interest of 10 percent or more in a CFC and is therefore required to attribute income and losses. Income interests are not aggregated because this would result in double counting of income and losses. Although associated persons have common economic interests, so that it is appropriate to aggregate interests for control purposes, they derive income and losses with respect to their interests in CFCs in their own right. Income interests are aggregated for the purposes of determining whether a person has an income interest of 10 percent or more. This rule prevents avoidance of the 10 percent threshold for income attribution by fragmentation of interests among associates. However, double counting of income and losses does not occur because income and losses are attributed only on the basis of the income interest actually held by the associated persons.

Associated persons and nominees

4.5 The treatment of interests held by associated persons and nominees differs, both in relation to the calculation of control interests and the calculation of income interests. A person is deemed to hold interests held by any of the person's nominees and such interests are deemed not to be held by the nominees: s.245A(2)(a). This rule applies for the purposes of calculating control and income interests. Interests held by associated persons are taken into account in calculating a person's control interests but they are not generally taken into account in calculating income interests. If interests held by an associated person are taken into account in calculating a person's control interests the associated person still holds those interests. There is no rule equivalent to that applying to nominees that the associated person is deemed not to hold the control interests. Where double counting of a control interest in a foreign company results from the application of the associated persons rules, s.245C(7) may apply to ensure that the interest is counted only once.

4.6 Interests held by nominees are deemed to be held by the person for whom the nominee acts, and not by the nominee, because the interests are not held by the nominee in the nominee's own right. The treatment thus reflects the capacity in which the nominee actually holds the interests. In the case of

associated persons, although there is a common economic interest among associates interests are held by associates in their own capacity. Consequently, it is appropriate to aggregate interests of associates in calculating control interests because, by virtue of their common economic interest, associates can be expected to act together in exercising control of the company. However, in calculating income interests it is not appropriate to aggregate interests of associates because associates derive income in relation to those interests in their own right.

Rules applying in relation to companies

Overview

4.7 Three provisions in s.245B contain rules which apply to relationships with companies:

(a) Section 245B(a) provides that two companies are associated where the companies consist substantially of the same shareholders or are under the control of the same person or persons, or where any group of persons holds income interests of 50 percent or more in each of the two companies. Two companies are not deemed to be associated under this provision if one of the companies is not resident in New Zealand.

(b) Section 245B(b) provides that a company and a person other than a company are associated if the other person holds an income interest of 50 percent or more in the company.

(c) Section 245B(c) provides that a company and a person are associated where the person is associated with another person who is associated with the company.

Association of two companies: s.245B(a)

(a) Companies with substantially the same shareholders

(i) number of shareholders

4.8 Section 245B(a)(i) provides that two companies are associated if they consist substantially of the same shareholders. There is no limit on the number of shareholders who are taken into account in establishing whether two companies consist substantially of the same shareholders. Two companies would consist substantially of the same shareholders, for example, whether two or twenty shareholders held a substantial portion of each company.

(ii) companies to which s.245B(a)(i) applies

4.9 Subject to the proviso to s.245B(a), s.245B(a)(i) applies with respect to any two companies. The provision applies whether or not the companies are resident in New Zealand. However, by virtue of the proviso, s.245B(a)(i) does not apply where one of the companies is not resident in New Zealand. Thus, a resident and a non-resident company with substantially the same shareholders are not associated persons. The objective of this exception is to ensure that New Zealand subsidiaries of non-resident companies are not associated with other subsidiaries of the non-resident parent company that are resident outside New Zealand. The exception does not apply where both companies are resident outside New Zealand.

(iii) substantially the same shareholders

4.10 Section 7(4) provides that two companies are deemed to consist substantially of the same shareholders for the purposes of the Income Tax Act if not less than 50 percent of the paid-up capital of each of them, or not less than 50 percent in nominal value of the allotted shares in each of them, is held by shareholders in the other. Paid-up capital is the aggregate of the payments made in respect of the issued capital of the company. This will include amounts paid in respect of partly paid-up and fully paid-up shares. It does not include amounts paid by way of a premium on the issue of shares. The nominal value of shares is the portion of the nominal capital of the company that the shares represent. The "nominal capital" is the capital of the company authorised in the memorandum or articles of association or in any resolution of the company increasing the capital. Nominal capital is divided into issued and unissued capital. In the context of s.7(4), the nominal value of the allotted shares is therefore the nominal value of the issued shares only.

4.11 For example, if the nominal capital of a company is $1,000 divided into 1,000 $1 shares, and of this nominal capital 600 $1 shares are subscribed for by shareholders, the nominal value of the allotted shares is $600. If the shares were fully paid, the paid-up capital would be $600. If the shares were partly paid to the extent of 50 cents per share, the paid-up capital would be $300.

4.12 For the purposes of s.7, where a nominee of any person holds any shares, nominal capital, paid-up capital, or voting power in a company, or has by any other means a power of control in a company, or is entitled to a share of profits distributed by a company, the person for whom the nominee acts is deemed to hold those shares, nominal capital, paid-up capital, voting power or that power of control or title to profits. Further, the person and the nominee are deemed to be one person. This means that the shares and other interests held by the nominee are not deemed to be held by both the person and the nominee in applying the 50 percent tests in s.7(4). Applying the nominee rule, if A, B and C hold 50

percent of the paid-up capital of Co1, and nominees of A, B and C hold 50 percent of the paid-up capital of Co2, Co1 and Co2 would consist substantially of the same shareholders in terms of s.7. This is because the 50 percent interest held by the nominees would be deemed to be held by A, B, and C and not less than 50 percent of the paid-up capital of each company would be held by the same shareholders.

4.13 Section 7(1) defines a "nominee" of a person as being any other person who may be required to exercise voting power in relation to any company in accordance with the direction of that person, or who holds shares or debentures directly or indirectly on behalf of that person. The term also includes any relative of the person.

4.14 "Relative" is defined in s.2 in relation to any person as meaning any other person connected with the person by blood relationship, marriage, or adoption and includes a trustee for a relative. "Blood relationship" means a connection within the fourth degree of relationship. The degree of relationship between two persons is determined by counting the number of steps between them. For example, a person is within the third degree of relationship with the person's uncle because there are three steps between the person and the uncle: one to the person's mother or father; two to the person's grandmother or grandfather; and three to the person's uncle. Persons are connected by marriage in terms of the "relative" definition if one is married to the other or to a person who is connected by blood relationship to the other. That is, relatives include spouses and persons connected within the fourth degree of relationship to spouses. Persons are connected by adoption in terms of the "relative" definition if one has been adopted as the child of the other or as a child of a person who is within the third degree of relationship to the other.

(iv) shareholders

4.15 Section 245B(a)(i) applies where two companies consist of substantially the same "shareholders". The term "shareholders" includes persons holding shares in the companies. If one or both of the companies is a unit trust it also includes persons holding units in the unit trust because s.211(2)(c) deems unit holders in unit trusts to be shareholders for the purposes of the Income Tax Act. The term "shareholder" would not include persons holding options to acquire shares. However, option holders may be taken into account in determining whether two companies are under the control of the same person or persons in terms of s.245B(a)(ii). The shareholders taken into account may be resident or non-resident, or there may be a mixture of resident and non-resident shareholders.

4.16 Section 7(4) provides that in determining whether two companies consist substantially of the same shareholders, shares in one company that are held by another company are deemed to be held by shareholders in that other company. The shares held by the other company are held on a pro rata basis by the shareholders in that company. For example, if Co1 held 60 percent of the shares of Co2, and A and B each held 50 percent of the shares of Co1, A and B would each be deemed to hold 50 percent of the 60 percent shareholding of Co1 in Co2. If there are further companies in the chain the process is repeated. Thus, in the example if A is a company shareholders in A are deemed to hold the shares in Co2 that A is deemed to hold by application of s.7(4).

- Example 6

Facts: (i) A, B and C hold shares in two companies, Co1 and Co2. Both companies are resident in New Zealand. The total nominal capital, issued capital and paid-up capital of the two companies is as follows:

	Co1 $	Co2 $
nominal capital (divided into $1 shares)	1,000	1,500
issued capital	500	1,000
paid-up capital (shares issued by Co1 fully paid; shares issued by Co2 partly paid to the extent of 10 cents per share)	500	100

(ii) The shares held by A, B and C in Co1 have a nominal value of $300. The shares held by A, B and C in Co2 have a nominal value of $500 and are paid-up to the extent of $50.

Result: (i) Co1 and Co2 are resident in New Zealand. The proviso to s.245B(a) therefore does not prevent s.245B(a)(i) from applying.

(ii) A, B and C hold 60 percent of the nominal value of the allotted shares of Co1: ie they hold shares with a nominal value of $300 and the total nominal value of the shares issued by Co1 is $500. They also hold 60 percent of the paid-up capital of Co1. A, B and C hold 50 percent of the nominal value of the allotted shares of Co2: ie the total nominal value of the issued shares is $1,000 and the nominal value of the shares held by A, B and C is $500. A, B and C also hold 50 percent of the paid-up capital of Co2: ie they hold $50 of the $100 paid-up capital.

(iii) Co1 and Co2 consist substantially of the same shareholders because not less than 50 percent in nominal value of the allotted shares in each

company is held by A, B and C. Co1 and Co2 would also consist substantially of the same shareholders on the grounds that not less than 50 percent of the paid-up capital in each company is held by A, B and C. As Co1 and Co2 consist substantially of the same shareholders, they are associated in terms of s.245B(a)(i).

- Example 7

Facts: A, B and C hold shares in Co1. These shares amount to 55 percent of the paid-up capital and the nominal value of issued shares of Co1. A and B also hold shares in Co2. Those shares amount to 40 percent of the paid-up capital and nominal value of issued shares of Co2. C does not hold shares in Co2. However, C's spouse holds shares in Co2 that constitute 12 percent of the paid-up capital and nominal value of issued shares of Co2. C's spouse holds no shares in Co1. Co1 and Co2 are both non-resident companies.

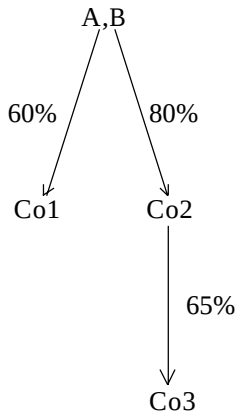
Result: (i) Co1 and Co2 are both resident outside New Zealand. Therefore, the proviso to s.245B(a) does not prevent that provision from applying to deem the companies to be associated.

(ii) If the holding of C's spouse is ignored Co1 and Co2 would not consist substantially of the same shareholders. This is because A and B are the only shareholders in both Co1 and Co2 and their holding in Co2 is less than 50 percent of the paid-up capital or of the nominal value of issued shares of that company.

(iii) C's spouse is a "relative" of C as defined in s.2. By virtue of s.7(1), C's spouse is therefore a nominee of C. The shares held by C's spouse are therefore deemed to be held by C: s.7(4). A, B and C therefore hold 52 percent of the paid-up capital and the nominal value of issued shares of Co2. Co1 and Co2 consist substantially of the same shareholders because A, B and C hold not less than 50 percent of the paid-up capital or the nominal value of issued shares of each company. Co1 and Co2 are therefore associated persons in terms of s.245B(a).

- Example 8

Facts: A and B each hold 30 percent of the paid-up capital and of the nominal value of the issued shares of Co1. A and B also each hold 40 percent of the paid-up capital and of the nominal value of the shares of Co2 (ie an aggregate of 80 percent). Co2 holds 65 percent of the paid-up capital and of the nominal value of the issued shares of Co3. Co1, Co2 and Co3 are all companies that are resident in New Zealand. These facts are illustrated as follows:



Result: (i) The three companies are all resident in New Zealand. Therefore, the proviso to s.245B(a) does not prevent s.245B(a)(i) from applying.

(ii) Co1 and Co2 consist substantially of the same shareholders because A and B hold not less than 50 percent of the paid-up capital or nominal value of the issued shares of Co1 and Co2. Co1 and Co2 are therefore associated by virtue of s.245B(a)(i).

(iii) Section 7(4) provides that in determining whether companies consist substantially of the same shareholders, shares in one company held by another company are deemed to be held by the shareholders of that other company. A and B are therefore deemed to hold shares in Co3 in proportion to their shareholding in Co2. A and B each hold 40 percent of the paid-up capital and of the nominal value of Co1. A and B thus each hold 40 percent of Co2's 65 percent holding of paid-up capital and issued nominal capital in Co3: ie 26 percent, or 52 percent in aggregate.

(iv) Co1 and Co3 therefore consist substantially of the same shareholders because A and B hold not less than 50 percent of the paid-up capital or of the nominal value of the issued shares of each company (ie 60 percent in Co1 and 52 percent in Co2). Co1 and Co3 are therefore associated by virtue of s.245B(a)(i). Co2 and Co3 also consist substantially of the same shareholders because A and B hold not less than 50 percent of the paid-up capital or of the value of nominal capital of both companies. Co2 and Co3 are therefore also associated by virtue of s.245B(a)(i).

(b) Companies under the control of the same person or persons

(i) Description of test

4.17 Section 245B(a)(ii) provides that two companies are associated if they are under the control of the

same person or persons. The control tests set out in s.7(2) apply in determining whether two companies are under the control of the same persons. By s.7(2), a company is deemed to be under the control of the persons:

(i) by whom more than 50 percent of the shares, nominal capital, paid-up capital or voting power is held; or

(ii) who by any other means have control of the company; or

(iii) who by reason of the shareholding at the end of the income year would be entitled to more than 50 percent of the profits for that year if the profits were distributed by way of dividend.

4.18 Section 245B(a)(ii) applies to any two companies that are under the control of the same person or persons. The companies may be resident or non-resident. However, by the proviso to s.245B(a) the rule does not apply if one of the companies is non-resident. Section 245B(a)(ii) applies if two companies are under the control of the same "person or persons". The use of "person", rather than "shareholder" as used in s.245B(a)(i), indicates that it is not necessary for the persons controlling the companies to be shareholders in the companies. There is no limit on the number of persons taken into account in applying s.245B(a)(ii). Also, the persons taken into account may be resident or non-resident.

4.19 In applying the tests set out in s.7(2) shares, nominal capital, paid-up capital, voting capital or any other power of control of a company held by a nominee of a person are deemed to be held by the person. Also, any entitlement of a nominee of a person to a distribution of profits of a company is deemed to be an entitlement of the person. The definition of "nominee" which applies for the purposes of s.7 is discussed above in relation to s.245B(a)(i).

(ii) Application of s.7(2) to two companies

4.20 The rules set out in s.7(2) define the circumstances in which persons control one company. In determining whether two companies are under the control of a person or persons the rules in s.7(2) are therefore applied separately to each company. Two companies will thus be under the control of the same person or persons if that person or those persons control each of the companies in terms of s.7(2), whether the same rule in s.7(2) is satisfied with respect to each company or whether each company is deemed to be controlled by the person or persons by virtue of a different rule in that provision. For example, a person controls two companies if the person controls one company by virtue of holding more than 50 percent of its paid-up capital and the other company by virtue of being entitled to more than 50 percent of the company's profits if distributed. This point is illustrated in example 9 below.

(iii) Control by holding shares, nominal capital, paid-up capital or voting power

4.21 Persons control a company in terms of s.7(2)(a) if they hold more than 50 percent of the shares, nominal capital, paid-up capital or voting power. If the company is a unit trust, the interests of the unit holders in the unit trust are deemed to be shares in the company: s.211(2)(b). Persons will therefore hold more than 50 percent of the shares in the unit trust if they hold more than 50 percent of the interests in the unit trust.

4.22 The second situation in which persons are deemed to control a company by virtue of s.7(2)(a) is where the persons hold more than 50 percent of the nominal capital of the company. The nominal capital is the total capital of the company authorised in the memorandum or articles of association or by company resolution. The reference to nominal capital is to the total nominal capital of the company: ie to the aggregate of the issued and unissued capital. Consequently, if only a portion of the nominal capital is issued cases may arise where a person, or group of persons, has more than 50 percent of the issued capital of the company but not more than 50 percent of the nominal capital.

4.23 The third situation in which persons are deemed to control a company by virtue of s.7(2)(a) is where they hold more than 50 percent of the paid-up capital of the company. Paid-up capital is the aggregate amount of the nominal capital of the company that has been paid-up. It includes amounts paid in respect of shares that are paid in full and amounts paid on shares that are partly paid. It does not include amounts paid by way of a premium on the issue of shares. If the company is a unit trust s.211(2)(d) applies in calculating the paid-up capital. By that provision, there is deemed to be paid-up in respect of shares that a unit holder is deemed to hold the nominal amount of the unit holder's interest in the unit trust or, if the interest is not paid to the manager or trustee of the unit trust in full or if there is no nominal amount with respect to the interest, the amount received by the manager or trustee in respect of the interest other than on its resale. Therefore, the total amount of paid-up capital of a unit trust is the aggregate of the amounts deemed by s.211(2)(d) to be paid-up in respect of all units in the unit trust.

4.24 The fourth situation in which persons are deemed to control a company by virtue of s.7(2)(a) is where they hold more than 50 percent of the voting power of the company.

(iv) Control by any other means

4.25 Section 7(2)(b) provides that a company is under the control of persons who have "by any other means whatsoever control of the company". A company is under the control of persons "by any other means" where the method of control is one which is not specified in s.7(2)(a).

4.26 Persons "control" a company in the ordinary sense where they have control by the majority of votes at a general meeting of the company: *W P Keighery Pty Ltd* v *FCT* (1958) 100 CLR 66, 85; *Mendes* v *Commissioner of Probate Duties (Vict)* (1967) 122 CLR 152, 164, 169. Control exercised by the board of directors does not constitute control of the company because the decisions of the board are made on behalf of the company and not by it: *Mendes* 160, 169.

4.27 A company is controlled by persons in terms of s.7(2)(b) where those persons control the company by a majority of votes at a general meeting. This may constitute a different group of persons than that which holds more than 50 percent of the voting power and which is therefore deemed to be in control of the company by s.7(2)(a). That is, persons are deemed to be in control of a company by s.7(2)(a) if they hold more than 50 percent of the voting power even if they do not exercise the voting power. However, s.7(2)(b) focuses on the exercise of voting power so that persons who consistently exercise their voting power may control the company although they would not do so if other persons holding shares in the company exercised their voting power.

4.28 Section 7(2)(b) applies where control of a company is exercised indirectly. Thus, persons who control company A by virtue of having the majority of the voting power at a general meeting of that company will also control company B if company A holds the majority of the votes in the general meeting of company B: *Mendes* v *Commissioner of Probate Duties (Vict)* (cited above); *Kolotex Hosiery (Australia) Pty Ltd* v *FCT* (1974-1975) 132 CLR 535, 572.

(v) Distribution of profits

4.29 Section 7(2)(c) provides that a company is deemed to be under the control of persons who by reason of their shareholding at the end of an income year would be entitled to more than 50 percent of the profits of the company for that year if those profits were distributed by way of dividend at the end of the year.

4.30 Section 7(2)(c) is applied on the basis of the persons' shareholding at the end of the income year. Also, in applying s.7(2)(c) the question is the amount of the company's profits that the person would be entitled to receive by way of dividend if those profits were all distributed. It is not necessary that all of the profits actually be distributed. The reference to "profits" means that income and capital gains earned by the company are taken into account.
For the purposes of s.7(2)(c) a person is deemed to be entitled to a share of distributed profits that any nominee of the person is entitled to: s.7(5).

- Example 9

Facts: (i) A and B hold shares in NZco1 that constitute more than 50 percent of the nominal capital and paid-up capital of that company. A and B also hold shares in NZco2 and by virtue of holding those shares they exercise the majority of the voting power at general meetings of NZco2. NZco2 holds shares in NZco3 and by virtue of holding those shares exercises the majority of the voting rights at general meetings of NZco3.

(ii) All three companies are resident in New Zealand.

Result: (i) As all three companies are resident in New Zealand, the proviso to s.245B(a) does not prevent s.245B(a)(ii) from applying in determining whether any of the companies are associated.

(ii) By s.7(2)(a), A and B control NZco1 because they hold more than 50 percent of the nominal capital and paid up capital of that company. A and B also control NZco2 because they hold more than 50 percent of the voting power of that company in terms of s.7(2)(a) or because they control NZco 2 by any other means in terms of s.7(2)(b). NZco1 and NZco2 are therefore associated by virtue of s.245B(a)(ii) because they are under the control of the same persons, A and B.

(iii) A and B control NZco2 by virtue of exercising the majority of the votes at the general meetings of that company. NZco2 controls NZco3 by virtue of exercising the majority of the votes at the general meetings of NZco3. A and B therefore have control of NZco3 by any other means in terms of s.7(2)(b). Consequently, NZco2 and NZco3 are associated by virtue of s.245B(a)(ii). Also, NZco3 and NZco1 are associated because both companies are under the control of A and B: NZco1 is under the control of A and B by virtue of s.7(2)(a) and NZco3 is under the control of A and B by virtue of s.7(2)(b).

(c) Income interests of 50 percent or more

(i) Description of test

4.31 Section 245B(a)(iii) provides that two companies are associated where any group of persons

holds income interests in each of those companies that in aggregate amount to 50 percent or more. Income interests are calculated in accordance with s.245D in relation to persons with interests in CFCs. To ensure that s.245B(a)(iii) can be applied with respect to companies that are resident in New Zealand, it is provided that income interests are calculated under s.245D by omitting the words "controlled foreign" and "foreign" where they appear in s.245D. Section 245D is further modified for the purposes of applying s.245B(a)(iii) by assuming that s.245D(4) and (6) are omitted.

(ii) Calculation of income interests

4.32 The calculation of income interests is discussed in detail in Part 6 of this bulletin. The omission of s.245D(4) in calculating income interests means that entitlements to acquire interests in companies are not taken into account. The omission of s.245D(6) means that persons who become resident in New Zealand, or who cease to be resident in New Zealand, may have an income interest in a company on days when they are not resident in New Zealand.

4.33 The rules set out in s.245D(1) for calculating income interests are subject to s.245A(2)(e) and s.245E. Therefore, income interests are calculated on measurement days for the purposes of s.245B(a)(iii) unless an election is made in accordance with the proviso to s.245A(2)(e) not to calculate income interests on a measurement day basis. If income interests are calculated on a measurement day basis, s.245E applies to limit opportunities for manipulating interests around measurement days.

4.34 In calculating income interests the rules governing interests held by nominees (s.245A(2)(a)) and by partnerships (s.245A(3)) apply. For the purposes of s.245B(a)(iii) the "nominee" definition in s.245A(1) applies rather than the definition in s.7 which applies for the purposes of s.245B(a)(i) and (ii).

(iii)Companies

4.35 Section 245B(a)(iii) applies to any two resident or non-resident companies. However, pursuant to the proviso to s.245B(a) it does not apply where one of the companies is resident in New Zealand and the other is non-resident.

(iv) Group of persons

4.36 Section 245B(a)(iii) applies where a group of persons holds income interests in each of the companies of 50 percent or more. "Group of persons" is defined in s.245A(1) as including one person. Section 245B(a)(iii) may therefore apply where one or more persons holds income interests of 50 percent or more in two companies. The persons included in the group of persons may be resident in New Zealand or they may be non-resident.

- Example 10

Facts: (i) A holds shares in Co1 that entitle A to 100 percent of the voting power in relation to that company. The shares constitute 50 percent of the paid-up capital and of the nominal capital of Co1 and they carry with them the right to receive 50 percent of Co1's income on distribution.

(ii) Co1 holds shares in Co2 that constitute 50 percent of the paid-up capital and nominal capital of that company. The shares in Co2 carry no voting rights.

(iii) Co1 and Co2 are both resident in New Zealand.

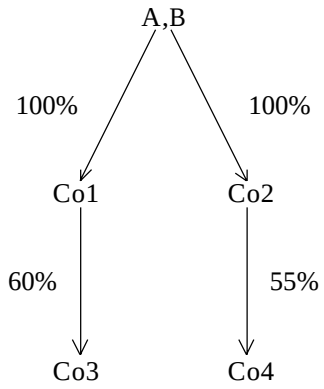
Result: (i) A has a direct income interest in Co1 equal to the highest percentage of the interests listed in s.245D(4) that A holds in the company. The highest interest is in the voting rights category. A thus has a direct income interest in Co1 of 100 percent. This direct income interest also represents A's income interest in Co1.

(ii) Co1 has a direct income interest in Co2 equal to the highest percentage of the interests listed in s.245D(4) that Co1 holds in Co2. Co1 thus has a direct income interest of 50 percent in Co2. Also, A has an indirect income interest in Co2 calculated by multiplying A's direct income interest in Co1 by Co1's direct income interest in Co2: ie 100% x 50% = 50%. A's income interest in Co2 is therefore 50 percent.

(iii) Co1 and Co2 are associated by virtue of s.245B(a)(iii) because A holds income interests in each of those companies of 50 percent or more.

- Example 11

Facts: A and B each hold shares in two New Zealand resident companies, Co1 and Co2, that constitute an income interest of 50 percent in each company: ie an aggregate of 100 percent in each company. Co1 holds a direct income interest in another New Zealand resident company, Co3, of 60 percent and Co2 holds a direct income interest in a non-resident company, Co4, of 55 percent. These facts are illustrated as follows:



Result: (i) Co1 and Co2 are associated by virtue of s.245B(a)(iii) because A and B as a group of persons together hold income interests in each company of 50 percent or more.

(ii) A and B each hold income interests in Co3 of 50% x 60% = 30%. As a group of persons A and B therefore hold aggregate income interests in Co3 of 60 percent. Consequently, Co3 is associated with both Co1 and Co2 by virtue of s.245B(a)(iii) because A and B have income interests in each of those companies of 50 percent or more.

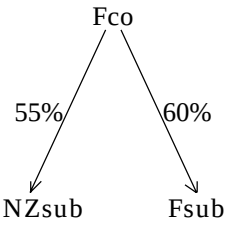
(iii) A and B each hold income interests in Co4 of 50% x 55% = 27.5%. As a group of persons, A and B therefore hold aggregate income interests in Co4 of 55 percent. However, Co4 is not associated with any of the other three companies by virtue of s.245B(a)(iii) because the proviso to s.245B(a) states that two companies are not associated under s.245B(a) where one of the companies is not resident in New Zealand. In the example, one of the companies, Co4, is not resident in New Zealand.

(d) Proviso to s.245B(a)

4.37 The proviso to s.245B(a) provides that two companies are not associated by virtue of s.245B(a) if one of the companies is not resident in New Zealand. The objective of this provision is to ensure that New Zealand resident subsidiaries of a non-resident parent company are not associated with non-resident subsidiaries of the non-resident parent. The proviso also operates to prevent a non-resident subsidiary of a New Zealand resident parent company from being associated with the parent company. However, in these circumstances it is not necessary to treat the resident parent company and the non-resident subsidiary as being associated to prevent the non-resident company being used to decontrol other non-resident companies because the indirect control interest rules operate to attribute interests held by the non-resident subsidiary to the resident parent.

- Example 12

Facts: Fco, a non-resident company, holds shares in NZsub, a New Zealand resident company, that constitute an income interest of 55 percent in NZsub. Fco also holds shares in Fsub, a non-resident company, that constitute an income interest of 60 percent in Fsub. These facts are illustrated as follows:



Result: (i) Fco holds an income interest of 55 percent in NZsub and 60 percent in Fsub. Therefore, Fsub and NZsub satisfy the terms of s.245B(a)(iii) to the extent that there is a person, Fco, who holds income interests in each company of 50 percent or more.

(ii) However, by virtue of the proviso to s.245B(a) Fsub and NZsub are not associated in terms of s.245B(a)(iii) because one of the companies, Fsub, is not resident in New Zealand.

(e) Comparison of s.245B(a)(i), (ii) and (iii)

4.38 The rules contained in s.245B(a) treat two companies as associated persons in a number of circumstances where persons have interests in each company. Although there may be some overlap between the three sets of rules contained in paragraphs (i), (ii) and (iii) of s.245B(a), there are also significant differences between those rules. In summary, the main features of paragraphs (i), (ii) and (iii) are as follows:

(i) Companies consisting substantially of the same shareholders: s.245B(a)(i)

a Interests taken into account are paid-up capital and issued nominal capital.

b Two companies are associated if 50 percent or more of the paid-up capital or issued nominal capital in each is held by the same shareholders.

c Paid-up capital and nominal capital held by a nominee is deemed to be held by the person for whom the nominee acts. For this purpose the definition of "nominee" contained in s.7(1) applies. This definition includes "relatives", as defined in s.2, as nominees.

d Shares in one company held by another company are deemed to be held by the shareholders in the other company. Those shares are then taken into account in calculating the proportion of paid up capital and issued nominal capital held by the shareholders in the company.

e The two companies may both be resident or

non-resident, but two companies are not associated if one is resident and the other is non-resident.

(ii) Companies under the control of the same person: s.245B(a)(ii)

a Interests taken into account are shares in the company, nominal capital, paid-up capital, voting power, any other means of controlling the company and rights to distributions of income.

b A company is under the control of the persons who hold more than 50 percent of the shares, nominal capital, paid-up capital or voting power of the company, who by any other means have control of the company, or who by reason of shareholding at the end of the year would be entitled to more than 50 percent of the profits of the company if those profits were distributed by way of dividend. Two companies are under the control of the same persons if those persons control each company by any one of these methods, whether the companies are controlled by the same method or by a different method.

c A company is controlled by persons by "any other means" if those persons carry the majority of votes at a general meeting of the company. Persons who exercise a majority of the votes at a general meeting of Company A control Company B if Company A exercises a majority of the votes at a general meeting of Company B.

d Shares, nominal and paid-up capital, voting power, the power of control or the title to profits held by a nominee are deemed to be held by the person for whom the nominee acts rather than by the nominee. The definition of "nominee" in s.7(1) applies for this purpose.

e The two companies may be resident or non-resident but two companies are not associated if one is resident and the other is non-resident.

(iii) Group of persons holding income interests in each company: s.245B(a)(iii)

a Two companies are under the control of a group of persons who hold income interests in each of those companies of 50 percent or more in aggregate.

b In calculating income interests the following interests are taken into account: paid-up capital, nominal capital, voting rights, rights to distributions of income and rights to distributions of assets. Income interests include direct income interests and indirect income interests. Indirect income interests are calculated by multiplying direct income interests held through chains of controlled companies.

c Interests held by nominees are deemed to be held by the person for whom the nominee acts. For this purpose the definition of "nominee" contained in s.245A applies. This definition does not encompass relatives.

d The two companies may be resident or non-resident but two companies are not associated if one is resident and the other is non-resident.

Companies and persons holding income interests of 50 percent or more: s.245B(b)

4.39 Section 245B(b) provides that a company and a person other than a company are associated if the person holds an income interest of 50 percent or more in the company. In calculating income interests for the purpose of this rule it is provided that s.245D is applied by omitting the words "foreign" and "controlled foreign" from s.245D and by omitting ss.245D(4) and (6).

4.40 The omission of the words "foreign" and "controlled foreign" from s.245D in calculating income interests for the purpose of s.245B(b) means that s.245B(b) applies whether the company is resident in New Zealand or is non-resident. The omission of s.245D(4) means that entitlements to acquire interests in companies are not taken into account in calculating income interests for the purposes of s.245B(b). Finally, the omission of s.245D(6) means that a person who ceases or becomes resident in New Zealand may hold an income interest in a company on any day on which the person was resident outside New Zealand.

4.41 The calculation of income interests is discussed in Part 6 of this bulletin.

4.42 Section 245B(b) applies only to associate a company and a person other than a company. It does not operate to associate two companies. However, if a person holds income interests of 50 percent or more in two companies those companies may be associated under s.245B(a). Section 245B(b) applies if one person holds an income interest in a company of 50 percent or more. It does not apply to associate a number of persons whose aggregate income interests in a company are 50 percent or more.

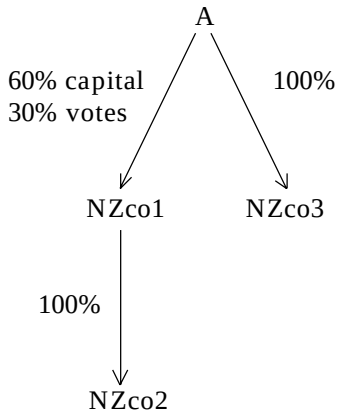
- Example 13

Facts: (i) A, a natural person, holds shares in NZco 1 that constitute 60 percent of the paid-up and

nominal capital of NZco 1 but which carry only 30 percent of the total voting power.

(ii) NZco 1 holds an interest in NZco 2 of 100 percent in each category of interest.

(iii) A also holds an interest in NZco 3 of 100 percent in each category of interest. The facts are illustrated as follows:



Result: (i) In terms of s.245D, as modified by s.245B(b), A holds an income interest of 60 percent in NZco 1: ie the highest of the things listed in s.245D(2) that is held by A in that company. Therefore, A and NZco 1 are associated by virtue of s.245B(b).

(ii) NZco 1 holds an income interest of 100 percent in NZco 2 but the two companies are not associated by virtue of s.245B(b) because that provision applies only to associate a company and a person other than a company. A holds an income interest in NZco 2 of 60 percent calculated by multiplying A's direct income interest in NZco 1 by NZco 1's direct income interest in NZco 2. Therefore, A and NZco 2 are associated by virtue of s.245B(b).

(iii) A holds an income interest in NZco 3 of 100 percent. Therefore, A and NZco 3 are associated by virtue of s.245B(b).

(iv) Although NZco 1 and NZco 2 are not associated under s.245B(b), they may be associated under s.245B(a)(iii) by virtue of A having an income interest of 50 percent or more in each company. Also, NZco 3 and NZco 1 and NZco 2 may be associated under s.245B(a)(iii) by virtue of A having an income interest of 50 percent or more in each company.

Companies and persons associated with associates of the company: s.245B(c)

4.43 Section 245B(c) provides that a company and a person are associated where the person, is by virtue of any of the provisions of s.245B, associated with another person who is associated with the company by virtue of any of the provisions of s.245B. That is, s.245B(c) treats as an associate of a company any person who is associated with an associate of the company in terms of s.245B. Section 245B is thus applied twice in these circumstances: once to establish whether a person is associated with a company; and, if a person is associated with the company, a second time to establish whether any other persons are associated with that person.

- Example 14

Facts: A holds shares in a company, Co1, that constitute 50 percent of the paid-up capital of Co1. B holds shares in Co2 that constitute 55 percent of the paid-up capital of Co2. A and B are natural persons who are married to each other.

Result: (i) A holds an income interest of 50 percent in Co1. A is therefore associated with Co1 by virtue of s.245B(b). B holds an income interest of 55 percent in Co2 and is therefore associated with Co2 by virtue of s.245B(b). A and B are associated by virtue of s.245B(d) because they are "relatives" as defined in s.245A(1).

(ii) By s.245B(c), Co1 and B are associated because A is associated with Co1 and B is associated with A: that is, B is associated with an associate of Co1. Also, Co2 and A are associated because B is associated with Co2 and A is associated with B.

(iii) Assuming that the proviso to s.245B(a) does not apply, Co1 and Co2 are associated by virtue of s.245B(a)(i) because they consist substantially of the same shareholders. That is, as relatives, A and B are nominees of each other who, by s.7(5), are deemed to be one person for the purposes of s.7. In terms of s.7(4), Co1 and Co2 thus consist of substantially the same shareholders because A and B hold not less than 50 percent of the paid-up capital in each company.

- Example 15

Facts: A holds shares in a company, Co1, that constitute 100 percent of the paid-up capital and nominal capital of Co1 and that carry 100 percent of the voting rights and rights to the distribution of 100 percent of the income and assets of Co1. A also holds shares in Co2 that constitute a 100 percent interest in each of those categories. Co2 is the settlor of a trust in terms of s.226 of the Income Tax Act. The trust is not for the benefit of employees of Co2.

Result: (i) Assuming that the trust is not for the benefit of Co2 employees, Co2 is associated with the trustee of the trust settled by it: s.245B(i).

(ii) Co1 and Co2 are associated by virtue of each of the tests set out in s.245B(a). Therefore, Co1 and the trustee of the trust settled by Co2 are associated by virtue of s.245B(c) because the trustee is associated with Co1 and Co1 is associated with Co2.

Rules applying to relatives

4.44 Section 245B(d) provides that any two persons who are relatives are associated. "Relatives" is defined in s.245A(1). The definition provides that "relative" in relation to any person means any other person connected with the person by blood relationship, marriage, or adoption and includes a nominee for a relative.

4.45 Persons are connected by blood relationship for the purposes of the "relative" definition in s.245A(1) if they are within the second degree of relationship. The degree of relationship between two persons is established by counting the number of steps between them. For example, there are two steps between a person and the person's grandparents: one to the person's parents and two to the person's grandparents. Therefore, a person is within the second degree of relationship with the person's grandparents. A person is also within the second degree of relationship of the person's brothers and sisters because there are two steps between them: a first to the person's parents and a second to the person's brothers and sisters. A person is therefore within the second degree of relationship with the person's parents, grandparents, children, grandchildren, and brothers and sisters.

4.46 Persons are connected by marriage for the purposes of the "relative" definition if one is married to the other or if the person is married to a person who is connected by blood relationship to the other. Thus, a person is connected by marriage with the person's spouse and with persons who are within the second degree of relationship with the person's spouse. A person is therefore connected by marriage to the parents, grandparents, and brothers and sisters of the person's spouse.

4.47 Persons are connected by adoption for the purposes of the "relative" definition if one has been adopted as the child of the other or as a child of a person who is within the first degree of relationship to the other. A person is within the first degree of relationship with the person's parents and children. Therefore, a person is connected by adoption with any person who adopts the person, with the parent of any person who adopts the person or with the children of any person who adopts the person. For example, if A and B adopt C then C is connected by adoption with A and B, with A and B's parents and with any other children of A and B.

4.48 In terms of the "relative" definition, a person's relatives include any nominees for the person's relatives. The term "nominee" is defined in s.245A(1). That definition is discussed above at paragraphs 3.75 to 3.79 By virtue of this rule, a person's relatives therefore include any nominees of persons connected by blood relationship, marriage or adoption with the person. For example, the nominee of a person's brother or sister would be a relative of the person because the brother or sister is within the second degree of relationship with the person and is therefore connected by blood relationship with the person.

Rules applying to partnerships

Partners and partnerships

4.49 Section 245B(e) provides that a partnership and any person are associated where the person is a partner in the partnership. A relationship between persons constitutes a partnership if a business is carried on by them for the purpose of making a profit.

4.50 Section 245B(e) applies whether the partnership is established under New Zealand law or under the law of another jurisdiction. For example, s.245B(e) would associate a person and a partnership if the person was a partner of a partnership which was governed by Hong Kong law. However, the question of whether a relationship constitutes a partnership is determined by applying the tests under New Zealand law for determining whether there is a partnership.

Partnerships and persons associated with partners

4.51 Section 245B(f) provides that a partnership and a person are associated where the person and a partner in the partnership are associated in terms of s.245B. As with s.245B(e), the question of whether a relationship constitutes a partnership is determined according to New Zealand law. Also, s.245B(f) applies whether the partnership is governed by New Zealand or foreign law.

4.52 Section 245B(f) applies where a person is associated with a partner in a partnership by virtue of any of the provisions contained in s.245B. This is illustrated in the following examples.

- Example 16

Facts: A is a partner in a partnership that is governed

by Hong Kong law. A also holds shares in a company that constitute an income interest of 55 percent in the company.

Result: As A has an income interest of 50 percent or more in the company, A and the company are associated by virtue of s.245B(b). The company is thus associated with a partner in the partnership. Consequently, the partnership and the company are associated by virtue of s.245B(f).

- Example 17

Facts: A holds shares in two New Zealand resident companies, Co1 and Co2, that constitute 100 percent of the paid-up capital and nominal capital of each company, that carry rights to 100 percent of the voting power of each company and that entitle A to a distribution of 100 percent of the income and assets of each company. Co1 is a partner in a partnership.

Result: (i) Co1 and Co2 are associated by virtue of s.245B(a). A is associated with each of Co1 and Co2 by virtue of s.245B(b) because A holds an income interest of at least 50 percent in each company. Co1 is associated with the partnership under s.245B(e) because Co1 is a partner in the partnership.

(ii) Co2 and the partnership are associated by virtue of s.245B(f) because Co2 is associated with a person, Co1, who is associated with the partnership. Also, A and the partnership are associated because A is associated with a person, Co1, who is associated with the partnership.

Rules applying to trusts

Trustees and beneficiaries: s.245B(g)

(a) Description of s.245B(g)

4.53 Section 245B(g) provides that two persons are associated where one person is a trustee of a trust and:

(i) the other person has benefited or will benefit under the trust, either directly or indirectly; or

(ii) the other person is associated with a settlor of the trust and the other person may benefit under the trust, either directly or indirectly.

The proviso to s.245B(g) provides that s.245B(g) does not apply if the trust is for the benefit of employees of an employer only. This exception applies only if the "other person" (ie the person who has, who will or who may benefit under the trust) or any person associated with the other person does not manage or control the affairs of the trust.

(b) Trustee definition

4.54 Section 245B(g) associates a trustee of a trust with persons who have, who will or who may benefit from the trust. In this context the definition of "trustee" set out in s.2 of the Income Tax Act is relevant. That definition provides that a trustee includes an executor and administrator and that a reference to a trustee of a trust "means that trustee only in the capacity as trustee of that trust and includes all trustees for the time being of that trust".

4.55 One consequence of the "trustee" definition in the context of s.245B(g) is that s.245B(g) associates a trustee with a person who has, will or may benefit under a trust only in the trustee's capacity as trustee of the trust. Therefore, if a person is associated with a trustee by virtue of s.245B(g), the person's control interests in a foreign company are calculated under s.245C(3) by taking into account the interests held by the trustee only in the trustee's capacity as trustee. Interests held by the trustee in any other capacity are not attributed to the person associated with the trustee. Similarly, interests held by the person associated with the trustee are attributed to the trustee only in the trustee's capacity as trustee.

4.56 A second feature of the "trustee" definition is that the term "trustee" includes all trustees of the trust. Therefore, if a person has benefited or will benefit under a trust, or if the person may benefit under a trust and the person is associated with a settlor of the trust, the effect of s.245B(g) is that the person is associated with all of the trustees of the trust in their capacity as trustees.

(c) Trustee and person who has benefited or who will benefit under the trust

4.57 Section 245B(g)(i) provides that two persons are associated if one person is the trustee of a trust under which the other person has benefited or will benefit, either directly or indirectly. This provision applies where the person is a beneficiary of the trust either because the person has benefited from the trust or because the person will benefit from the trust in the future.

(d) Trustee and person who may benefit under the trust

(i) Description of test

4.58 Section 245B(g)(ii) provides that two persons are associated if one person is the trustee of a trust under which the other person may benefit either directly or indirectly. However, this rule applies only if the person who may benefit under the trust is associated with any settlor of the trust by virtue of s.245B or s.8.

(ii) Settlor definition

4.59 The term "settlor" is defined in s.245A(1) as having the meaning assigned to it by s.226. This definition is discussed in Part 6 of the appendix to Taxpayer Information Bulletin No.5. Section 245B(g)(ii) applies where the person who may benefit under the trust is associated with any settlor of the trust. If there is more than one settlor of the trust s.245B(g)(ii) applies if the person who may benefit is associated with any one of the settlors.

(iii) Associated persons tests

4.60 Section 245B(g)(ii) applies where the person who may benefit under the trust is associated with any settlor of the trust in terms of s.8 or s.245B. The associated persons rules set out in s.245B are discussed in this part of this bulletin. Section 8(1) provides that persons associated with each other are:

(a) any two companies which consist substantially of the same shareholders or which are under the control of the same persons;

(b) any company and any person other than a company who holds 25 percent or more of the paid up capital or 25 percent or more in nominal value of the allotted shares of the company; or

(c) any two persons who are relatives; or

(d) a partnership and any person where the person and any partner in the partnership are associated persons under any of the preceding provisions of s.8(1).

4.61 Two companies that consist substantially of the same shareholders or that are under the control of the same persons are also associated by virtue of s.245B(a)(i) and (ii). Those provisions are discussed above at paragraphs 4.8 to 4.30 of this bulletin. Section 8(1)(a) is broader than s.245B(a) in that s.8(1)(a) does not contain a limitation equivalent to that set out in the proviso to s.245B(a). Therefore, s.8(1)(a) may operate to treat a resident company and a non-resident company as being associated for the purposes of s.245B(g).

4.62 Section 8(1)(b) provides that a company and a person other than a company are associated if the person holds 25 percent or more of the paid-up capital or allotted nominal capital of the company. Section 8(2) contains two rules that apply for the purpose of s.8(1)(b). First, section 8(2)(a) provides that paid-up capital of one company held by another company is deemed to be held by the shareholders in the other company. Second, section 8(2)(b) provides that where a nominee of any person holds any paid-up capital of a company the paid up capital is deemed to be held by the person. The definition of "nominee" for this purpose means any other person who may be required to exercise voting power in relation to the company in accordance with the directions of that person, or who holds shares directly or indirectly on behalf of that person: s.8(1)(b). It also includes any "relative" of the person as defined in s.2.

4.63 In some respects s.8(1)(b) is broader in scope to a similar provision in s.245B, s.245B(b). That provision associates a company and a person other than a company where the person holds an income interest of 50 percent or more in the company. Section 8(1)(b) is broader than s.245B(b) in that it applies at a lower threshold level: ie at 25 percent as compared with 50 percent. Also, the "nominee" definition taken into account for the purposes of s.8(1)(b) is broader because it includes relatives. However, a narrower range of interests are taken into account for the purposes of s.8(1)(b) than for the purposes of s.245B(b). In the case of the former section, paid-up capital and the nominal value of allotted shares only are taken into account. In the case of s.245B(b), the interests taken into account are nominal capital, paid-up capital, voting rights, entitlements to income and entitlements to the distribution of assets.

4.64 Section 8(1)(c) provides that any two persons who are relatives are associated. This is broader in scope than s.245B(d) because the definition of "relative" contained in s.2 applies in relation to s.8(1)(b) rather than the narrower definition contained in s.245A. The s.2 definition is broader than the s.245A definition in that it provides that:

(i) persons are connected by blood relationship if within the fourth degree of relationship (persons are connected by blood relationship by virtue of the s.245A definition if they are within the second degree of relationship);

(ii) persons are connected by marriage if one is married to the other or to a person who is connected by blood relationship to the other. This is broader than the equivalent provision in the s.245A definition because the concept of connection by blood relationship is broader in the context of the s.2 definition;

(iii) persons are connected by adoption if one has been adopted by the other or as a child of a person who is within the third degree of relationship to the other person. This is broader than the s.245A definition which provides that persons are connected by adoption if one has been adopted as the child of another or as a child of a person who is within the first degree of relationship to the other.

4.65 Section 8(1)(d) provides that a partnership and any person are associated where the person and any

partner in the partnership are associated in accordance with the preceding paragraphs of s.8(1). This test is framed in the same terms as s.245B(f). However, its effect is different because the tests of when persons are associated differs as between s.8 and s.245B.

(iv) Rule applies where the person "may" benefit

4.66 Section 245B(g)(ii) applies where a person who is associated with a settlor of a trust may benefit, either directly or indirectly, under the trust. The provision thus applies where a person who is associated with a settlor of a trust is a member of a class of potential beneficiaries of the trust. In these circumstances, s.245B(g)(ii) operates to associate the trustee of the trust and the potential beneficiary.

Examples

- Example 18

Facts: A is a settlor of a discretionary trust in terms of s.226 of the Income Tax Act. B is a member of the class of discretionary beneficiaries of the trust. B has not benefited from the trust and, as B is a member of a class of discretionary beneficiaries, it is not certain that B will benefit from the trust in the future. B is a company in which A holds an income interest of 100 percent.

Result: (i) B has not benefited from the trust and it is not certain that B will benefit from the trust in the future. Therefore, s.245B(g)(i) does not apply.

(ii) B is associated with the settlor of the trust, A, because A holds an income interest of 50 percent or more in B: s.245B(b). B may benefit under the trust because B is a member of the class of discretionary beneficiaries of the trust. Therefore, s.245B(g)(ii) applies and B is associated with the trustee of the trust.

- Example 19

Facts: A holds 20 percent of the paid-up capital of a company, NZco. B holds 25 percent of the paid-up capital of NZco. A and B are married to each other. NZco is a settlor of a trust and A is a member of the class of potential beneficiaries of the trust. A has not benefited from the trust.

Result: (i) A has not benefited from the trust and as A is a member of a class of potential beneficiaries it is not certain that A will benefit from the trust in the future. Therefore, s.245B(g)(i) does not apply.

(ii) A is not associated with the settlor of the trust, NZco, by virtue of s.245B. However, A is associated with NZco by virtue of s.8(1)(b). This is because by virtue of s.8(2)(b) B, as a relative of A, is a nominee of A and A is deemed to hold the paid-up capital held by B. A therefore holds 45 percent of the paid-up capital of NZco. In terms of s.8(1)(b), A therefore holds 25 percent or more of the paid-up capital of NZco and A and NZco are associated.

(iii) A is associated with a settlor of the trust and may benefit under the trust. Consequently, A is associated with the trustee of the trust by virtue of s.245B(g)(ii).

(e) Trusts settled for employees

4.67 The proviso to s.245B(g) sets out an exception to the rules contained in ss.245B(g)(i) and (ii). It provides that s.245B(g)(i) and (ii) do not apply if the trust is for the benefit of employees of an employer and neither the "other person" nor any person associated with the other person directly or indirectly manages or controls the affairs of the trust. The "other person" is the person referred to in s.245B(g)(i) and (ii) who has benefited, who will benefit, or who may benefit from the trust.

4.68 The objective of the exception is to ensure that employees are not associated with the trustee of a trust established to provide employment related benefits. In the absence of the proviso, s.245B(g) would operate, for example, to associate an employee of a large multinational company with the trustee of a trust established by the company to provide retirement benefits for employees of the company. This would not be an appropriate result in the context of the CFC legislation.

4.69 The first requirement for the proviso to apply is that the trust be for the benefit of employees of an employer. By s.2, an employee is a person who receives or is entitled to receive a source deduction payment. "Source deduction payment" is defined in s.6 as meaning a payment by way of salary or wages, an extra emolument or a withholding payment. "Salary or wages" is defined in s.2 in terms of certain payments made in relation to the employment of a person. The term "extra emolument" is also defined in relation to certain payments made in relation to the employment of a person. "Withholding payment" is defined in s.2 as being a payment which is deemed by regulations to be a withholding payment for the purposes of the Income Tax Act. The relevant regulations are the Income Tax (Withholding Payments) Regulations 1979. These regulations do not require the existence of an employment relationship. However, in practical terms a person who makes a payment of the kind described in the regulations will not establish a trust for the benefit of the recipient of the payment. Therefore, in the context of the proviso to s.245B(g) the term "employees" will generally be limited to situations where an employ-

ment relationship in the generally understood sense exists.

4.70 The second requirement in the proviso to s.245 is that the "other person" (ie the person who has benefited, who will benefit or who may benefit under the trust), or any person associated with that other person in terms of s.245B, must not directly or indirectly control or manage the affairs of the trust. This requirement ensures that the proviso does not apply if the person who has benefited or who may benefit under the trust manages or controls the trust and may therefore influence the amount of the benefit that the person receives from the trust.

Trustees of two trusts

(a) Application of s.245B(h)

4.71 Section 245B(h) provides that two persons are associated where each person is the trustee of a trust in relation to which there is at least one settlor in common. The definition of "trustee" in s.2 is relevant in this context. That definition provides that a reference to a trustee of a trust means the trustee only in the capacity as trustee of the trust. The effect of the definition is that two trustees who are associated under s.245B(h) are associated only in their capacity as trustees. Consequently, in calculating control interests under s.245C, interests held by trustees in their capacity as trustees are taken into account in calculating the control interests of other trustees with whom they are associated under s.245B(h). However, interests held by trustees in a private capacity are not attributed to associated trustees in this fashion. Also, trustees are only associated under s.245B(h) in respect of the trusts that have common settlors.

4.72 In determining whether two trusts have a settlor in common the term "settlor" has the meaning assigned to it by s.226. That meaning is discussed in Part 6 of the appendix to Taxpayer Information Bulletin No.5.

- Example 20

Facts: (i) NZco makes a disposition of property on the terms of a trust, Trust 1, at below market value. At the time at which NZco made the disposition, A holds control interests in NZco of 100 percent in each category of control interest listed in s.245C(4).

(ii) A lends money to another trust, Trust 2, at a rate of interest that is below the market rate.

Result: (i) The disposition of property by NZco on the terms of Trust 1 was at below market value. NZco is therefore a settlor of Trust 1 by virtue of s.226(1)(a). At the time of settlement by NZco, A held a control interest in each of the categories of control interest listed in s.245C(4) of 10 percent or more. Therefore, A is a settlor of Trust 1 by virtue of s.226(4).

(ii) The loan from A to Trust 2 is at a rate of interest that is below the market rate. A is therefore a settlor of Trust 2 by virtue of s.226(1)(b).

(iii) The trustees of Trust 1 and Trust 2 are associated by virtue of s.245B(h) because A is a settlor of both trusts.

(b) Proviso to s.245B(h)

4.73 The proviso to s.245B(h) sets out two exceptions to the rule that trustees of trusts with a common settlor are associated. The first applies where the settlor is a person other than a company, and the second applies where the settlor is a company. Both exceptions apply in the case where the settlor settled property on a trust for the benefit of employees and the settlor, or persons associated or connected with the settlor, does not manage or control the affairs of the trust. In these circumstances, the effect of the proviso is that the trustee of the trust settled for the benefit of employees of the settlor is not associated with any trustee of any other trust settled by the employer.

4.74 Paragraph (i) of the proviso to s.245B(h) provides that s.245B(h) does not apply where a settlor other than a company settles property on the terms of a trust for the benefit of employees of the settlor only. This exception applies only if the settlor or any person associated with the settlor in terms of s.245B(h) does not directly or indirectly manage or control the affairs of the trust.

4.75 Paragraph (ii) of the proviso provides that s.245B(h) does not apply if a settlor that is a company settles property on the terms of a trust for the benefit of its employees only. This exception applies only if the settlor, any person associated with the settlor in terms of s.245B, any executive or director of the settlor, or any person holding 25 percent of the paid-up capital of the settlor does not directly or indirectly manage or control the affairs of the trust.

Trustee and settlor

4.76 Section 245B(i) provides that two persons are associated where one is the trustee of a trust of which the other person is a settlor. The application of this rule is limited by a proviso. In terms of the proviso, s.245B(i) does not apply if the trust is for the benefit of employees of the settlor only. The proviso does

not apply if the settlor or any person associated with the settlor or, if the settlor is a company, any executive or director of the settlor or any person holding 25 percent or more of the paid up capital of the settlor, directly or indirectly manages or controls the affairs of the trust.

4.77 By virtue of the s.2 definition of "trustee", any reference to a trustee of a trust means the trustee in the trustee's capacity as trustee of the trust only. In the context of s.245B(i) this means that a trustee is associated with a settlor by virtue of that provision only in the trustee's capacity as trustee of the trust. Consequently, for the purposes of s.245C, only interests held by the trustee in the trustee's capacity as trustee of the trust in relation to which the trustee is associated with the settlor are taken into account in calculating the control interests of the settlor.

4.78 The term "settlor" has the meaning assigned by s.226. That meaning is discussed in Part 6 of the appendix to Taxpayer Information Bulletin No.5. The proviso to s.245B(i) is in the same terms as the proviso to s.245B(h). That proviso is discussed in paragraphs 4.73 to 4.75 of this bulletin.

Persons who habitually act in concert

4.79 Section 245B(j) provides that two persons are associated if they habitually act in concert with respect to the holding or exercise of any of the things listed in paragraphs (a) to (e) of s.245C(4). Persons are associated by virtue of s.245B(j) only in respect of the things in relation to which they act in concert: s.245B(j) proviso.

4.80 Two persons are associated by virtue of s.245B(j) if three requirements are satisfied:

(i) the persons must act in concert;

(ii) the acting in concert must be habitual; and

(iii) the acting in concert must be with respect to the holding or exercise of any of the things listed in paragraphs (a) to (e) of s.245C(4).

4.81 Persons act in concert if they act jointly or together or in collaboration. They do not act in concert if they act independently. Thus, persons who act independently but, who hold or exercise any of the things listed in s.245C(4)(a) to (e) in the same manner. are not acting in concert. However, persons do act in concert if, for example, there is an agreement between them to hold or exercise any of the things listed in s.245C(4)(a) to (e) in a particular manner. Such an agreement may be express or there may be an informal understanding as to how the persons are to act in relation to the things in question.

4.82 The second requirement is that the persons must "habitually" act in concert. Conduct is habitual if it is customary or usual or is to be regarded as being almost inevitable: *Dia*s v *O'Sulliva*n [1949] ALR 586, 589. For conduct to be habitual it is not necessary that the persons always act together. However, it is necessary that they usually act together. If persons act together only occasionally they do not act together habitually.

4.83 The third requirement is that the persons act together habitually with respect to the holding or exercise of any of the things listed in s.245C(4)(a) to (e). Those things are the paid-up and nominal capital of the company, the voting rights with respect to the company and the entitlement to receive income or assets of the company on distribution. Section 245B(j) applies whether the persons habitually act in concert with respect to the holding or exercise of any or all of the things listed in s.245C(4). By virtue of the proviso to s.245B(j), if the persons do not act in concert with respect to all of the things listed in s.245C(4), they are associated only to the extent of the things that they do act in concert in respect of. For example, two persons who habitually act in concert with respect to voting rights, but not with respect to any of the other things listed in s.245C(4), are associated in relation to those voting rights but not in relation to any of the other things.

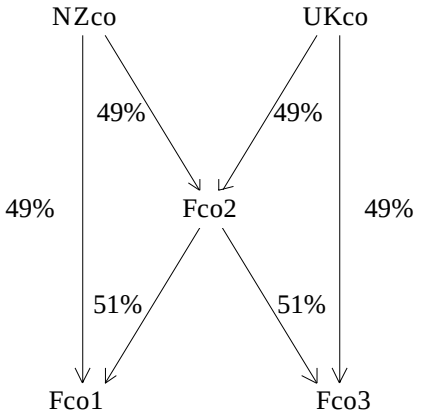
- Example 21

Facts: (i) NZco, a New Zealand resident company, holds control interests in a foreign company, Fco1, of 49 percent in each category of control interest listed in s.245C(4). NZco also holds control interests of 49 percent in each category in Fco2, another foreign company.

(ii) UKco, a United Kingdom resident company, holds control interests in Fco 2 of 49 percent in each category. The remaining 2 percent of the control interests in Fco2 are held by X, a resident of the country in which Fco2 is resident. UKco also holds control interests in another foreign company, Fco3, of 49 percent in each category of control interest.

(iii) Fco2 holds control interests in Fco1 and Fco3 in each category of control interest of 51 percent in each category.

(iv) The overall ownership structure may be represented as follows:



(v) In terms of an informal understanding between NZco and UKco, UKco exercises its voting rights in Fco2 in relation to Fco2's holding in Fco1 in accordance with the wishes of NZco. Similarly, NZco exercises its voting rights in Fco2 in relation to Fco's holding in Fco3 in accordance with the wishes of UKco.

(vi) It is assumed that NZco and UKco are not associated under ss.245B(a) to (i).

Result: (i) If the fact that NZco and UKco act in concert with respect to their interests in Fco2 were ignored, Fco1 would not be a CFC. NZco would have indirect control interests in Fco1 only if Fco2 were a CFC: s.245C(5). Fco2 would not be a CFC because NZco holds control interests in each category of only 49 percent. Therefore, Fco1 would not be a CFC because NZco would hold only direct control interests of 49 percent in that company.

(ii) NZco and UKco habitually act in concert with respect to the voting rights that they hold in Fco2. Therefore, in terms of s.245B(j) UKco is associated with NZco in respect of the voting rights held by UKco in Fco2. Consequently, by virtue of s.245C(3), NZco calculates its control interest in Fco2 in the voting rights category by taking into account the voting rights held by UKco in Fco2. Fco2 is thus a CFC because NZco holds a control interest in Fco of 98 percent in the voting rights category. NZco holds an indirect control interest in Fco1 of 51 percent in each category of control interest: s.245C(5). Fco1 is therefore a CFC because NZco holds direct and indirect control interests in Fco1 of 100 percent in aggregate.

(iii) Fco3 would also be a CFC because NZco would be deemed to hold a control interest of 98 percent in Fco2 in the voting rights category and is therefore deemed to hold the 51 percent direct control interests held by Fco2 in Fco3: s.245C(5).

PART 5: CONTROLLED FOREIGN COMPANY DEFINITION AND CALCULATION OF CONTROL INTERESTS

Overview of s.245C

5.1 Section 245C sets out the definition of a controlled foreign company (CFC) and the rules for determining whether a foreign company is a CFC. The definition of a CFC is relevant primarily in relation to Part IVA of the Income Tax Act. However, it is also relevant for the purposes of:

(a) Part XIIB of the Income Tax Act (the dividend withholding payment regime);

(b) Part XIIC of the Income Tax Act (the provisions governing the maintenance of branch equivalent tax accounts);

(c) the rule contained in section 226(4) that a person is a settlor of a trust if the person holds a control interest of 10 percent or more in a CFC, or in a company that would be a CFC if it were a foreign company, at any time when that company made a settlement on a trust.

5.2 In outline, s.245C(1) sets out the definition of a CFC. Section 245C(2) extends the CFC definition set out in s.245C(1) to include any foreign company where any number of New Zealand resident directors hold control interests in the company in any category of interest listed in s.245C(4) of 50 percent or more. Section 245C(3) contains a definition of the term "control interest". Section 245C(4) lists five categories of interest in a company that are taken into account in calculating direct control interests. Section 245C(5) sets out the method of calculating indirect control interests. The term "qualified control interests" is defined in s.245C(6). This term is relevant for the purposes of the rules set out in s.245C(5) for calculating indirect control interests. Rules to prevent the double counting of control interests in relation to one group are contained in ss.245C(7) and (8). Section 245C(9) contains an anti-avoidance rule that applies where persons resident in New Zealand enter into an arrangement whereby control interests in a foreign company are held by other persons.

Controlled foreign company definition: s.245C(1)

Description

5.3 Section 245C(1) provides that a foreign company is a CFC in relation to one of its accounting periods if at any time during that accounting period

there is a group of five or fewer persons resident in New Zealand whose control interest, or the aggregate of whose control interests, in the foreign company in any of the categories of control interest listed in s.245C(4) is equal to or greater than 50 percent. A transitional exception to this rule is set out in the proviso to s.245C(1). By virtue of the proviso, if the accounting period of a foreign company commenced before 1 April 1988 the foreign company is a CFC only if the control test is satisfied at any time during the part of the accounting period that falls on and after 1 April 1988.

5.4 The essential elements of the "controlled foreign company" definition are:

(a) the definition applies to "companies" that are foreign companies;

(b) the definition is applied in relation to each accounting period of the foreign company;

(c) a foreign company is a CFC in relation to an accounting period if the control test is satisfied at any time during that period;

(d) there must be a group of five or fewer persons resident in New Zealand who hold the requisite quantity of control interests;

(e) the control test is applied in respect of each category of control interest specified in s.245C(4);

(f) 50 percent or more of the control interests in any category must be held by the group of five or fewer residents.

Nature of the company

5.5 Section 245C(1) applies only to companies. Further, s.245C(1) applies only to companies that are foreign companies. The term "company" is defined in s.2. That definition is discussed in paragraphs 3.46 to 3.52 of this bulletin. The term "foreign company" is defined in s.245A(1). That definition is discussed in paragraphs 3.44 to 3.59 of this bulletin.

Accounting period

5.6 Section 245C(1) is applied in relation to each accounting period of the foreign company. If the control test set out in s.245C(1) is satisfied at any time during the foreign company's accounting period, the foreign company is a CFC for the accounting period. The term "accounting period" is defined in s.245A(1). That definition is discussed in Part 3 of this bulletin at paragraphs 3.3 to 3.8. The rules governing changes in accounting periods of foreign companies are set out in s.245I. Those rules are discussed in Part 11 of this bulletin.

Application of control test at any time during accounting period

5.7 A foreign company is a CFC in relation to an accounting period if the control test set out in s.245C(1) is satisfied at any time during the accounting period. Section 245C(3) is expressed to apply subject to s.245A(2)(e) and s.245E. Thus, where s.245A(2)(e) applies to all persons holding control interests in the foreign company, the control test set out in s.245C(1) is effectively applied only on the measurement days that relate to the accounting period. This is because by virtue of s.245A(2)(e) control interests held by persons between measurement days are deemed not to vary in these circumstances. However, where any person holding a control interest in a foreign company makes an election in accordance with the proviso to s.245A(2)(e), the control test is applied on each day of the company's accounting period. The foreign company will be a CFC if the control test is satisfied on any day during the accounting period.

5.8 The reference to s.245C(3) applying subject to s.245E indicates that where a person calculates control interests on a measurement day basis, the rules contained in s.245E apply in calculating the control interests held by the person on the measurement day. Those rules are designed to reduce opportunities for temporary variations in interests in foreign companies to be made around measurement days.

Group of five or fewer persons

5.9 A foreign company is a CFC if there is a group of five or fewer persons resident in New Zealand whose control interest, or the aggregate of whose control interests, in the foreign company in any category of control interest is 50 percent or more. The application of the control test to a group of five or fewer residents is based on control tests contained in the CFC legislation of other countries. The rationale for requiring interests to be concentrated in a group of five or fewer persons is that the smaller the group the more likely it is that the members of the group will act together to control the company.

5.10 Section 245A(1) provides that the term "group of persons" includes one person. Therefore, the requirement that there be a group of five or fewer persons resident in New Zealand whose control interest in any category of control interest is 50 percent or more will be satisfied if one person holds a control interest in any category of 50 percent or more. There is no minimum interest that a person must hold to be taken into account in applying the control test. For example, if A holds 49 percent of the paid up capital of a foreign company and B holds 1 percent, A and B will constitute a group of five or fewer persons for the purposes of s.245C(1).

5.11 Control interests of a person may be calculated by taking into account include interests held by other persons. This may occur because interests held by associates are aggregated or because entitlements to acquire interests held by other persons are taken into account. Therefore, interests of more than five persons may be taken into account in determining whether the control test is satisfied. For example, assume that five New Zealand residents hold 45 percent in aggregate of the nominal capital of a foreign company and that an associate of one of the members of the group holds 5 percent of the nominal capital of the company. In these circumstances, the 5 percent nominal capital held by the associate is taken into account in calculating the control interest of the member of the group with whom the associate is associated. The group of five residents will consequently hold control interests of 50 percent in aggregate in the nominal capital category and the company will be a CFC.

5.12 The five or fewer persons who hold control interests in any category must be resident in New Zealand. Section 241 of the Income Tax Act sets out the rules for determining whether a person is resident in New Zealand. Inland Revenue's interpretation of those rules is set out in Public Information Bulletin No.180.

Test applied in relation to each category of interest

5.13 The control test is applied separately to each category of interest listed in s.245C(4). Different categories of interest in a company may have different rights or powers attached to them. The application of the control test with respect to each category of interest listed in s.245C(4) thus reduces opportunities for avoiding the control test by creating different categories of shares or other interests in a company.

5.14 A foreign company will be a CFC if the control test is satisfied in relation to any category of interest. For example if a group of five or fewer residents holds 50 percent or more of the rights to vote in relation to a foreign company, the foreign company is a CFC even if the group does not hold 50 percent or more of the interests in any of the other categories of interest listed in s.245C.

5.15 The test is satisfied where the "control interest", or the aggregate of the control interests, of the group of five or fewer residents in any category of control interest is 50 percent or more. The method of calculating control interests is set out in s.245C(3). That provision is discussed in paragraphs 5.24 to 5.30 of this bulletin.

Control interest equal to or greater than 50 percent

5.16 A foreign company is a CFC if the control interests of a group of five or fewer residents in any category of interest is equal to or greater than 50 percent. It is not necessary to establish that the control interests of a group of five or fewer New Zealand residents is greater than 50 percent. It is sufficient if the control interests of such a group in any category are equal to 50 percent.

Proviso to s.245C(1)

5.17 The proviso to s.245C(1) sets out a transitional rule that applies where the accounting period of a foreign company straddles the implementation date of the CFC regime - 1 April 1988. It provides that in the case of such an accounting period the foreign company is a CFC only if the control test is satisfied at any time within that part of the accounting period that falls on or after 1 April 1988. This provision reflects the 1 April 1988 application date of the CFC regime.

5.18 The effect of the proviso is that a foreign company will not be a CFC in relation to an accounting period that commenced before 1 April 1988 if the control test is satisfied in relation to the company at any time during the part of the accounting period falling before 1 April 1988 but if it is not satisfied at any time during the part of the accounting period falling on or after that date. If the control test is satisfied at any time during the part of the accounting period falling on or after 1 April 1988, the foreign company is a CFC in relation to the accounting period. However, in these circumstances only income derived or losses sustained by the CFC in the portion of the accounting period falling after 1 April 1988 are attributed to persons holding income interests in the CFC: s.245G(3).

Foreign companies controlled by New Zealand resident directors

5.19 Section 245C(2) extends the definition of a CFC contained in s.245C(1). It applies where:

(a) a foreign company is not a CFC in relation to an accounting period by virtue of s.245C(1); and

(b) at any time during the accounting period there is a group of New Zealand resident directors of the foreign company whose control interests in the foreign company in any category of control interest listed in s.245C(4) is equal to or greater than 50 percent.

In these circumstances, the New Zealand resident directors are deemed to be a group of five or fewer persons and the foreign company is deemed to be a CFC.

5.20 The rationale for s.245C(2) is that any number of directors with interests in a company may be able to exercise control of the company by virtue of their position as directors. Therefore, where directors hold interests in a company it is not appropriate to limit the control group to five or fewer persons.

5.21 Section 245C(2) focuses on the control interests held by the directors. This test differs from the test of company residence contained in s.241(6)(d). Under that test a company is resident in New Zealand if control of the company by it directors in their capacity as directors is exercised in New Zealand. The focus of that test is therefore on whether the directors exercise directorial functions in New Zealand to the extent that they control the company from New Zealand. Under s.245C(2), the focus is on whether the aggregate control interests of the resident directors in any category of interest is 50 percent or more. Section 241(6) is applied prior to s.245C(2) because if the company is resident in New Zealand it will be a foreign company only if it is a dual resident company of the type described in paragraph (b) of the s.245A(1) definition of "foreign company". If the company is not a foreign company, s.245C(2) does not apply.

5.22 The term "director" is defined in s.2. Inland Revenue's interpretation of that definition is set out in paragraphs 4.23 to 4.32 of Public Information Bulletin No.180. That Public Information Bulletin also sets out Inland Revenue's interpretation of the residence rules contained in s.241. Those rules are relevant in establishing whether there is a group of resident directors who hold control interests in a foreign company of 50 percent or more.

5.23 Where there is a group of resident directors whose control interests in any category of interest are 50 percent or more, s.245C(2) provides that those resident directors are deemed to be a group of five or fewer persons and the foreign company is deemed to be a CFC. It is necessary to deem the group of directors to be a group of five or fewer persons to allow the indirect control interest rules contained in s.245C(5) to operate. Those rules attribute interests held by a CFC in another foreign company to a group of five or fewer persons who hold a control interest in the CFC of 50 percent or more. If there is more than one such group, a series of rules establishes the group to which the interests are attributed. Therefore, the effect of s.245C(2) in these circumstances is to ensure that a group of directors with control interests in a CFC of 50 percent or more constitutes a group of five or fewer persons for the purpose of establishing whether any foreign company in which the CFC holds control interests is also a CFC.

Calculation of control interests: s.245C(3)

Description

5.24 Section 245C(3) sets out the rules for calculating control interests held by New Zealand residents in foreign companies. It provides that a resident's control interest in a foreign company in any category of interest and at any time is the aggregate of any direct and indirect control interests held by the person, and by associates of the person, in the company at that time. Any reference to a "control interest" in Part IVA of the Income Tax Act is therefore a reference to the aggregate control interest described in s.245C(3).

Application of s.245C(3)

5.25 Section 245C(3) is applied in relation to each category of control interest listed in s.245C(4). Thus, direct control interests and indirect control interests held by a person and by persons associated with the person are aggregated on a category by category basis. Interests held in one category are not aggregated with interests held in another category.

5.26 A person will hold only one direct control interest in a company in any particular category. However, it is possible to have more than one indirect income interest in a company where interests in the company are held through several CFCs. Thus, s.245C(3)(c) refers to the indirect control "interest or interests" held by a person in a foreign company.

5.27 Direct and indirect control interests held by associated persons are aggregated in calculating a person's control interest. The question of whether persons are associated is determined in accordance with s.245B. That provision is discussed in Part 4 of this bulletin. Interests held by associated persons are taken into account whether the associated person is resident or non-resident. For example, if a resident is a settlor of a trust that has only non-resident trustees, the settlor and the trustee are associated by virtue of s.245B(i) and the settlor is deemed to hold the direct and indirect control interests held by the non-resident trustees in any foreign companies for the purposes of s.245C.

5.28 Similarly, assume that A is resident in New Zealand, A's brother, B, is resident in Australia, and A's sister, C, is resident in New Zealand. Assume also that A, B and C each hold direct or indirect control interests in a foreign company. In these circumstances, A would have a control interest in the foreign company that included the direct and indirect control interests in the company that are

held by B and C. A's sister, C, would also have a control interest in the foreign company that included the direct and indirect control interests held by A and B. Sections 245C(7) and (8) would prevent the same interest from being double counted within the one group of five or fewer persons.

5.29 The direct and indirect control interests taken into account under s.245C(3) are those that are "held" by the person or by the person's associates. Section 245C(4) provides that a person holds direct control interests equal to the percentage of the things listed in that provision that the person holds or is entitled to acquire. Subsections 245C(5) and (6) provide that direct control interests held by CFCs are taken into account in calculating indirect control interests. Therefore, in determining whether a person holds a direct control interest or an indirect control interest, things that the person holds or is entitled to acquire, or things that a CFC in which the person holds a control interest holds or is entitled to acquire, are taken into account. The question of whether a person is entitled to acquire any of the things listed in s.245C(4) is determined in accordance with s.245A(2)(b).

5.30 Control interests are calculated on the basis of the direct and indirect control interests held by a person and associates of the person at a particular time. If a person calculates control interests on a measurement day basis in accordance with s.245A(2)(e), the person's control interest in any category on a particular day will be the aggregate of the direct and indirect control interests held by the person and by the person's associates on the measurement day that applies to determine the person's control interest on the particular day. If a person elects not to apply s.245A(2)(e), so that control interests are calculated on a daily basis, the person's control interest in any category at a particular time will be the aggregate of the direct and indirect control interests actually held by the person and by persons associated with the person at that time.

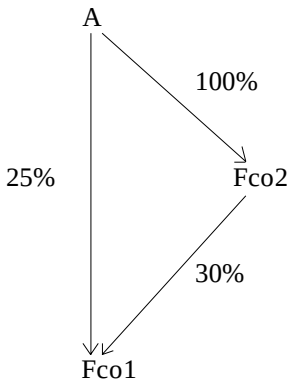
Examples

- Example 22

Facts: (i) A, a New Zealand resident individual, holds direct control interests in Fco1, a foreign company. A calculates control interests in Fco1 on a measurement day basis. On the 30 June 1990 measurement day A holds direct control interests in Fco 1 of 25 percent in each category of interest. On that measurement day A also holds control interests in Fco2, another foreign company, of 100 percent in each category of interest.

(ii) On the 30 June 1990 measurement day Fco2 holds control interests in Fco 1 of 30 percent in each category of interest. The accounting periods of Fco1 and Fco2 end on 31 December 1990.

(iii) The facts may be represented as follows:



Result: (i) The control test is satisfied in relation to Fco2 on the 30 June 1990 measurement day because on that day A holds control interests of 50 percent or more in at least one of the categories of control interest listed in s.245C(4). Therefore, Fco2 is a CFC in relation to its accounting period ending on 31 December 1990.

(ii) On the 30 June 1990 measurement day A holds an indirect control interest in Fco 1 of 30 percent in each category of control interest listed in s.245C(4): s.245C(5). A also holds direct control interests in Fco1 of 25 percent in each category of control interest. Therefore, by virtue of s.245C(3), A holds a control interest in Fco1 of 55 percent in each category of control interest: ie 25% + 30% = 55%. As the control test is satisfied in relation to Fco1 on the 30 June 1990 measurement day, Fco1 is a CFC in relation to its accounting period ending on 31 December 1990.

- Example 23

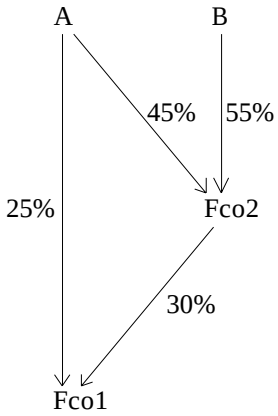
Facts: (i) A and B, two New Zealand residents, hold direct control interests in a foreign company, Fco2. A also holds direct control interests in another foreign company, Fco1. Fco2 holds direct control interests in Fco1.

(ii) All control interests are calculated on a measurement day basis. On the 30 June 1990 measurement day A holds direct control interests in Fco1 of 25 percent in each category of control interest. A also holds direct control interests in Fco2 of 45 percent in each category of control interest.

(iii) On the 30 June 1990 measurement day B holds direct control interests in Fco2 of 55 percent in each category of control interest. Fco2 holds direct control interests in Fco1 of 30 percent in

each category of control interest. The accounting periods of Fco1 and Fco2 both end on 31 December 1990.

(iv) The facts are illustrated as follows:



Result: (i) The control test is satisfied in relation to Fco2 on the 30 June 1990 measurement day because on that day B, a New Zealand resident, holds control interests of 50 percent or more in at least one of the categories of control interest listed in s.245C(4). The control test would also be satisfied in relation to Fco2 by aggregating the control interests held by A and B in the company on that day. As the control test is satisfied in relation to Fco2 on the 30 June 1990 measurement day, Fco2 is a CFC for its accounting period ending on 31 December 1990.

(ii) By virtue of s.245C(5), the 30 percent direct control interests held by Fco2 in Fco1 on the 30 June 1990 measurement day are deemed to be held by B. This is because in terms of s.245C(5)(a)(ii) B comprises the group of persons that holds a control interest of 50 percent or more in Fco2 and that is the smallest in number. B therefore holds indirect control interests in Fco1 of 30 percent in each category of control interest. B does not hold any direct control interests in Fco1. Thus, in terms of s.245C(3), B holds control interests in Fco2 of 30 percent in each category of control interest on the 30 June 1990 measurement day.

(iii) A holds direct control interests in Fco1 of 25 percent in each category of control interest on the 30 June 1990 measurement day. A does not hold indirect control interests in Fco 1 because Fco2's direct control interests in Fco1 are deemed to be held by B. Therefore, in terms of s.245C(3) A holds control interests in Fco1 of 25 percent in each category of control interest on the 30 June 1990 measurement day.

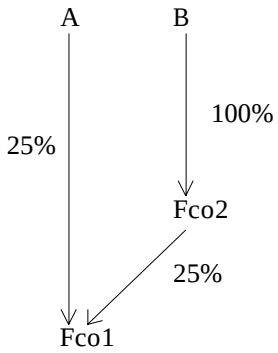
(iv) A and B constitute a group of five or fewer persons resident in New Zealand whose control interests in Fco1 in any category aggregate to 50 percent or more on the 30 June 1990 measurement day: ie 25% + 30% = 55%. As the control test is satisfied in relation to Fco1 on the 30 June 1990 measurement day, Fco1 is a CFC in relation to its accounting period ending on 31 December 1990.

- Example 24

Facts: (i) A, a New Zealand resident, holds direct control interests in a foreign company, Fco1, in each category of control interest. These control interests are calculated on a measurement day basis. On the 30 June 1990 measurement day A holds direct control interests in Fco1 of 25 percent in each category.

(ii) B, a non-resident, is the trustee of a trust settled by A. The trust is not for the benefit of employees of A. On the 30 June 1990 measurement day B holds direct control interests in Fco2, another foreign company, of 100 percent in each category of control interest. These interests are held in B's capacity as trustee of the trust settled by A. Fco2 holds direct control interests in Fco1 of 25 percent in each category of control interest. The accounting periods of Fco1 and Fco2 end on 31 December 1990.

(iii) The facts are illustrated as follows:



Result: (i) A and B are associated persons by virtue of s.245B(i) because B is the trustee of a trust settled by A. The proviso to s.245B(i) does not prevent A and B from being associated because the trust is not for the benefit of employees of A.

(ii) By virtue of s.245C(3), A's control interests in Fco1 and Fco2 are calculated by taking into account the direct and indirect control interests held by B in those companies. Therefore, on the 30 June 1990 measurement day A holds control interests in Fco2 of 100 percent in each category of control interest. As the control test is satisfied in relation to Fco2 on the 30 June 1990 measurement day Fco2, is a CFC in relation to its ac-

counting period ending on 31 December 1990.

(iii) By virtue of s.245C(5), B holds indirect control interests in Fco1 of 25 percent in each category of control interest on the 30 June 1990 measurement day. These indirect control interests are deemed to be held by A for the purposes of calculating A's control interests in Fco1. A's control interest in each category of control interest in Fco1 on the 30 June 1990 measurement day is therefore the aggregate of A's direct control interest in that company and the indirect control interest held by A's associate, B: ie 25% + 25% = 50%. The control test is satisfied in relation to Fco1 on the 30 June 1990 measurement day because a resident, A, holds a control interest in at least one category of control interest of 50 percent or more in Fco1 on that day. Therefore, Fco1 is a CFC in relation to its accounting period ending on 31 December 1990.

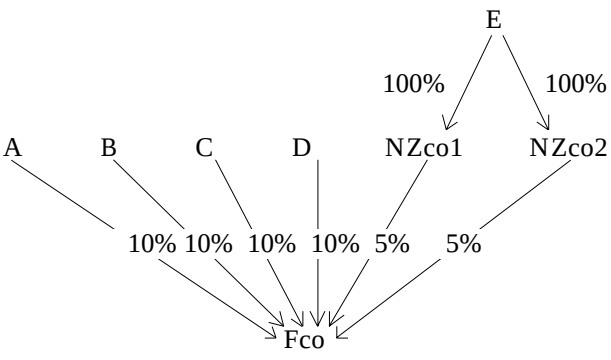
- Example 25

Facts: (i) Four New Zealand residents, A, B, C and D, each hold direct control interests in a foreign company, Fco. These interests are calculated on a measurement day basis. On the 30 June 1990 measurement day A, B, C and D each hold direct control interests in Fco of 10 percent in each category of control interest. On the 30 June 1990 measurement day two New Zealand resident companies, NZco1 and NZco2, each hold direct control interests in Fco of 5 percent in each category of control interest. Fco's accounting period ends on 31 December 1991.

(ii) On the 30 June 1990 measurement day E, a New Zealand resident, holds shares in both NZco1 and NZco2 that constitute 100 percent of the paid-up capital and nominal capital of each company.

(iii) There are no relationships existing between A, B, C, D or E that would result in any of them being associated in terms of any of the rules set out in s.245B.

(iv) The facts are illustrated as follows:



Result: (i) If the control interests held by A, B, C, D, NZco1 and NZco2 are taken into account alone, the control test would not be satisfied in relation to Fco on the 30 June 1990 measurement day. This is because on that day there would be no group of five or fewer persons resident in New Zealand whose control interests in any category aggregate to 50 percent or more. The control interests of A, B, C, D, NZco1 and NZco2 would aggregate to 50 percent but there would be six residents in this group rather than the required five.

(ii) By virtue of E's shareholding in NZco1 and NZco2, those companies are associated under all of the provisions contained in s.245B(a). By s.245C(3), NZco1's control interests in Fco on the 30 June 1990 measurement day are therefore calculated as the aggregate of the 5 percent direct control interests held by NZco1 and the 5 percent direct control interests held by NZco2. NZco1 thus holds control interests in Fco of 10 percent in each category on the 30 June 1990 measurement day.

(iii) The control test is therefore satisfied in relation to Fco on the 30 June 1990 measurement day because a group of five or fewer residents, A, B, C, D, and NZco1, hold control interests in any category of 50 percent on that day: ie the aggregate 40 percent held by A, B, C, and D and the 10 percent held by NZco1. Therefore, Fco is a CFC in relation to its accounting period ending on 31 December 1990.

(iv) The same result could be arrived at by aggregating the 10 percent control interests held by NZco2 (ie the 5 percent direct control interests held by NZco2 and the 5 percent direct control interests held by NZco1 as an associate of NZco2) in each category with the control interests held by A, B, C and D.

Direct control interests: s.245C(4)

Significance and description

5.31 Section 245C(4) sets out the rules for calculating direct control interests. Direct control interests held by a person are taken into account in calculating the person's control interests in terms of s.245C(3). Also, direct control interests are taken into account in calculating "qualified control interests" under s.245C(6). In turn, qualified control interests are taken into account in calculating indirect control interests under s.245C(4). The calculation of direct control interests under s.245C(4) is therefore central to the calculation of control interests under s.245C(3), that in turn being central to the question of whether a foreign company is a CFC.

5.32 Section 245C(4) provides that a person holds direct control interests in a foreign company at any time equal to each percentage of five listed things that the person holds or is entitled to acquire at that time. The listed things are:

(a) the percentage of the total paid-up capital of the foreign company;

(b) the percentage of the total nominal capital of the foreign company;

(c) the percentage of the total rights to vote or participate in any decision making concerning distributions to be made, the constitution of the foreign company, any variation in the capital of the foreign company, or the appointment or election of directors;

(d) the percentage of the income of the foreign company for the accounting period that the person would be entitled to receive or to have dealt with in that person's interest or on that person's behalf if the income were distributed on the last day of the accounting period, and the entitlement of the person to receive income, or to have it dealt with, were the same at all other times during the accounting period;

(e) the percentage of the value of the net assets of the foreign company that the person would be entitled to receive if all the assets of the company were distributed.

Rationale for different categories of interest

5.33 Five different categories of interest are taken into account in calculating direct control interests, and therefore in calculating control interests and in applying the control test in s.245C(1), to limit opportunities for avoiding the control test by creating several different categories of interest in a foreign company with different rights attached to each interest. A control test that simply focused on the percentage of the shares held by a person would not work because shares could be created that constituted a small percentage of the total number of shares in the company but which effectively permitted the holder to control the company; for example, because the shares carried the majority of the voting rights in the company.

Calculation of direct control interests

(a) General

5.34 Direct control interests are calculated under s.245C(4) in relation to the percentage of each listed thing that a person holds or is entitled to acquire. In some cases a person may hold interests in each of the listed categories. For example, shares in a company may represent a portion of the paid-up capital and nominal capital of the company, carry voting rights and entitle the holder to distributions of income and assets. In other cases a person may not hold an interest in all of the listed categories. For example, s.245A(2)(c) provides that if a person holds a debenture of the type described in s.192 or s.195 the interest payable on the debenture is treated as a distribution of income for the purposes of s.245C(4). A person holding a debenture of this type will therefore hold an interest in the entitlement to distributions of income category. However, it is unlikely that the debentures would constitute an interest in any of the other listed categories.

5.35 Interests of the type described in s.245C(4) will often arise from the holding of shares in a foreign company. However, s.245C(4) is not limited to interests arising from the holding of shares. First, s.245C(4) provides that a person holds direct control interests in the categories of things that the person holds or is entitled to acquire and in determining whether a person is entitled to acquire any of the listed things a range of instruments, such as options and convertible notes, is taken into account: s.245A(2)(b). Second, debentures of the type described in s.192 and s.195 are taken into account in calculating the direct control interest held by a person in the entitlement to distributions of income category. Third, s.245C(4) is not by its terms limited to interests that arise through the holding of shares in a company.

(b) Paid-up capital and nominal capital

5.36 The first two categories of direct control interest are the percentage of the paid-up capital or nominal capital of the foreign company that the person holds or is entitled to acquire. Nominal capital is the nominal capital of the company authorised in the company's memorandum or articles of association or in any resolution of the company increasing the capital. Paid-up capital is the portion of the nominal capital of the company that is paid-up by the shareholders. For example, assume that a company has share capital of $1 million divided into one million $1 shares and that all of these shares are issued to shareholders. Assume also that these shares are partly paid to the extent of 50 cents per share. In this case, the nominal capital of the company is $1 million. However, because the issued shares are only partly paid to the extent of 50 cents per share, the paid-up capital is only $500,000. If a call is later made for a further 20 cents to be paid in respect of the shares the paid-up capital of the company will increase to $700,000. If shares are issued at a premium, the premium does not represent paid-up capital of the company.

5.37 Nominal capital may be divided into issued capital and unissued capital. For example, a com-

pany may have an authorised capital of $1 million divided into one million $1 shares but it may issue only 600,000 shares. The nominal capital of the company in this case remains the total authorised share capital of the company, whether issued or unissued. In the example the nominal capital of the company would be $1 million. The paid-up capital will be the portion of the issued capital of the company that is paid-up. Thus, if the issued shares are fully paid the company will have paid-up capital of $600,000. However, if the issued shares are partly paid to the extent of 20 cents per share the paid-up capital will be $120,000.

- Example 26

Facts: On the 30 June 1990 measurement day Fco, a foreign company incorporated in Hong Kong, has authorised capital of HK$1 million divided into 1 million HK$1 shares. Fco has issued 500,000 shares and on the 30 June 1990 measurement day A, a New Zealand resident, holds 300,000 of those issued shares. The remaining 200,000 issued shares are held by non-residents. The issued shares are partly paid to the extent of 50 cents per share. Fco's accounting period ends on 31 December 1990.

Result: (i) Fco's nominal capital is HK$1 million. A holds shares which represent 30 percent of Fco's total nominal capital on the 30 June 1990 measurement day. Fco's paid-up capital is HK$250,000: ie 500,000 x 50 cents = HK$250,000. A holds 300,000 of the issued shares on the 30 June 1990 measurement day. These represent HK$150,000 of the total paid-up capital of HK$250,000, or 60 percent of the paid-up capital.

(ii) On the 30 June 1990 measurement day A holds a direct control interest in Fco in the nominal capital category of 30 percent. A also holds a direct control interest in Fco in the paid-up capital category of 60 percent on that day. Assuming that A holds no indirect control interests in Fco, and that no persons associated with A hold direct or indirect control interests in Fco, A has control interests in Fco in the nominal capital category of 30 percent and in the paid-up capital category of 60 percent. The control test is therefore satisfied in relation to Fco on the 30 June 1990 measurement day because A has a control interest in Fco of 50 percent or more in one of the categories of interest listed in s.245C(4) on that day. Consequently, Fco is a CFC in relation to its accounting period ending on 31 December 1990.

(c) Rights to vote or to participate in decision making

5.38 The third category of direct control interest listed in s.245C(4) that a person may hold is the percentage of the total rights to vote or participate in decision making that the person holds or is entitled to acquire concerning:

(i) the distributions to be made by the foreign company (not being decision making undertaken by directors acting only in their capacity as directors); or

(ii) the constitution of the foreign company; or

(iii) any variation in the capital of the foreign company; or

(iv) the appointment or election of directors of the foreign company.

If the percentage of the rights to vote or to participate in decisions that a person holds or is entitled to acquire varies as between these four types of decisions, the person's direct control interest in this category is calculated as the highest percentage of rights to vote or to participate in decisions that the person holds or is entitled to acquire.

5.39 The inclusion of rights to participate in decision making in addition to rights to vote encompasses the situation where, for example, decisions are made by members of the company outside company meetings and these decisions are binding on the company. In these circumstances, the members participate in decision making but they do not exercise voting powers. Rights to participate in decision making, as opposed to voting rights, may also be taken into account where there is no provision in the constitution of the foreign company for the exercise of voting rights but where members participate in decision making in relation to the company. This may be the case in relation to some of the entities that are not companies in the traditional sense but which nevertheless fall withing the s.2 definition of "company".

5.40 The percentage of the rights to vote or participate in decision making that a person holds or is entitled to acquire may differ from the percentage of the interests held by the person in the other categories if, for example, the company issues different classes of shares with different rights attached. This is illustrated in the following example:

- Example 27

Facts: (i) Fco, a foreign company incorporated in the Cook Islands, has authorised capital of $1 million divided into one million $1 shares. Fco has issued 500,000 shares. This issued capital is divided into 100,000 ordinary voting shares and 400,000 non-voting preference shares. The ordinary shares carry one vote per share at any

meeting of Fco. The issued shares are fully paid. Fco's accounting period ends on 31 December 1990.

(ii) On the 30 June 1990 measurement day the ordinary shares are held by A, a New Zealand resident. The preference shares are held by a non-resident, B.

Result: (i) A holds $100,000 of the total nominal capital of Fco of $1 million on the 30 June 1990 measurement day. A therefore holds a direct control interest of 10 percent in the nominal capital category on that day.

(ii) A holds $100,000 of the paid-up capital of Fco of $500,000 on the 30 June 1990 measurement day. A therefore holds a direct control interest of 20 percent in the paid-up capital category on that day.

(iii) A holds all of the voting rights in relation to Fco on the 30 June 1990 measurement day. A therefore holds a direct control interest in the voting rights category of 100 percent on that day. By s.245C(3), A holds a control interest in the voting rights category of 100 percent. The control test is therefore satisfied in relation to Fco on the 30 June 1990 measurement day because a New Zealand resident, A, holds a control interest in one of the categories listed in s.245C(4) of 50 percent or more on that day. Consequently, Fco is a CFC in relation to its accounting period ending on 31 December 1990.

(d) Distributions of income

5.41 The fourth category of direct control interest that a person may hold or be entitled to acquire at any time is the percentage of the income of the foreign company that the person is entitled to receive by way of distribution. The percentage entitlement to distributions that a person is entitled to at any time is calculated as the portion of the income of the company for the accounting period in which that time falls that the person would be entitled to receive, or to have dealt with in that person's interest or on that person's behalf, if that income were distributed on the last day of the accounting period and the person's entitlement to receive income or to have it dealt with were the same at all other times during the accounting period.

5.42 A direct control interest in this category is therefore calculated by:

(i) establishing the interest held by the person at the time at which it is necessary to calculate the person's entitlement to a distribution of income;

(ii) assuming that the interest held by the person at the relevant time is held by the person at the end of the accounting period of the foreign company; and

(iii) establishing the percentage of the income of the foreign company for the relevant accounting period that the person would be entitled to receive in respect of the interest deemed to be held on the final day of the foreign company's accounting period if all of the company's income for that period were distributed on that day.

5.43 This process is repeated for every day in respect of which it is necessary to calculate the person's direct control interests. If the person calculates control interests on a measurement day basis pursuant to s.245A(2)(e), it will be necessary to make the calculation in respect of the measurement days that establish the control interests held by the person during the accounting period of the foreign company.

- Example 28

Facts: (i) The accounting period of Fco, a foreign company incorporated in Hong Kong, ends on 31 May 1991. A, a New Zealand resident, holds shares in Fco during that accounting period. A calculates control interests in Fco on a measurement day basis. Fco earns income of HK$1 million during its accounting period ending on 31 May 1991 and HK$1.5 million during its accounting period ending on 31 May 1992.

(ii) The number of shares held by A on the measurement days that are relevant for the purposes of Fco's accounting period ending on 31 May 1991, and the amount and percentage of Fco's income that this shareholding would entitle A to receive by way of distribution if the shares held by A on the measurement day in question were held at the end of Fco's accounting period, are illustrated in the following table. It is assumed that A is the only person resident in New Zealand who holds an interest in Fco.

Measurement day	30/6/90	30/9/90	31/12/90	31/3/91	30/6/91
Shares held (millions)	1	1.5	3	5.5	5.5
Entitlement to distribution if shares held at end of accounting period (HK$ 000)	100	150	300	550	825
Percentage of Fco's income that shares held on measurement day would entitle A to receive if shares held at end of Fco's accounting period	10	15	30	55	55

Result: (i) If the one million shares held by A on the 30 June 1990 measurement day were held by A on 31 May 1991, the end of Fco's accounting period, A would be entitled to a distribution of HK$100,000 if all of Fco's income were distributed on 31 May 1991. This would represent 10 percent of Fco's income. A thus holds a direct control interest in the entitlement to distributions of income category of 10 percent on 30 June 1990, and on each day preceding that date that falls after 31 March 1990: s.245A(2)(e).

(ii) By the same process, A holds a direct control interest in the entitlement to distributions of income category of 15 percent on the 30 September 1990 measurement day, 30 percent on the 31 December 1990 measurement day and 55 percent on the 31 March 1991 measurement day. The 30 June 1991 measurement day is relevant because pursuant to s.245A(2)(e) the control interests held by A on that day are deemed to be held on that day and on each day preceding that day that falls after the 31 March 1991 measurement day. Therefore, the control interests held by A on 30 June 1991 will be deemed to be held by A on the days falling on and between 1 April 1991 and 31 May 1991, the end of Fco's accounting period.

(iii) A holds a control interest in the entitlement to distributions of income category of 55 percent on 31 March 1991 and on each day in the three month period preceding that date. Fco is therefore a CFC in relation to its accounting period ending on 31 May 1991 because on the 31 March 1991 measurement day a person resident in New Zealand, A, holds a control interest in the entitlement to distributions of income category of 50 percent or more.

5.44 In applying s.245C(4)(d), interest payable on debentures to which s.192 or s.195 of the Income Tax Act would apply is treated as a distribution of income: s.245A(2)(c). In the context of s.245C(4)(d) this means that the amount of the income of a foreign company that a person would be entitled to receive or to have dealt with at the end of the company's accounting period is calculated by treating interest payable on a debenture described in s.192 or s.195 as income of the company that would be distributed to the person.

(e) Distributions of assets: s.245C(4)(e)

5.45 The fifth category of interest taken into account in calculating direct control interests held by a person in a foreign company is the percentage of the value of the net assets of the foreign company that the person would be entitled to receive, or to have dealt with in the person's interest or on the person's behalf, if all the assets of the company were distributed at that time, whether on the winding up of the company or otherwise.

5.46 The reference to "net assets" means the residue of assets after liabilities have been discharged. The focus is therefore on assets that shareholders would receive if all of the assets of the company were distributed because shareholders would receive the net assets after liabilities had been discharged.

5.47 Section 245C(4)(e) is applied on the particular day that it is necessary to calculate direct control interests. For example, if direct control interests are calculated on the 30 June 1990 measurement day it is assumed that the net assets of the company are distributed on that day and the person's direct control interest in the s.245C(4)(e) category is the percentage of the net assets that the person would receive or have dealt with in the person's interest in the event of such a hypothetical distribution on that day. This contrasts with s.245C(4) which is applied at the end of the accounting period of the foreign company on the basis of the interest held by the person on the day in relation to which the control interest is calculated.

5.48 Rights to distributions of assets on wind up may differ between different classes of shareholder. Also, the priority of entitlements to distributions may differ between different classes of shareholder. These different priorities may affect the percentage of the net assets of the foreign company that a person would be entitled to receive at a particular time.

5.49 The quantum of the distribution that a person would be entitled to is determined on the assumption that the company is wound up or all of the assets of the company are otherwise distributed. The focus is therefore on the person's rights to distributions on wind up or in other circumstances where it may be necessary to distribute all of the company's assets.

Indirect control interests: s.245C(5) and (6)

Overview

5.50 Section 245C(5) sets out the rules for calculating indirect control interests in a foreign company. Indirect control interests held by a person and by associated persons in each category of control interest are aggregated with direct control interests held by the person and by associated persons in each category: s.245C(3). The aggregate percentage in each category constitutes the person's control interest in that category. Control interests are then taken into account in determining whether a foreign company is a CFC in terms of s.245C(1).

5.51 Indirect control interests arise where a CFC, referred to as a "first tier CFC", holds "qualified

control interests" in another foreign company, referred to as an "underlying foreign company". In these circumstances, the qualified control interests are allocated to persons holding control interests in the first tier CFC in accordance with the rules set out in s.245C(5)(a). The persons to whom the qualified control interests are thus allocated have indirect control interests in the underlying foreign company in each of the categories of interest allocated to them. "Qualified control interests" are defined in s.245C(6) as being direct control interests held by the first tier CFC, and by persons associated with the first tier CFC, in the underlying foreign company. By s.245C(5)(b), indirect control interests down a chain of CFCs are calculated by applying the rules set out in s.245C(5)(a).

Description of rules

5.52 Section 245C(5)(a) provides that where a first tier CFC at any time has qualified control interests in an underlying foreign company in any of the categories of control interest listed in s.245C(4), those qualified control interests are deemed to be held at that time by persons holding control interests in the first tier CFC in accordance with a series of rules that are applied sequentially. The rules provide that qualified control interests held by a first tier CFC in another foreign company are deemed to be held as follows:

(i) if there is only one group of five or fewer persons resident in New Zealand whose control interest, or the aggregate of whose control interests, in the first tier CFC is equal to or greater than 50 percent, the qualified control interests are held by that group;

(ii) if there is more than one group of persons whose control interest in the first tier CFC is equal to or greater than 50 percent, the qualified control interests are held by the group of persons that is smallest in number;

(iii) if there is more than one such group of persons that is smallest in number, the qualified control interests are held by the group whose control interest, or the aggregate of whose control interests, in the first tier CFC is highest;

(iv) if there is more than one group that is smallest in number and that has the highest control interest in the first tier CFC, the qualified control interests are allocated in full to each of the groups. However, if the application of this rule results in any direct control interest, or any part of such an interest, being counted more than once in relation to any group of five or fewer persons the direct control interest is counted only once in relation to that group.

5.53 If there is more than one person in any of the groups to which qualified control interests are allocated under any of these rules, the qualified control interests are deemed to be held by each member of the group pro rata to the member's income interest in the first tier CFC. The qualified control interests that a person is deemed to hold in accordance with these rules constitute indirect control interests held by the person in the underlying foreign company. These indirect control interests are aggregated on a category by category basis with any direct control interests held by the person in the underlying foreign company, and with any direct and indirect control interests held by any persons associated with the person, to calculate the person's control interests in the underlying foreign company. The control test set out in s.245C(1) is then applied to determine whether the underlying foreign company is a CFC.

5.54 If an underlying foreign company is a CFC that has qualified control interests in another foreign company the rules set out in s.245C(5)(a) are applied on the basis of the underlying foreign company being the first tier CFC. This rule applies down any chain of CFCs.

Allocation of qualified control interests

(a) Allocation of all qualified control interests

5.55 Section 245C(6) provides that the "qualified control interests" at any time of a first tier CFC in an underlying foreign company comprise any direct control interests held at that time by the first tier CFC, or by persons associated with the first tier CFC, in the underlying foreign company. These qualified control interests are allocated in full to persons who hold control interests in the first tier CFC in accordance with the rules in s.245C(5). The group of persons to which the qualified control interests are allocated under s.245C(5) are deemed to hold all of those interests. Thus, allocation is not made by matching categories of interests held in the first tier CFC with categories held by the first tier CFC in the underlying foreign company.

5.56 For example, assume that a first tier CFC holds qualified control interests in an underlying foreign company in each of the categories listed in s.245C(4) except the voting rights category. Assume further that NZco is the only person resident in New Zealand holding control interests in the CFC and that these interests are 55 percent in the voting rights category and 25 percent in the other categories. In terms of s.245C(5)(a)(i), NZco constitutes a group of five or fewer persons resident in New Zealand whose control interest in the first tier CFC is equal to or greater than 50 percent: ie the control interest in the voting rights category is 55 percent. The qualified control interests in each category held by the first tier

CFC in the underlying foreign company are therefore deemed to be held by NZco. That is, by virtue of holding a control interest of 55 percent in the voting rights category, NZco is deemed to hold all categories of qualified control interests held by the first tier CFC in the underlying foreign company.

(b) Allocation to persons with control interests

5.57 Qualified control interests held by a first tier CFC in an underlying foreign company are allocated to groups of five or fewer residents who hold control interests in the first tier CFC. In calculating the control interests of a group of five or fewer residents in the first tier CFC, direct and indirect control interests held by more than five persons may be taken into account if persons associated with members of the group of five or fewer persons hold direct or indirect control interests in the company.

5.58 For example, assume that four New Zealand residents each hold a direct control interest in a foreign company of 12 percent in the voting interest category and that two non-residents each hold a direct control interest in the company of 5 percent in the voting interests category. If the non-residents are associated with any of the four residents, their direct control interests are taken into account in calculating the control interests of the residents. Thus, although direct control interests held by six persons are taken into account the four residents will constitute a group of five or fewer persons whose control interest in any category is equal to or greater than 50 percent.

Allocation to individual members of a group of persons

5.59 The concluding language of s.245C(5)(a) provides that if there is more than one person in any of the groups of persons that are deemed to hold qualified control interests in a foreign company by virtue of that provision, those qualified control interests are held by each person in the group pro rata to the person's "income interest" in the first tier CFC.

5.60 Income interests are calculated in accordance with s.245D. That section is discussed in Part 6 of this bulletin.

Rule (i): allocation where one group of five or fewer persons

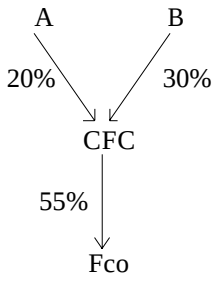
5.61 The first rule set out in s.245C(5)(a) is that if there is only one group of five or fewer persons resident in New Zealand whose control interest, or the aggregate of whose control interests, in the first tier CFC is equal to or greater than 50 percent, the qualified control interests held by the CFC in an underlying foreign company are deemed to be held by that group. In terms of the concluding language of s.245C(5)(a), if there is more than one person in the group the qualified control interests are held by the persons in the group pro rata to their income interests in the first tier CFC.

- Example 29

Facts: (i) Two New Zealand residents, A and B, each hold control interests in CFC, a controlled foreign company. No other residents hold control interests in CFC. A and B calculate their control interests in CFC on a measurement day basis in accordance with s.245A(2)(e).

(ii) On the 30 September 1990 measurement day A holds control interests in CFC of 20 percent in each category of control interest listed in s.245C(4) and B holds control interests of 30 percent in each category. Also, CFC holds qualified control interests in a foreign company, Fco, of 55 percent in each category of interest. A and B calculate their control interests in Fco on a measurement day basis. Fco's accounting period ends on 31 December 1990.

(iii) interests held on 30 September 1990 are illustrated as follows:



Result: (i) A and B are the only group of five or fewer New Zealand residents who hold a control interest in CFC, the first tier CFC, in terms of s.245C(5)(a). Therefore, the qualified control interests held by CFC in Fco are deemed to be held by A and B.

(ii) CFC holds qualified control interests in Fco of 55 percent in each category of control interest. By virtue of s.245C(5)(a), these are deemed to be held by A and B pro rata to their income interests in CFC. A holds an income interest of 20 percent in CFC and B holds an income interest of 30 percent. Therefore, the qualified control interests held by CFC in Fco are allocated to A and B as follows:

- allocation to A

$$55\% \times \frac{20}{50} = 22\%$$

- allocation to B

$$55\% \times \frac{30}{50} = 33\%$$

(iii) Therefore, on the 30 September 1990 measurement day A holds indirect control interests in Fco in each category of control interest of 22 percent and B holds indirect control interests of 33 percent. Assuming that A and B do not hold direct control interests in Fco, and that no person associated with A or B holds direct or indirect control interests in Fco, the control interests held by A and B in Fco in each category are 22 percent and 33 percent respectively. The control test is satisfied in relation to Fco on the 30 September 1990 measurement day because a group of five or fewer New Zealand residents holds control interests in Fco in any category of 50 percent or more on that day. Consequently, Fco is a CFC in relation to its accounting period ending on 31 December 1990.

Rule (ii): Allocation where more than one group of five or fewer persons

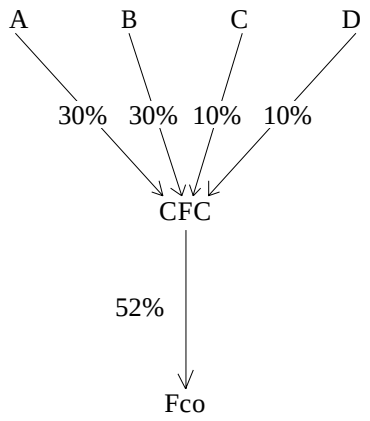
5.62 Section 245C(5)(a)(ii) provides that if there is more than one group of persons that holds a control interest in the first tier CFC the qualified control interests held by that CFC in an underlying foreign company are deemed to be held by the group of persons holding a control interest in the first tier CFC that is smallest in number.

- Example 30

Facts: (i) Four New Zealand residents, A, B, C and D, hold control interests in CFC, a controlled foreign company. These interests are calculated on a measurement day basis in accordance with s.245A(2)(e). On the 30 June 1990 measurement day A and B each hold control interests in each category of control interest of 30 percent and C and D each hold control interests in each category of 10 percent. No other resident holds control interests in CFC on that day.

(ii) On the 30 June 1990 measurement day CFC holds qualified control interests in Fco, a foreign company, of 52 percent in the paid-up capital, nominal capital, and rights to distributions of income and assets categories. CFC does not hold a qualified control interest in Fco in the voting interests category. A, B, C and D calculate control interests in Fco on a measurement day basis. Fco's accounting period ends on 31 December 1990.

(iii) The interests held on 30 June 1990 are as follows:



Result: (i) The groups of residents holding a control interest in CFC of 50 percent or more on 30 June 1990 are:

Members of group	Aggregate control interest * %
A, B	60
A, C, D	50
B, C, D	50
A, B, C	70
A, B, D	70
A, B, C, D	80

* The control interests held by A, B, C and D in CFC are the same in each category. Therefore, the amounts indicated are the same in each category of control interest.

(ii) Section 245C(5)(a)(i) does not apply because there is more than one group of five or fewer residents who hold a control interest in CFC of 50 percent or more.

(iii) Therefore, s.245C(5)(a)(ii) applies and the qualified control interests held by CFC in Fco are deemed to be held by the group of persons holding a control interest in CFC that is smallest in number. A and B constitute the group of persons holding a control interest in CFC that is smallest in number.

(iv) CFC holds qualified control interests in Fco in each category of interest except the voting rights category. Therefore, A and B are deemed to hold indirect control interests in Fco in each category of interest except the voting interests category. The qualified control interests are held by A and B pro rata to their income interest in CFC. A and B each have a 30 percent income interest in CFC. Therefore, the qualified control interests are deemed to be held equally by A and B so that each holds indirect control interests in Fco of 26 percent in each category of interest except the voting rights category.

(v) Assuming that neither A nor B holds direct control interests in Fco, and that persons associated with A and B do not hold direct or indirect control interests in Fco, A and B each hold control interests in Fco of 26 percent in every category of interest except the voting rights category. The control test is therefore satisfied in relation to Fco on the 30 June 1990 measurement day because a group of five or fewer residents, A and B, hold control interests in any category of 50 percent or more on that day. Consequently, Fco is a CFC in relation to its accounting period ending on 31 December 1990.

(vi) C and D do not hold indirect control interests in Fco by virtue of their direct control interests in CFC because the 52 percent qualified control interests held by CFC in Fco are allocated in full to A and B.

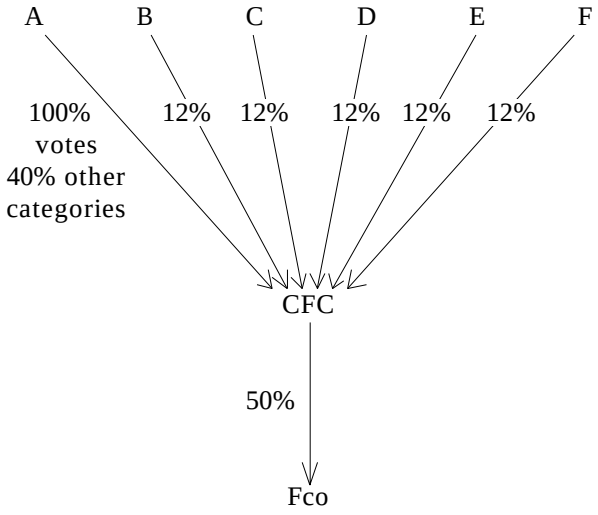
- Example 31

Facts: (i) Six New Zealand residents, A, B, C, D, E and F, hold control interests in CFC, a controlled foreign company. These interests are calculated on a measurement day basis in accordance with s.245A(2)(e).

(ii) On the 30 June 1990 measurement day A holds a control interest in CFC in the voting rights category of 100 percent and in the other categories of 40 percent. B, C, D, E and F hold non-voting preference shares issued by CFC. The shares held by each of B, C, D, E and F constitute 12 percent of the nominal capital and paid-up capital and constitute a control interest of 10 percent in the rights to distributions of income and assets categories. There are no associated persons relationships between A, B, C, D, E or F.

(iii) On the 30 June 1990 measurement day CFC holds qualified control interests in another foreign company, Fco, of 50 percent in each category of control interest. Fco's accounting period ends on 31 December 1990.

(iv) The interests held in CFC and Fco are illustrated as follows:



where the 12 percent held by each of B, C, D, E and F is in each category of control interest except the voting rights category.

Result: (i) The groups of five or fewer persons resident in New Zealand that hold a control interest of 50 percent or more in CFC are:

Members of group	Aggregate control interest	
	Voting rights	Other categories*
	%	%
A	100	40
A,B	-	52
A,C	-	52
A,D	-	52
A,E	-	52
A,F	-	52
A,B,C	-	64
A,B,D	-	64
A,B,E	-	64
A,B,F	-	64
A,C,D	-	64
A,C,E	-	64
A,C,F	-	64
A,D,E	-	64
A,D,F	-	64
A,E,F	-	64
A,B,C,D	-	76
A,B,C,E	-	76
A,B,C,F	-	76
A,B,D,E	-	76
A,B,D,F	-	76
A,C,D,E	-	76
A,C,D,F	-	76
A,D,E,F	-	76
A,B,C,D,E	-	88
A,B,C,D,F	-	88
A,B,C,E,F	-	88
A,C,D,E,F	-	88
B,C,D,E,F	-	60

* These figures represent the percentage interest held by the group members in each category of interest other than the voting rights category.

(ii) Section 245C(5)(a)(i) does not apply as there is more than one group of five or fewer persons resident in New Zealand that holds a control interest in CFC of 50 percent or more. Therefore, by virtue of s.245C(a)(ii) the qualified control interests held by CFC in Fco are held by the group of persons holding a control interest of 50 percent or more that is smallest in number. The smallest group is A.

(iii) A is deemed to hold the qualified control interests held by CFC in Fco. A therefore holds indirect control interests of 50 percent in Fco in each category of control interest. B, C, D, E and F do not hold indirect control interests in Fco, notwithstanding their direct control interests in CFC. Assuming that A does not hold a direct control interest in Fco, and that no person associated with A holds a direct or indirect control interest in Fco, A holds control interests of 50 percent in Fco in each category of control interest on the 30 June 1990 measurement day. As the control test is satisfied on the 30 June 1990 measurement day, Fco is a CFC in relation to its accounting period ending 31 December 1990.

(iv) The effect of s.245C(5)(a)(ii) in this case is to prevent a dilution of the qualified control interests held by CFC in Fco. Such a dilution would occur if those control interests were allocated to A, B, C, D, E and F. The result the dilution might be that Fco would not be classified as a CFC because although a group of residents held control interests in Fco of 50 percent there might be more than 5 persons in the group. Section 245C(5)(a)(ii) prevents this from happening by deeming all of the qualified control interests in Fco to be held by A.

Rule (iii): Allocation to group with highest control interest

5.64 Section 245C(5)(a)(iii) applies where s.245C(5)(a)(ii) does not result in an allocation of qualified control interests because there is more than one group of five or fewer residents that is smallest in number that holds a control interest in the first tier CFC of 50 percent or more. In these circumstances, the qualified control interests are deemed to be held by the group whose control interest or control interests in the first tier CFC is highest.

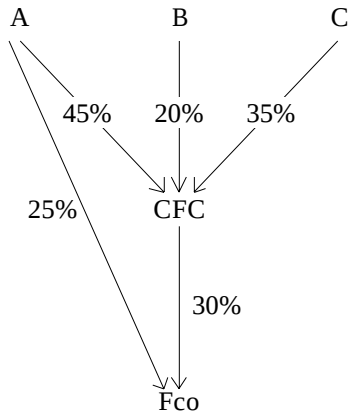
- Example 32

Facts: (i) Three New Zealand residents, A, B and C, hold control interests in CFC, a controlled foreign company. These interests are calculated on a measurement day basis in accordance with s.245A(2)(e).

(ii) On the 30 September 1990 measurement day A holds control interests in CFC of 45 percent in each category, B holds control interests of 20 percent in each category and C holds control interests of 35 percent in each category. There are no associated persons relationships between A, B and C.

(iii) On the 30 September 1990 measurement day CFC holds qualified control interests in Fco, a foreign company, of 30 percent in each category of control interest. A holds direct control interests in Fco of 25 percent in each category of control interest. Fco's accounting period ends on 31 December 1990.

(iv) The interests held in CFC and Fco are illustrated as follows:



Result: (i) The groups of five or fewer residents holding a control interest of 50 percent or more in CFC on the 30 September 1990 measurement day are:

Members of group	Aggregate control interest*
	%
A,B	65
A,C	80
B,C	55
A,B,C	100

* The listed groups have control interests in each of the five categories of control interest. The control interests are listed only once because on the facts the percentage interests are the same in each category.

(ii) The qualified control interests are not allocated in accordance with s.245C(5)(a)(i) because there is more than one group of five or fewer residents that holds a control interest in CFC of 50 percent or more. Also, there are three groups (A,B; A,C; and B,C) that are smallest in number. Therefore, the qualified control interests are not allocated in accordance with s.245C(5)(a)(ii).

(iii) As there is more than one group holding a control interest in CFC that is smallest in number, the qualified control interests held by CFC in Fco are allocated in accordance with

s.245C(5)(a)(iii). The group of residents that is smallest in number and that holds the highest control interest in CFC on the 30 September 1990 measurement day is A and C. A and C are therefore deemed to hold the 30 percent qualified control interests held by CFC in Fco. These interests are held by A and C pro rata to their income interests in CFC. A holds a 45 percent income interest in CFC and C holds a 35 percent income interest. The qualified control interests are therefore deemed to be held as follows:

- interests held by A

$$30\% \times \frac{45\%}{80\%} = 16.87\%$$

- interests held by C

$$30\% \times \frac{35\%}{80\%} = 13.13\%$$

(iv) A holds an indirect control interest in Fco of 16.87 percent in each category of interest and C holds indirect control interests of 13.13 percent in Fco on the 30 September 1990 measurement day. A also holds direct control interests in Fco of 25 percent in each category of control interest on that day. A therefore holds control interests in Fco of 41.87 percent in each category of control interest: ie the aggregate of the direct and indirect control interests. C holds a control interest of 13.13 percent in Fco.

(v) The control test is satisfied in relation to Fco on the 30 September 1990 measurement day because a group of five or fewer residents, A and C, holds control interests in Fco in at least one of the categories of control interest listed in s.245C(4) of 50 percent or more on that day: ie 41.87% + 13.13% = 55%. Consequently, Fco is a CFC in relation to its accounting period ending on 31 December 1990.

Rule (iv): Allocation to each group in full

5.66 Section 245C(5)(a)(iv) applies where s.245C(5)(a)(i) to (iii) do not apply because there is more than one group of five or fewer residents whose control interest in any category is more than 50 percent, which is smallest in number and which has the highest control interest. In these circumstances, s.245C(5)(a)(iv) provides that the qualified control interests held by the first tier CFC in the underlying foreign company are allocated in full to each of the groups. By the proviso to s.245C(5)(a)(iv), if the application of s.245C(5)(a)(iv) would result in any direct control interest being counted more than once in relation to a group of residents that control interest is counted only once.

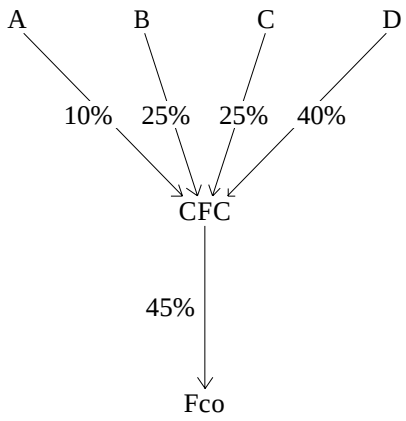
5.67 The proviso applies where the effect of s.245C(5)(a)(iv) is that any "direct control interest", or any part thereof, is counted twice. The effect of s.245C(5)(a)(iv) is to allocate qualified control interests as defined in s.245C(6). Qualified control interests consist of direct control interests held by a CFC and by persons associated with a CFC. Thus, the allocation of qualified control interests in full to more than one group may result in double counting of the direct control interests that make up the qualified control interests. Where this is the case the proviso requires that the direct control interest be counted only once in relation to any group of five or fewer persons. This does not mean that the direct control interests may not be counted more than once in relation to different groups of persons. For example, if a resident to whom qualified control interests in an underlying foreign company are allocated under s.245C(5)(a)(iv) is a member of several groups of persons holding control interests in the underlying foreign company, the qualified control interests may be counted in relation to each group but they may not be counted more than once within the same group.

- Example 33

Facts: (i) Four New Zealand residents, A, B, C and D, hold control interests in CFC, a controlled foreign company. A, B, C and D calculate their control interests in CFC on a measurement day basis in accordance with s.245A(2)(e). On the 31 December 1990 measurement day A holds control interests in CFC of 10 percent in each category of control interest, B and C hold control interests of 25 percent in each category, and D holds control interests of 40 percent in each category. There are no associated persons relationships between A, B, C and D.

(ii) On the 31 December 1990 measurement day CFC holds qualified control interests in Fco, a foreign company, of 45 percent in each category of control interest. A, B, C and D calculate their control interests in Fco on a measurement day basis. The accounting period of Fco ends on 31 December 1990.

(iii) The interests held in CFC and Fco are illustrated as follows:



Result: (i) The groups of five or fewer residents holding a control interest of 50 percent or more in CFC on the 31 December 1990 measurement day are:

Members of group	Aggregate control interest* %
A,D	50
B,C	50
B,D	65
C,D	65
A,B,C	60
A,C,D	75
A,B,D	75
B,C,D	90
A,B,C,D	100

* The listed groups have control interests in each of the five categories of control interest. The control interests are listed only once because on the facts the percentage interests are the same in each category.

(ii) The qualified control interests cannot be allocated under s.245C(5)(a)(i) because there is more than one group of five or fewer residents whose control interest in CFC is 50 percent or more. The qualified control interests cannot be allocated under s.245C(5)(a)(ii) because there are four groups that are the smallest in number: ie A,D; B,C; B,D; and C,D. Section 245C(5)(a)(iii) does not allocate the qualified control interests because there are two of the groups that are smallest in number and that have the highest control interest: ie B,D; and C,D. Therefore, s.245C(5)(a)(iv) applies and the qualified control interests are allocated to both groups in full.

(iii) The qualified control interests are deemed to be held by the members of the two groups pro rata to their income interests in CFC on the 31 December 1990 measurement day. B holds a 25 percent income interest in CFC and D holds a 40 percent income interest in CFC. The 45 percent qualified control interests allocated to B and D are held as follows:

- allocation to B

$$45\% \times \frac{25\%}{65\%} = 17.31\%$$

- allocation to D

$$45\% \times \frac{40\%}{65\%} = 27.69\%$$

The qualified control interests are also allocated to C and D in full pro rata to their income interests in CFC. C holds a 25 percent income interest in CFC and D holds a 40 percent income interest. Therefore, the 45 percent qualified control interests are allocated to C to the extent of 17.31 percent with the remaining 27.69 percent being allocated to D.

(iv) The qualified control interests allocated to B, C and D under s.245C(5)(a)(iv) are indirect control interests. B and C each hold indirect control interests in each category of 17.31 percent on the 31 December 1990 measurement day. D holds indirect control interests in each category of 55.38 percent on that day. Assuming that B, C and D do not hold direct control interests in Fco, and that no persons associated with B, C and D hold direct or indirect control interests in Fco, B and C each hold control interests in Fco of 17.31 percent in each category, and D holds control interests in Fco of 55.38 percent in each category, on the 31 December 1990 measurement day.

(v) Fco is a CFC in relation to its accounting period ending on 31 December 1990 if any group of five or fewer residents holds control interests of 50 percent or more in Fco in any category of control interest at any time in that period. There are four groups that have an aggregate control interest in Fco of 50 percent or more on the 31 December 1990 measurement day:

Members of group	Aggregate control interests %
D	55.38
C,D	72.69
B,D	72.69
B,C,D	90.00

(vi) However, in calculating the aggregate control interests of these groups there has been double counting of the direct control interests held by CFC in Fco. The double counting arises, and is dealt with by the proviso to s.245C(5)(a)(iv), as follows:

(A) Group comprising D

In this case the direct control interest held by CFC in Fco in each category of control interest has been counted twice to the extent of 27.69 percent. This double counting arises because D is a member of both groups to which the direct control interests held by CFC in Fco are allocated in full by virtue of s.245C(5)(a)(iv). D's pro rata share of the direct control interests held by CFC in Fco is therefore counted twice.

The effect of the proviso to s.245C(5)(a)(iv) is that in determining whether D constitutes a group of five or fewer persons whose control interest in Fco in any category is 50 percent or more the portion of the direct control interests held by CFC in Fco that would be counted more than once in relation to D by virtue of s.245C(5)(a)(iv) is counted only once. The result is that D holds control interests of 27.69 percent in Fco in each category of interest. D therefore does not hold a control interest in any category of 50 percent or more.

(B) Group comprising C and D

Double counting arises again in relation to this group because D is taken to hold control interests in Fco of 55.38 percent in each category of interest. In calculating D's control interests in Fco double counting arises because D's pro rata share of the direct control interests held by CFC in Fco are counted twice by virtue of D being a member of both groups to which those direct control interests are allocated under s.245C(5)(a)(iv).

The effect of the proviso to s.245C(5)(a)(iv) is that in determining whether C and D constitute a group of five or fewer residents whose control interests in Fco in any category are 50 percent or more, the 27.69 percent indirect control interests held by D in Fco which would be counted twice in relation to D are counted only once. The aggregate control interests held by C and D in each category are therefore 45 percent. Consequently, C and D do not constitute a group of five or fewer residents whose control interests in Fco are 50 percent or more in any category.

(C) Group comprising B and D

The analysis with respect to B and D is the same as that applied in relation to C and D. Double counting arises because D's pro rata portion of the direct control interests held by CFC in Fco is counted twice. Counting those interests only once, B and D hold control interests in each category of 45 percent.

(D) Group comprising B, C and D

Double counting of direct control interests arises in relation to this group for two reasons. First, as with the three other groups considered, double counting arises because D's pro rata share of the direct control interests held by CFC in Fco is counted twice. By counting those direct control interests only once the control interests held by B, C and D in each category are reduced to 62.31 percent.

Second, double counting occurs because the 45 percent direct control interests held by CFC in Fco in each category are counted to the extent of 17.31 percent by both B and C. This occurs because by virtue of s.245C(5)(a)(iv) the direct control interests held by CFC in Fco are allocated in full to C and D and to B and D. Applying the proviso to s.245C(5)(a)(iv), if the 17.31 percent direct control interests are counted only once, 8.655 percent by B and C, the control interests of B, C and D in each category aggregate to 45 percent. B, C and D therefore do not constitute a group of five or fewer residents whose control interests in any category aggregate to 50 percent or more.

(vii) The control interests held by the four groups identified in paragraph (v) above on the 31 December 1990 measurement day after the application of the proviso to s.245C(5)(a)(iv) are:

Members of group	Aggregate control interests	
	before application of proviso	after application of proviso
	%	%
D	55.38	27.69
C,D	72.69	45.00
B,D	72.69	45.00
B,C,D	90.00	45.00

Fco is therefore not a CFC in relation to its accounting period ending on 31 December 1990 (assuming that the control test is not satisfied on any of the other measurement days that apply in relation to that accounting period) because there is no group of five or fewer New Zealand residents who hold control interests in Fco in any category of control interest of 50 percent or more on the 31 December 1990 measurement day.

Application of s.245C(5) to a chain of CFCs

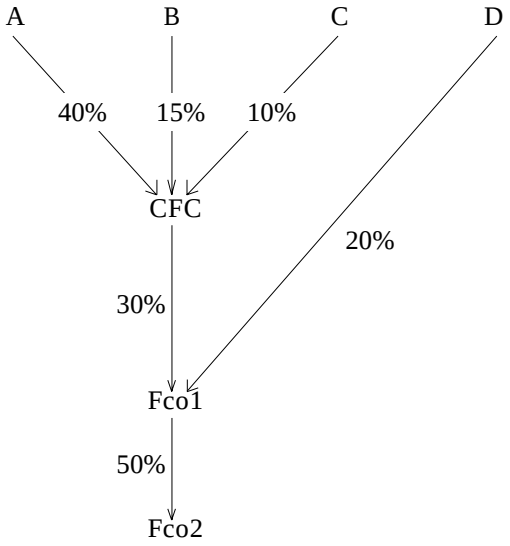
5.68 Section 245C(5)(a) provides rules for calculating indirect control interests held by persons in an underlying foreign company where such persons hold control interests in a CFC which holds qualified control interests in the underlying foreign company. Section 245C(5)(b) applies where such an underlying foreign company is itself a CFC and holds qualified control interests in another foreign company. In these circumstances, s.245C(5)(b) provides that s.245C(5)(a) is applied on the basis of the underlying foreign company being the first tier CFC referred to in that provision. This rule applies down any chain of CFCs.

- Example 34

Facts: (i) Three New Zealand residents, A, B and C, hold control interests in CFC, a controlled foreign company. CFC holds qualified control interests in Fco1, a foreign company, and Fco1 holds qualified control interests in Fco2, another foreign company. A fourth New Zealand resident, D, holds direct control interests in Fco1. All control interests are calculated on a measurement day basis in accordance with s.245A(2)(e). The accounting periods of Fco1 and Fco2 end on 31 December 1990.

(ii) On the 30 June 1990 measurement day A holds control interests in CFC in each category of 40 percent, B holds control interests in CFC in each category of 15 percent and C holds control interests in each category of 10 percent. CFC holds qualified control interests in Fco1 in each category of 30 percent and Fco1 holds qualified control interests in Fco2 in each category of 50 percent. D holds direct control interests in Fco1 in each category of 20 percent.

(iii) The control interests held on the 30 June 1990 measurement day are illustrated as follows:



Result:

Application of s.245C(5) in relation to Fco1

(i) The 30 percent qualified control interests held by CFC in Fco1 are allocated in accordance with s.245C(5)(a). There are three groups of residents holding a control interest of 50 percent or more in CFC:

Members of group	Aggregate control interest %
A,B	55
A,C	50
A,B,C	65

(ii) The qualified control interests are not allocated in accordance with s.245C(5)(a)(i) because there is more than one group of five or fewer persons resident in New Zealand whose control interest in any category in CFC is 50 percent or more on the 30 June 1990 measurement day. Also, the qualified control interests are not allocated in accordance with s.245C(5)(a)(ii) because there are two groups of five or fewer residents that are smallest in number holding a control interest in CFC of 50 percent or more on the 30 June 1990 measurement day: ie A and B, and A and C. By virtue of s.245C(5)(a)(iii) the qualified control interests are deemed to be held by A and B because of the two groups with the smallest number of persons, the group comprising A and B holds the highest control interest.

(iii) The 30 percent qualified control interests held by CFC in Fco1 are allocated to A and B pro rata to their income interests in CFC. A has an income interest of 40 percent in CFC and B has an income interest of 15 percent. The qualified control interests are therefore deemed to be held on the 30 June 1990 measurement day as follows:

- allocation to A

$$30\% \times \frac{40\%}{55\%} = 21.82\%$$

- allocation to B

$$30\% \times \frac{15\%}{55\%} = 8.18\%$$

(iii) By s.245C(5)(a), A and B therefore have indirect control interests in Fco1 in each category of interest of 21.82 percent and 8.18 percent respectively on the 30 June 1990 measurement day. In terms of s.245C(3), A and B hold control interests in Fco1 in each category of 21.82 percent and 8.18 percent respectively on that measurement day. By virtue of the direct control

interests held by D in Fco1, D holds control interests in Fco1 in each category of 20 percent.

(iv) Fco1 is a CFC in relation to its accounting period ending on 31 December 1990 because the control interests of A, B and D in Fco1 aggregate to 50 percent on the 30 June 1990 measurement day.

Application of s.245C(5) in relation to Fco2

(v) In calculating the indirect control interests held by residents in Fco2, s.245C(5)(a) is applied on the basis of Fco1 being a first tier CFC. This means that the qualified control interests held by Fco1 in Fco2 are allocated to persons holding a control interest in Fco1 in accordance with the rules in s.245C(5)(a).

(vi) There is only one group of five or fewer residents, A, B, and D, that holds a control interest in Fco1 of 50 percent or more on the 30 June 1990 measurement day. Therefore, the 50 percent qualified control interests held by Fco1 in Fco2 are deemed to be held by A, B and D on that measurement day: 245C(5)(a)(i). The qualified control interests are held by A, B and D pro rata to their income interests in Fco1. D has an income interest in Fco1 of 20 percent. The income interests of A and B in Fco1 are calculated by multiplying the direct income interest held respectively by A and B in Fco1 by the direct income interest held by Fco1 in Fco2. A has an income interest in Fco1 of 12 percent (ie 40% x 30%) and B has an income interest in Fco1 of 4.5 percent (ie 15% x 30%). The qualified control interests held by Fco1 in Fco2 are therefore deemed to be held as follows on the 30 June 1990 measurement day:

- allocation to A

$$50\% \times \frac{12\%}{36.5\%} = 16.44\%$$

- allocation to B

$$50\% \times \frac{4.5\%}{36.5\%} = 6.16\%$$

- allocation to D

$$50\% \times \frac{20\%}{36.5\%} = 27.40\%$$

(vii) A, B and D therefore hold indirect control interests in Fco2 in each category of 16.44 percent, 6.16 percent and 27.40 percent respectively on the 30 June 1990 measurement day. A, B and D also have control interests in Fco2 in these amounts, assuming that they do not hold direct control interests in Fco2 and that no person associated with any of them holds direct or indirect control interests in Fco2.

(viii) Fco2 is a CFC in relation to its accounting period ending on 31 December 1990 because the aggregate control interests of A, B and D in Fco2 in at least one category of control interest are 50 percent or more on the 30 June 1990 measurement day: ie 16.44% + 6.16% + 27.40% = 50%.

Application of indirect control interest rules at a particular time

5.69 Section 245C(5) applies in calculating indirect control interests held by a person in a foreign company. In terms of s.245C(5), qualified control interests held by a first tier CFC in an underlying foreign company at any time are allocated to groups of five or fewer residents which at that time hold control interests of 50 percent or more in the first tier CFC in any category of control interest. Therefore, qualified control interests held by a first tier CFC at any time are allocated to residents in accordance with s.245C(5) only if at that time there is a group of five or fewer residents that holds a control interest in the first tier CFC of 50 percent or more in any category.

5.70 In this context it is emphasised that although s.245C(1) provides that a foreign company is a CFC in relation to an accounting period if the control test is satisfied at any time during that period, it does not provide that the foreign company is a CFC on every day during the period. Therefore, although a foreign company may be a CFC in relation to an accounting period, qualified control interests held by the CFC in an underlying foreign company are allocated to persons holding control interests in the CFC only at times when there is a group of five or fewer residents that holds a control interest in the CFC of 50 percent or more.

- Example 35

Facts: (i) A New Zealand resident, A, holds direct control interests in Fco, a foreign company, in each category, and Fco1 holds direct control interests in each category in Fco2, another foreign company. A is the only resident holding control interests in Fco1 and no person associated with A holds direct or indirect control interests in Fco1 or Fco2. All control interests are calculated on a measurement day basis in accordance with s.245A(2)(e). The accounting periods of Fco1 and Fco2 end on 31 May.

(ii) The direct control interests held by A in Fco1, and the direct control interests held by Fco1 in Fco2, on the measurement days that are relevant for determining whether Fco1 and Fco2 are CFCs in relation to the accounting periods end-

ing on 31 May 1991 are recorded in the following table. The percentages represent direct control interests held by A and Fco1 in each category of control interest listed in s.245C(4).

Measurement day	30/6/90 %	30/9/90 %	31/12/90 %	31/3/91 %	30/6/91 %
Direct control interests held by A in Fco1	20	30	40	55	60
Direct control interests held by Fco1 in Fco2	50	50	50	45	45

Result: (i) A holds direct control interests in Fco1 in each category of control interest of 55 percent from 1 January 1991 to 31 March 1991 and of 60 percent from 1 April 1991 to 31 May 1991. Assuming that A does not hold indirect control interests in Fco1, and that no person associated with A holds direct or indirect control interests in Fco1, A holds control interests in Fco1 of 55 percent from 1 January 1991 to 31 March 1991 and 60 percent from 1 April 1991 to 31 May 1991. Fco1 is therefore a CFC in relation to its accounting period ending 31 May 1991 because A holds a control interest of 50 percent or more in any category in Fco1 at any time during that accounting period.

(ii) Fco1 holds direct control interests in Fco2 of 50 percent from 1 June 1990 until 31 December 1990. However, these direct control interests are not deemed to be held by A pursuant to s.245C(5)(a) because A did not at any time during that period constitute a group of five or fewer residents whose control interest in Fco in any category was 50 percent or more.

(iii) Fco1 holds direct control interests in Fco2 of 45 percent from 1 January 1991 to 31 May 1991. These direct control interests are deemed to be held by A in accordance with s.245C(5)(a)(i) because during that period A does constitute a group of five or fewer residents whose control interest in Fco1 in any category of interest is 50 percent or more. A therefore holds indirect control interests in Fco2 in each category of 45 percent on and between 1 January 1991 and 31 May 1991. Assuming that A does not hold any other direct or indirect control interests in Fco2 at any time during that period, and that no person associated with A holds direct or indirect control interests in Fco2 at any time during that period, A holds control interests in Fco2 in each category of control interest of 45 percent.

(iv) Fco2 is not a CFC in relation to its accounting period ending 31 May 1991 because there is no group of five or fewer residents which at any time during that accounting period holds control interests in Fco2 of 50 percent or more in any category.

Qualified control interests: s.245C(6)

5.71 Section 245C(6) defines the term "qualified control interests" for the purpose of s.245C(5). It provides that the qualified control interests at any time of a first tier CFC in an underlying foreign company comprise the aggregate of any direct control interests held at that time by the first tier CFC, or by any person associated with the first tier CFC, in the underlying foreign company.

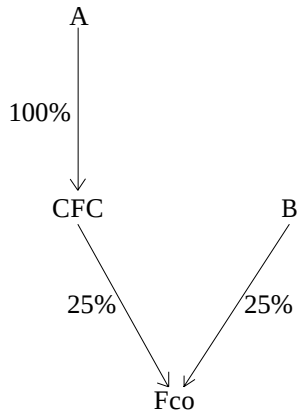
5.72 The inclusion of direct control interests held by persons associated with the first tier CFC in qualified control interests ensures that lower tier foreign companies cannot be decontrolled by the fragmentation of direct control interests among persons associated with a CFC. Section 245C(3) prevents residents avoiding the control test by fragmenting control interests among associated persons; however, it does not prevent the control test from being avoided in relation to underlying foreign companies by the fragmentation of control interests among persons associated with a CFC. Section 245C(6)(b) therefore fills in what would otherwise be a gap in some circumstances.

- Example 36

Facts: (i) A New Zealand resident, A, holds control interests in CFC, a controlled foreign company. CFC holds control interests in Fco, a foreign company. A non-resident, B, holds control interests in Fco. CFC and B habitually act in concert with respect to their voting rights in Fco. Control interests are calculated on a measurement day basis in accordance with s.245A(2)(e). Fco's accounting period ends on 31 December 1990.

(ii) On the 30 September 1990 measurement day A holds control interests in CFC of 100 percent in each category of control interest. CFC holds direct control interests in Fco of 25 percent in each category, and B holds direct control interests in each category of 25 percent.

(iii) These control interests are illustrated as follows:



Result: (i) CFC and B are associated in relation to the control interests held in the voting rights category by virtue of s.245B(j). Consequently, on the 30 September 1990 measurement day CFC holds qualified control interests in Fco of 25 percent in each category except the voting rights category and 50 percent in the voting rights category.

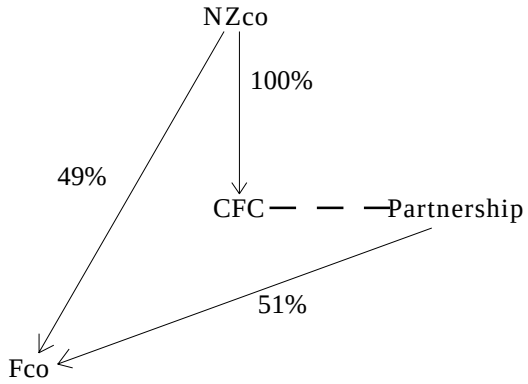
(ii) The qualified control interests are deemed to be held by A by virtue of s.245C(5)(a)(i). A holds a control interest in Fco of 50 percent in the voting rights category on the 30 September 1990 measurement day. Fco is therefore a CFC in relation to its accounting period ending on 31 December 1990.

- Example 37

Facts: (i) NZco, a New Zealand resident company, holds control interests in CFC. CFC is a member of a partnership that holds control interests in Fco, a foreign company. The partnership is governed by foreign law and all of the partners are non-residents. NZco holds direct control interests in Fco. Control interests are calculated on a measurement day basis in accordance with s.245A(2)(e). Fco's accounting period ends on 31 December 1990.

(ii) On the 30 June 1990 measurement day NZco holds control interests in CFC of 100 percent in each category of interest. NZco also holds control interests in Fco of 49 percent in each category of control interest. The partnership holds control interests in Fco of 51 percent in each category of control interest.

(iii) The control interests are illustrated as follows:



Result: (i) CFC does not hold any direct control interests in Fco on the 30 June 1990 measurement day. However, CFC is associated with the partnership by virtue of s.245B(f). Therefore, the direct control interests held by the partnership in Fco on the 30 June 1990 measurement day are qualified control interests held by CFC in Fco. These qualified control interests are deemed to be held by NZco by virtue of s.245C(5)(a)(i).

(ii) NZco therefore holds indirect control interests in Fco of 51 percent in each category of control interest and direct control interests of 49 percent in each category on the 30 June 1990 measurement day. Aggregating these amounts as required by s.245C(3), NZco holds control interests in Fco of 100 percent in each category of control interest on the 30 June 1990 measurement day. Fco is therefore a CFC in relation to its accounting period ending on 31 December 1990.

Double counting of control interests by virtue of associated persons rules: s.245C(7)

5.73 Section 245C(7) provides that where the application of s.245B would result in the double counting of a direct control interest or an indirect control interest in relation to a group of five or fewer persons, that interest is counted only once in relation to that group.

5.74 The anti-double counting rule applies where double counting of a direct or indirect control interest would occur because of s.245B. Section 245B describes the circumstances in which persons are associated for the purposes of Part IVA of the Act. Section 245C(3) provides that the control interest of a person is calculated by aggregating direct and indirect control interests held by the person and direct and indirect control interests held by persons associated with the person. Section 245C(7) is therefore designed to overcome double counting of direct and indirect control interests that may arise by virtue of the aggregation of direct and indirect control interests held by associated persons.

5.75 Section 245C(7) applies only to prevent double counting of direct or indirect control interests in relation to one group of five or fewer residents. It does not prevent a direct or indirect control interest from being taken into account in relation to several different groups of residents.

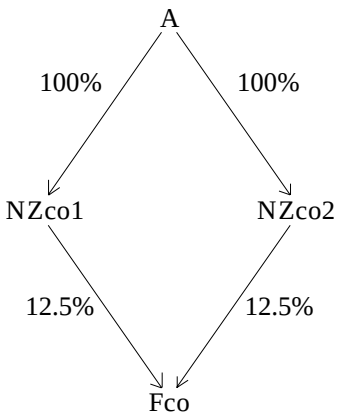
5.76 Double counting can arise by virtue of the associated persons rules because the persons described in s.245B are each associated with the other. For example, if A and B are associated by virtue of s.245B, A is associated with B and B is associated with A. Therefore, in calculating the control interests of A and B in a foreign company A takes into account the control interests held by both A and B and B takes into account the control interests held by both B and A. Double counting of the control interests held by both A and B will occur if A and B are part of the same group of persons.

- Example 38

Facts: (i) A, a New Zealand resident, holds shares in two New Zealand resident companies, NZco1 and NZco2. NZco1 and NZco2 each hold control interests in Fco, a foreign company. These control interests are calculated on a measurement day basis in accordance with s.245A(2)(e). The accounting period of Fco ends on 31 July 1991.

(ii) On the 31 December 1990 measurement day the shares held by A in NZco1 and NZco2 constitute 100 percent of the paid-up and nominal capital of those companies. NZco1 and NZco2 each hold control interests in Fco of 12.5 percent in each category of control interest.

(iii) These interests are illustrated as follows:



Result: (i) NZco1 and NZco2 are associated by virtue of s.245B(a). NZco1's control interests in Fco are therefore calculated by aggregating the direct control interests held by NZco1 and NZco2. On this basis NZco1 would hold control interests in Fco of 25 percent in each category on the 31 December 1990 measurement day. Similarly, NZco2 would calculate its control interests by aggregating its own direct control interests with the direct control interests held by NZco1. NZco2 would therefore hold control interests in Fco of 25 percent in each category on the 31 December 1990 measurement day. Together, NZco1 and NZco2 would hold control interests in Fco of 50 percent in each category of control interest on the 31 December 1990 measurement day.

(ii) There are two instances of double counting of direct control interests in this example. First, the 12.5 percent direct control interests held by NZco2 in Fco are counted once in calculating NZco1's control interests and a second time in calculating NZco2's control interests. Second, the 12.5 percent direct control interests held by NZco1 in Fco are counted once in calculating NZco1's control interests and again in calculating NZco2's control interests.

(iii) Applying s.245C(7), the direct control interests held by NZco1 and NZco2 in Fco are counted only once in determining whether NZco1 and NZco2 constitute a group of five or fewer residents whose control interests in Fco in any category are 50 percent or more on the 31 December 1990 measurement day. The effect of this rule is that NZco1 and NZco2 are each deemed to hold control interests in Fco of only 12.5 percent on that measurement day. The aggregate control interests of NZco1 and NZco2 in each category are therefore only 25 percent. Consequently the interests held by NZco1 and NZco2 on the 31 December 1990 measurement day do not result in Fco being a CFC in relation to its accounting period ending on 31 July 1991.

5.77 In example 38 double counting occurred because the direct control interests held by NZco1 and NZco2 were deemed to be held by the other company and were aggregated with the control interests actually held by the other company. The effect of s.245C(7) on the facts was that the application of the associated persons rules was negated. However, those rules were negated only for the purpose of determining whether NZco1 and NZco2 constituted a group of five or fewer residents whose control interests in Fco in any category were 50 percent or more. The rules would not be negated for other purposes. For example, if three other residents, B, C, and D, each held control interests in Fco of 9 percent in each category, B, C, D, and NZco1 would constitute a group of five or fewer residents whose control interests in Fco was 50 percent or more: ie the aggregate 27 percent held by B, C, and D plus the 25 percent held by NZco1. Thus, s.245C(7) would not negate the application of the associated persons rules for the purpose of determining whether B, C, D and NZco1 constitute a group of five or fewer residents whose control interest in Fco in any cate-

gory is 50 percent or more.

5.78 As illustrated in example 38, the potential for double counting of direct or indirect control interests arises where two associated persons are resident in New Zealand. In these circumstances double counting is likely to occur whenever the resident associates are members of the same group for the purposes of determining whether any group of five or fewer residents holds control interests in a foreign company of 50 percent or more. Double counting is less likely to occur where a non-resident is associated with a resident. In these circumstances the non-resident cannot form part of a group of five or fewer residents holding control interests in a foreign company. Therefore, double counting cannot arise by virtue of the associated persons being members of the same group of five or fewer residents.

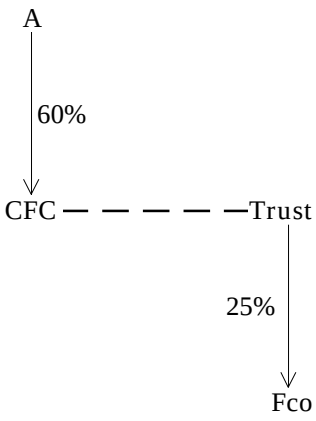
5.79 However, double counting of control interests held by non-resident associated persons may occur in two situations. The first is where more than one resident is associated with the non-resident. Double counting will occur only if the residents are part of the same group for the purposes of determining whether a foreign company is a CFC. For example, if two New Zealand residents, A and B, settle shares in a foreign company on non-resident trustees the trustees will be associated with both A and B by virtue of s.245B(i), assuming that the proviso to that subsection does not apply. The direct control interests held by the trustees in the foreign company by virtue of holding the settled shares would be taken into account in calculating the control interests of both A and B in the foreign company. If A and B were members of a group of five or fewer residents for the purpose of determining whether the foreign company was a CFC, double counting of the interests held by the trustees in the foreign company would occur. Section 245C(7) would apply to prevent such double counting.

5.80 The second situation where double counting of control interests held by a non-resident associated person might occur is where a resident is associated with a non-resident who is associated with a CFC in which the resident holds a control interest. Double counting would occur if the direct and indirect control interests held by the non-resident were deemed to be held by the resident through the associated persons rules and through the indirect control rules.

- Example 39

Facts: (i) A New Zealand resident, A, holds control interests in CFC, a controlled foreign company. CFC settles an interest in a foreign company, Fco, on a trust with non-resident trustees. A held control interests in CFC of more than 10 percent in each category at the time CFC settled the trust. Interests are calculated on a measurement day basis in accordance with s.245A(2)(e). Fco's accounting period ends on 31 March 1991.

(ii) On the 30 June 1990 measurement day A holds control interests in CFC of 60 percent in each category and the trustees hold control interests in Fco of 25 percent in each category. These interests are illustrated as follows:



Result: (i) CFC and the trustees are associated by virtue of s.245B(i), assuming that the proviso to that subsection does not apply. The direct control interests held by the trustees in Fco therefore constitute qualified control interests which, in accordance with s.245C(5), are deemed to be held by persons holding a control interest in CFC. Assuming that no other residents hold control interests in CFC, s.245C(5)(a)(i) would apply and A would be deemed to hold indirect control interests of 25 percent in Fco on the 30 June 1990 measurement day.

(ii) A and the trustees are associated because A is a settlor of the trust by virtue of s.226(4). In terms of that provision, where a CFC settles a trust any person who holds a control interest in the CFC of 10 percent or more in any category of control interest at the time of settlement is a settlor of the trust. Therefore, pursuant to s.245C(3)(b) the direct control interests held by the trustees in Fco are taken into account in calculating A's control interests in Fco on the 30 June 1990 measurement day.

(iii) The 25 percent direct control interests held by the trustees would therefore be taken into account twice in calculating A's control interests in Fco on the 30 June 1990 measurement day. This would mean that A would hold control interests in Fco in each category of 50 percent on that measurement day, although the trustees hold control interests in Fco of only 25 percent on that day. By s.245C(7), the direct control interests held by the trustees in Fco are counted

only once by A in determining whether A holds control interests of 50 percent or more in Fco. A therefore holds control interests of 25 percent in Fco in each category of control interest. Consequently, Fco is not a CFC in relation to its accounting period ending on 31 March 1991 by virtue of the control interests held by A in Fco on the 30 June 1990 measurement day.

Double counting of control interests occuring because entitlements to acquire interests taken into account: s.245C(8)

5.81 Section 245C(8) contains an anti-double counting rule that applies where any of the interests listed in s.245C(4) would be counted more than once because one person holds any of those interests and another person is entitled to acquire them. Section 245C(8) provides that in these circumstances the interest in question is counted only once.

5.82 Direct and indirect control interests are calculated by taking into account interests that a person, including a CFC, holds or is entitled to acquire. Double counting of the interests listed in s.245C(4) could therefore occur where a person who holds a listed interest and a person who is entitled to acquire that interest are members of the same group of five or fewer persons. If such double counting does occur, s.245C(8) provides that the interest is counted only once in relation to that group.

- Example 40

Facts: (i) A and B are resident in New Zealand. B holds shares in Fco, a foreign company. A holds an option to acquire those shares. A and B calculate their control interests in Fco on a measurement day basis. On the 30 June 1990 measurement day B's shares constitute 25 percent of the paid up and nominal capital of Fco. They also carry 25 percent of the voting rights of Fco and entitle B to a distribution of 25 percent of the income and assets of Fco.

(ii) On the 30 June 1990 measurement day another New Zealand resident, C, holds direct control interests in Fco of 30 percent in each category of control interest.

Result: (i) B holds control interests in Fco of 25 percent in each category of control interest by virtue of B's shareholding in Fco. In terms of s.245A(2)(b), A is entitled to acquire the interests held by B because A has an option to acquire them. Therefore, A holds control interests in Fco of 25 percent in each category of control interest. C also holds control interests in Fco of 30 percent in each category of control interest.

(ii) A and B would constitute a group of five or fewer residents whose aggregate control interests in Fco in any category are 50 percent or more on the 30 June 1990 measurement day because their control interests in each category aggregate to 50 percent on that day. However, double counting occurs because the interests held by B are taken into account in calculating A's and B's control interests. By s.245C(8), the interests held by B are counted only once in determining whether A and B constitute a group of five or fewer residents with a control interest of 50 percent or more in any category. A and B therefore hold aggregate control interests in Fco of 25 percent in each category.

(iii) A and B do not constitute a group of five or fewer residents whose control interest in Fco in any category is 50 percent or more. However, the aggregate control interest of A and C in each category is 55 percent and the aggregate control interest of B and C in each category is 55 percent. No double counting arises in relation to these two groups because the interests are taken into account once in relation to the B and C group by virtue of B holding the interests, and once in relation to the A and C group by virtue of A being entitled to acquire the interests. Section 245C(8) does not apply in these circumstances.

Arrangements to decontrol foreign companies: s.245C(9)

5.83 Section 245C(9) contains an anti-avoidance rule that applies where two or more New Zealand residents enter into an arrangement in relation to a foreign company whereby control interests in the foreign company are held by another person and the purpose, or a purpose, of the arrangement is to prevent the foreign company from being a CFC. In these circumstances, the control interests subject to the arrangement are deemed to be held equally by the persons resident in New Zealand who entered into the arrangement.

5.84 Several features of the legislation are designed to prevent avoidance of the control test set out in s.245C(1). These are:

(a) control interests are separately calculated in relation to five categories of control interest;

(b) interests held by nominees are deemed to be held by the person for whom the nominee acts;

(c) interests held by associated persons are aggregated;

(d) entitlements to acquire or to require the extinguishment or cancellation of interests are taken into account;

(e) interests held by a CFC in another foreign company are deemed to be held by persons who hold an interest in the CFC on a basis that reduces opportunities for diluting such interests; and

(f) interests held by persons associated with a CFC in another foreign company are aggregated with interests held by the CFC in the foreign company for the purpose of calculating indirect control interests to ensure that lower tier CFCs cannot be decontrolled by fragmenting control interests held by a CFC.

5.85 Section 245C(9) buttresses these rules by ensuring that arrangements between residents to have interests held by other persons are not effective to defeat the control test where the purpose, or a purpose, of the arrangement is to prevent the company from being a CFC. An additional buttress is provided by s.99 of the Income Tax Act. Inland Revenue's policy on the application of s.99 is set out in Tax Information Bulletin No.8.

PART 6: CALCULATION OF INCOME INTERESTS

Overview

6.1 Section 245D sets out the rules for calculating income interests in CFCs. Income interests are relevant in determining the amount of the income or losses of a CFC that are attributed to persons who hold interests in the CFC. Income interests are also relevant in determining the foreign tax credits that a person is entitled to claim against New Zealand tax payable on income attributed from a CFC.

6.2 In outline, s.245D(1) provides that a person's income interest in a CFC is calculated by aggregating the person's direct income interest in the CFC with any indirect income interests held by the person in the CFC. Direct income interests are calculated in accordance with s.245D(2) and indirect income interests are calculated in accordance with s.245D(3). Section 245D(4) sets out the situations in which entitlements to acquire interests in a CFC are taken into account in calculating income interests. Section 245D(5) provides the method for calculating income interests where the income interest of a person varies during the accounting period of a CFC. Section 245D(6) provides that any person who becomes or ceases to be resident in New Zealand is treated as not holding an income interest on any measurement day when the person was not resident in New Zealand.

Comparison of income interests and control interests

6.3 The same categories of interest are taken into account in calculating income interests and control interests. In both cases the interests taken into account are paid-up capital, nominal capital, voting rights, entitlements to distributions of income and entitlements to distributions of assets. However, income interests differ from control interests in the following respects:

(a) A person may have control interests in each category of control interest. However, income interests are calculated as the highest of the interests that a person holds in the listed categories of interest.

(b) Interests held by nominees are taken into account in calculating a person's income interest but interests held by associated persons are generally ignored. Income interests held by associated persons are only relevant in determining whether a person holds an income interest of 10 percent or greater in a CFC, and is therefore required to attribute income or losses from the CFC.

(c) Entitlements to acquire interests in a CFC are not taken into account in calculating income interests except in the circumstances specified in s.245D(4).

(d) Indirect income interests are calculated by multiplying the direct income interest held by a person in a first tier CFC by direct income interests held by the first tier CFC in lower tier CFCs, and so on down any chain of CFCs. This differs from the calculation of indirect control interests where direct control interests held by a first tier CFC in an underlying foreign company are allocated in full to groups of five or fewer residents who hold a control interest in the first tier CFC of 50 percent or more in any category.

(e) Interests held by persons associated with a CFC are not taken into account in calculating the indirect income interest held by a person in a lower tier CFC. Such interests are taken into account in calculating indirect control interests as "qualified control interests" that are allocated to groups of five or fewer residents holding a control interest in the first tier CFC.

(f) Control interests are calculated at a particular point in time and a foreign company is a CFC in relation to an accounting period if the control test is satisfied at any time during the period.

Income interests are also calculated at particular points in time (either on measurement days or daily) and if there is any variation in a person's income interest during an accounting period of a CFC the income interest for the accounting period is calculated by an averaging process set out in s.245D(5).

6.4 Interests held by associated persons are not taken into account in calculating income interests because a taxpayer does not have a beneficial interest in the income of an associated person. However, interests held by associated persons are aggregated in calculating control interests because a relationship with an associated person enables a taxpayer to increase his or her control of a company, although not necessarily his or her income.

6.5 The circumstances in which entitlements to acquire interests in a CFC are taken into account in calculating income interests are narrower than those in which such entitlements are taken into account in calculating control interests. This is because another resident may hold the interest to be acquired and that resident may be assessable on the income derived in respect of that interest. Also, the entitlements may not be exercised and may therefore represent only the potential to gain access to income. This may be the case where the amount payable to exercise the entitlement exceeds the market value of the interest to be acquired. In these cases entitlements to acquire interests are not taken into account in calculating income interests because the failure to exercise the entitlement is based on the value of the interest rather than on any intention to defer tax on income derived by the CFC. In other cases entitlements may be used to defer tax on income derived by a CFC. In these other cases, listed in s.245D(4), entitlements to acquire interests are taken into account in calculating income interests.

6.6 Indirect control interests are calculated by allocating all of the direct control interests held by a CFC, and by persons associated with a CFC, in an underlying foreign company to groups of residents holding control interests in the CFC. This treatment is not appropriate in calculating indirect income interests because although a group of persons may control a CFC they are not necessarily entitled to all of its income. For example, if a group of persons holds control interests in a CFC in each category of 60 percent they will be entitled to 60 percent of its income, not 100 percent. Therefore, to ensure that only the proportionate share of a CFC's income is attributed to persons holding an income interest in it, indirect income interests are calculated by multiplying the direct income interest held by a person in a first tier CFC by the direct income interest held by the first tier CFC in an underlying CFC. This multiplicative process is repeated down a chain of CFCs.

6.7 In calculating indirect control interests qualified control interests held by a first tier CFC in an underlying foreign company are allocated to a group of five or fewer residents holding control interests in the first tier CFC in accordance with the rules in s.245C(5). The effect of those rules is that persons holding control interests in the first tier CFC may not hold indirect control interests in the underlying foreign company because they do not form part of the the group of residents to whom the qualified control interests are allocated under s.245C(5). However, a person may have an indirect income interest in a CFC without holding a control interest in that CFC. Indirect income interests are calculated independently from indirect control interests.

Definition of income interest: s.245D(1)

Definition

6.8 Section 245D(1) provides that the income interest of a person in a CFC at any time is calculated by aggregating any direct and indirect income interests held by the person in the CFC at that time.

Calculation on measurement day or daily basis

6.9 Section 245D(1) applies subject to s.245A(2)(e) and s.245E. Section 245A(2)(e) provides that if a person holds an income interest on a measurement day the person is deemed to hold the same income interest from the preceding measurement day until and including the measurement day on which the person holds the income interest. Similarly, if a person does not hold an income interest in a CFC on a measurement day the person is deemed not to hold an income interest from the preceding measurement day until the measurement day on which the person does not hold an income interest. In terms of the proviso to s.245A(2)(e), a person may elect not to apply s.245A(2)(e). If an election is made the elector's income interest in the CFC in respect of which the election was made is calculated on a daily basis. Section 245A(2)(e) is discussed in Part 3 of this bulletin.

6.10 If the income interest in a CFC of a person who calculates income interests on measurement days is the same on each measurement day on which income interests are calculated in relation to the accounting period of the CFC, the income interest held on any one of those days will effectively by the income interest held by the person for the accounting period. If the person holds a different income interest on different measurement days the income interest for the accounting period is calculated in accordance with the formula set out in s.245D(5). The measurement days that are relevant in calculating an income interest in relation to an accounting period are not only those falling within the CFC's

accounting period. For example, if the accounting period of a CFC ends on 31 October 1990 the income interest held by the person on the 31 December 1990 measurement day will determine the income interest held by the person from 1 October 1990 to 31 October 1990.

6.11 If a person elects not to calculate an income interest in a CFC on a measurement day basis it is necessary to calculate the income interest on each day falling within the accounting period of the CFC in relation to which the income interest is calculated. If the income interest varies during the accounting period the income interest for the period is calculated in accordance with the formula in s.245D(5).

6.12 Section 245D(1) applies subject to s.245E. That section, discussed in Part 7 of this bulletin, is designed to reduce opportunities for manipulating control interests or income interests around measurement days. The reference to s.245E in s.245D(1) makes it clear that where s.245E has been applied to determine the income interest held by a person in a CFC on a measurement day, the interest that is taken into account in calculating the person's income interest under s.245D(1) will be the interest that the person is deemed to hold by virtue of s.245E.

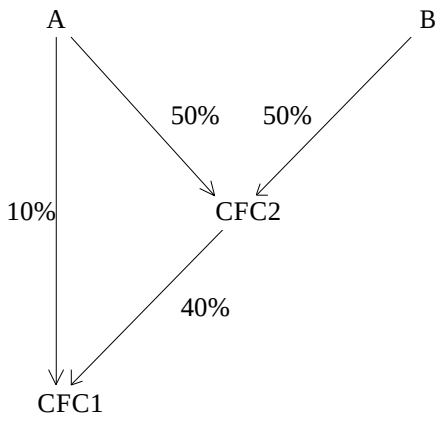
Aggregation of direct and indirect income interests

6.13 Section 245D(1) provides that an income interest of a person in a CFC at any time is calculated by aggregating any direct income interest and any indirect income interest or interests held by the person at that time in the CFC. The reference to a direct income "interest" and to indirect income "interests" is because although a person may have only one direct income interest it is possible to hold more than one indirect income interest by virtue of holding indirect income interests in a CFC through several interposed CFCs.

- Example 41

Facts: (i) A New Zealand resident, A, holds a direct income interest in two controlled foreign companies, CFC1 and CFC2. CFC2 holds a direct income interest in CFC1. Another New Zealand resident, B, holds a direct income interest in CFC2. A and B calculate income interests in both companies on a measurement day basis.

(ii) On the 30 September 1990 measurement day A holds a direct income interest of 10 percent in CFC1 and a direct income interest of 50 percent in CFC2. B holds a direct income interest of 50 percent in CFC2. CFC2 holds a direct income interest of 40 percent in CFC1. These interests are represented as follows:



Result: (i) A has an indirect income interest in CFC1 by virtue of holding a direct income interest in CFC2 and CFC2 holding a direct income interest in CFC1. This income interest is calculated as 50% x 40% = 20%. A holds a direct income interest in CFC1 of 10 percent. A's income interest in CFC1 on the 30 September 1990 measurement day is the aggregate of A's direct and indirect income interest in that company: ie 20% + 10% = 30%.

(ii) A holds a direct income interest in CFC2 of 50 percent. A does not hold an indirect income interest in CFC2. Therefore, A's income interest in CFC2 is 50 percent.

(iii) B holds an indirect income interest in CFC1 by virtue of holding a direct income interest in CFC2 and CFC2 holding a direct income interest in CFC1. This indirect income interest is calculated as 50% x 40% = 20%. B does not hold a direct income interest in CFC1. Therefore, B has an income interest of 20 percent in CFC1. B holds a direct income interest of 50 percent in CFC2 but no indirect income interests. B therefore has an income interest of 50 percent in CFC2.

(iv) The income interests in this example are calculated in relation to the 30 September 1990 measurement day. The income interests for the accounting periods of the CFCs in relation to which the 30 September 1990 measurement day calculation is made may differ from the income interests held by A and B on that measurement day. This will be the case if A and B hold different income interests on other measurement days on which calculations of income interests are made in respect of the CFCs' accounting periods. In these circumstances, the income interests held by A and B for the accounting periods would be determined in accordance with the formula in s.245D(5).

Direct income interest definition: s.245D(2)

6.14 Section 245D(2) provides that a person has a direct income interest in a CFC at any time equal to the highest percentage of the five following interests that the person holds at that time:

(a) the percentage of the total paid-up capital of the CFC;

(b) the percentage of the nominal capital of the CFC;

(c) the percentage of the total rights to vote or participate in decision making concerning the distributions to be made by the CFC, the constitution of the CFC, any variation in the capital of the CFC, or the appointment or election of directors of the CFC;

(d) the percentage of the income of the CFC for the accounting period in which the income interest is calculated which the person would be entitled to receive or have dealt with in that person's interest or on that person's behalf if that income were distributed on the last day of the accounting period and the person's entitlement to income were the same at all other times during the accounting period;

(e) the percentage of the value of the net assets of the CFC which the person would be entitled to receive or have dealt with in that person's interest or on that person's behalf in the event of a distribution of all of the CFC's assets at that time.

6.15 These interests are the same as those taken into account in calculating direct control interests. However, a person holds only one direct income interest in a CFC. That income interest is calculated as the highest of the percentages of the listed interests held by the person in the CFC. The listed interests are discussed at paragraphs 3.31 to 3.49 of this bulletin in the context of the rules governing the calculation of direct control interests.

- Example 42

Facts: (i) Three New Zealand residents, A, B and C, hold income interests in CFC, a controlled foreign company. These income interests are calculated on a measurement day basis in accordance with s.245A(2)(e).

(ii) On the 30 June 1990 measurement day CFC has nominal capital of $1 million divided into one million $1 shares. 500,000 of these shares have been issued. The issued shares are fully paid up. A holds 300,000 of the issued shares, B holds 150,000 and C holds 50,000. The shares held by C are non-voting preference shares. The shares held by A and B entitle them to 67 percent and 33 percent of the voting rights in relation to CFC respectively. The shares held by A, B and C entitle them respectively to a distribution of 57 percent, 28 percent and 15 percent of the income and of the net assets of CFC.

Result: (i) The percentage interest held by A, B, and C in each category of interest is:

Category of interest	Holder of interest		
	A	B	C
	%	%	%
Paid-up capital	60	30	10
Nominal capital	30	15	5
Voting rights	67	33	-
Rights to income	57	28	15
Rights to assets	57	28	15

(ii) The direct income interest of A, B, and C is calculated as the highest of the interests held in the five categories. Therefore, A has a direct income interest in CFC of 67 percent, B has a direct income interest of 33 percent, and C has a direct income interest of 15 percent.

(iii) The result is that New Zealand residents hold income interests of more than 100 percent: ie 67% + 33% + 15% = 115%. Section 245H may apply in these circumstances to reduce the aggregate income interests of A, B and C to 100 percent. That section is discussed in Part 10 of this bulletin.

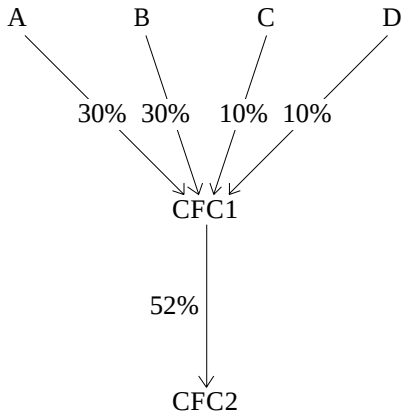
Indirect income interests

6.16 Section 245D(3) provides that where a person has a direct income interest in a CFC, referred to as a first tier CFC, at any time and that first tier CFC has a direct income interest in another CFC, referred to as an underlying CFC, the person has an indirect income interest in the underlying CFC. This indirect income interest is calculated by multiplying the income interest of the person in the first tier CFC by the income interest of the first tier CFC in the underlying CFC. Where there are two or more CFCs interposed between the person and the underlying CFC the indirect income interest of the person in the underlying CFC is calculated by multiplying the direct income interests of each interposed CFC in each chain of CFCs.

- Example 43

Facts: Four New Zealand residents, A, B, C and D, hold income interests in CFC1, a controlled foreign company. These interests are calculated on measurement days in accordance with s.245A(2)(e). On the 30 June 1990 measurement

day A and B each hold a direct income interest of 30 percent in CFC1 and C and D each hold a direct income interest of 10 percent. CFC1 holds a direct income interest of 52 percent in another controlled foreign company, CFC2. CFC2's accounting period ends on 31 July 1990. The facts are illustrated as follows:



Result: (i) A, B, C and D each have an indirect income interest in CFC2. This is calculated by multiplying their direct income interest in CFC1 by the direct income interest held by CFC1 in CFC2. The indirect income interests are:

A: 30% x 52% = 15.6%

B: 30% x 52% = 15.6%

C: 10% x 52% = 5.2%

D: 10% x 52% = 5.2%

Assuming that A, B, C and D do not hold direct income interests or other indirect income interests in CFC2, these indirect income interests constitute the income interests held in CFC2.

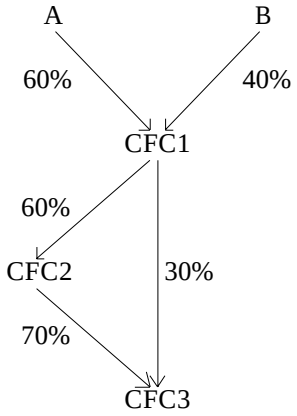
(ii) The facts in this example are largely the same as those in Example 31. That example is concerned with the calculation of indirect control interests. It is concluded in Example 31 that by virtue of s.245C(5) the 52 percent direct control interests held by CFC1 in CFC2 (referred to as Fco in Example 31) are deemed to be held by A and B. A and B therefore hold indirect control interests in CFC2 but C and D do not. However, although C and D do not hold indirect control interests in CFC2 they do hold indirect income interests in that company.

(iii) The income interests calculated in para (i) are the income interests held on the 30 June 1990 measurement day. If the income interests are the same for other measurement days that are relevant in calculating income interests for the accounting period of CFC2 ending on 31 July 1990, the income interests calculated in para (i) will be the income interests of A, B, C and D for that accounting period. If the income interests recorded on the relevant measurement days for the accounting period vary, the income interests for the period will be calculated according to the formula in s.245D(5).

- Example 44

Facts: (i) Two New Zealand residents, A and B, hold direct income interests in CFC1, a controlled foreign company. CFC1 holds a direct income interest in another controlled foreign company, CFC2, and CFC2 holds a direct income interest in another controlled foreign company, CFC3. CFC1 also holds a direct income interest in CFC3. Income interests are calculated on a measurement day basis.

(ii) On the 30 September 1990 measurement day A holds a direct income interest of 60 percent in CFC1 and B holds a direct income interest of 40 percent in CFC1. CFC1 holds a direct income interest of 60 percent in CFC2 and 30 percent in CFC3. CFC2 holds a direct income interest of 70 percent in CFC3. These interests are illustrated as follows:



Result: (i) The indirect income interests of A and B in CFC2 are calculated as:

A: 60% x 60% = 36%

B: 40% x 60% = 24%

(ii) A and B have indirect income interests in CFC3 by virtue of the direct income interests held by CFC1 and CFC2 in CFC3. These indirect income interests, and the income interests held by A and B in the CFC3, are calculated as follows:

Interest	Calculation of income interest	
	A %	B %
Indirect interest held by virtue of CFC1's direct income interest in CFC2 and CFC2's direct income interest in CFC3	25 (1)	16.8 (2)
Indirect interest held by virtue of CFC1's direct income interest in CFC3	18 (3)	12 (4)
Income interest in CFC3 (5)	43	28.8

notes: (1) 60% x 60% x 70% = 25%
(2) 40% x 60% x 70% = 16.8%
(3) 60% x 30% = 18%
(4) 40% x 30% = 12%
(5) The aggregate of the two indirect income interests held by A and B.

(iii) The income interests calculated in paragraph (ii) are the income interests held by A and B on the 30 September 1990 measurement day. Income interests will also be calculated on other measurement days for the purpose of establishing the income interest of A and B in the three CFCs for the relevant accounting periods of those companies. If the income interests recorded on those measurement days differ, the income interests in relation to the accounting periods will be calculated in accordance with s.245D(5).

6.17 Indirect income interests are calculated by multiplying direct income interests held in each CFC in a chain of CFCs. Direct income interests are calculated as the highest percentage of the things listed in s.245D(2) held by a person at a particular time. Therefore, indirect income interests are calculated by multiplying the highest percentage of the listed things held directly in each CFC in a chain of CFCs. For example, assume that a resident holds 20 percent of the voting rights of a CFC and 10 percent of the paid-up capital, nominal capital, and rights to distributions of income and assets of the CFC. Assume also that the CFC holds 20 percent of the voting rights in another CFC and 60 percent of the interests in the other listed categories. In these circumstances, the resident holds a direct income interest in the CFC of 20 percent and the CFC holds a direct income interest of 60 percent in the other CFC. The resident's indirect income interest in the other CFC is calculated as 20% x 60% = 12%.

Calculation of income interests where the control test is not satisfied at all times during the accounting period

6.18 Income interests are calculated in respect of a foreign company for an accounting period where the foreign company is a CFC for the accounting period. Income interests are calculated on measurement days or on a daily basis. Where an income interest varies over an accounting period, the income interest for the period is calculated in accordance with the formula in s.245D(5). Direct income interests are calculated as the highest of the things listed in s.245D(2) held by a person at a particular time. A person will have a direct income interest in a CFC at a particular time whether or not the control test is satisfied in relation to the CFC at that time. That is, if a foreign company is a CFC at any time during an accounting period it is a CFC in relation to that period and a person holding an interest will have an income interest in the CFC at the other times when income interests are measured in relation to that period although the control interest is not satisfied at those other times.

6.19 For example, if the accounting period of a foreign company ends on 31 July 1990 and five or fewer residents hold control interests in the company of 50 percent or more on the 30 June 1990 measurement day, residents holding an interest in the company will be required to calculate direct income interests in the company on other measurement days falling within the period even if the control test is not satisfied on those days. The income interests thus calculated will be averaged under the formula contained in s.245D(5).

6.20 In the case of indirect income interests calculated under s.245D(3), a person will not have an indirect income interest in an underlying CFC at a particular point in time unless the control test is satisfied in relation to the underlying CFC at that time. This follows from the language in s.245D(3) that the underlying foreign company must "at that time" be a CFC. If the control test is not satisfied in relation to the underlying CFC at the particular time, persons who hold income interests in the first tier CFC will not hold indirect income interests in the underlying CFC. This is the case even if the control test is satisfied in relation to the underlying CFC at another time during the accounting period of the underlying CFC.

6.21 The calculation of income interests in a CFC for an accounting period where the company is not a CFC for the entire accounting period is illustrated in examples 3 to 5 in Part 3 of this bulletin.

Entitlements to acquire and calculation of income interests: s.245D(4)

Description of rule

6.22 Section 245D(4) sets out the circumstances in which an entitlement to acquire an interest in a CFC is taken into account in calculating an income interest. For s.245D(4) to apply the following conditions must be satisfied:

(a) the income interest of a person resident in New Zealand (referred to as the "taxpayer") in a CFC would be greater if any person, whether the

taxpayer or another person (such person being referred to as the "option holder"), were deemed to hold any of the things listed in s.245D(2) that the option holder was entitled to acquire but did not hold;

(b) the things that the option holder was entitled to acquire were held by a non-resident other than a CFC or by a person resident in New Zealand with an income interest in the CFC of less than 10 percent; and

(c) any of the three following conditions is satisfied:

(i) having regard to the economic or financial gain that the the taxpayer derives as a result of the CFC deriving income in the accounting period in which the income interest is calculated, the effect of the option holder being entitled to acquire, but not holding, the thing listed in s.245D(2) is to defeat the intent and application of Part IVA of the Income Tax Act in relation to the taxpayer;

(ii) the consideration payable in money or money's worth by the option holder to exercise the option holder's entitlement to acquire the thing listed in s.245D(2) is less than the market value of that thing on any date upon which the option holder may exercise that entitlement; or

(iii) the option holder or any person associated with the option holder has provided financial assistance, whether by way of a loan, guarantee, the provision of security or otherwise, to the holder of the thing listed in s.245D(2) for the purpose of or in connection with the acquisition or holding of that thing.

Where these conditions are satisfied, the income interest of the taxpayer in the CFC is calculated on the basis that the option holder is deemed to hold the thing that the option holder is entitled to acquire.

Income interest of resident greater if entitlement taken into account

6.23 The first condition to satisfy for s.245D(4) to apply is that the income interest of a person resident in New Zealand (such person being referred to as the "taxpayer") in a CFC at any time would be greater if any person, whether the taxpayer or another person (such person being referred to as the "option holder"), were deemed to hold any of the things listed in s.245D(2) that the option holder was entitled to acquire but did not hold at that time.

6.24 The option holder may be the taxpayer or another person. If the option holder is a person other than the taxpayer the income interest of the taxpayer in a CFC would be greater, for example, if the option holder were itself a CFC that was entitled to acquire an interest in the CFC in relation to which the taxpayer's income interest is being calculated. If the taxpayer held an income interest in the option holder CFC, the effect of deeming the option holder CFC to hold the interest in the other CFC would be to increase the taxpayer's indirect income interest in the other CFC. For example, assume that a New Zealand resident, A, holds a direct income interest in a controlled foreign company, CFC1 and that CFC1 holds an option to acquire shares in another controlled foreign company, CFC2. In these circumstances, the first condition is satisfied because A's income interest in CFC2 would be higher if CFC1 were deemed to hold the shares in CFC2 that it is entitled to acquire.

6.25 Section 245D(4) applies in relation to things that the option holder is "entitled to acquire" but does not hold. The circumstances in which a person is entitled to acquire things listed in s.245D(2) are specified in s.245A(2)(b). In terms of that provision, a person is deemed to be entitled to acquire anything that the person is entitled to acquire or that the person is entitled to require the cancellation or extinguishment of. Section 245A(2)(b) is discussed in paragraphs 3.85 to 3.104 of this bulletin.

Interest held by non-resident other than a CFC or by a resident with income interest of less than 10 percent

6.26 The second condition to be satisfied for s.245D(4) to apply is that the things that the option holder is entitled to acquire, but does not hold, must be held by a person not resident in New Zealand other than a CFC or by a person resident in New Zealand with an income interest in the CFC of less than 10 percent for the accounting period in question.

6.27 The purpose of this condition is to prevent double taxation where an interest held by a CFC or resident is likely to result in attribution of income to a resident or to a person who holds an interest in the CFC. If things that a person is entitled to acquire are held by a CFC, they will be taken into account in calculating the indirect income interest of any resident who holds a direct income interest in the CFC. Therefore, it is not appropriate to deem the option holder to hold the things held by the CFC that the option holder is entitled to acquire. Consequently, s.245D(4) applies where the option holder is entitled to acquire things held by non-residents other than CFCs.

6.28 If the things that the option holder is entitled to acquire are held by a resident, the things will be taken into account in calculating the income interest of the resident. Therefore, s.245D(4) does not apply generally if the things are held by a resident. How-

ever, if the resident holding the things that the option holder is entitled to acquire has an income interest of less than 10 percent in the CFC there will be no attribution of income with respect to the interest by virtue of s.245F(1)(b). Consequently, s.245D(4) does apply if the things that the option holder is entitled to acquire are held by a resident with an income interest of less than 10 percent.

Three cases to which s.245D(4) applies

6.29 Sections 245D(4)(a), (b) and (c) set out three situations in which s.245D(4) applies. The first situation, set out in s.245D(4)(a), is where having regard to the economic or financial gain the taxpayer derives as a result of the CFC deriving income in the accounting period in which the income interest is calculated the effect of the option holder being entitled to acquire, but not holding, things listed in s.245D(2) is to defeat the intent and application of Part IVA in relation to the taxpayer.

6.30 The situation contemplated by s.245D(4)(a) is where the taxpayer derives an economic or financial gain by virtue of the CFC deriving income but where the intent and application of Part IVA is defeated because there is no attribution of this income to the taxpayer as the option holder is only entitled to acquire, but does not hold, the things listed in s.245D(2).

6.31 However, s.245D(4)(a) applies only where by virtue of the CFC deriving "income" in the accounting period the effect is to defeat the intent and application of Part IVA in relation to the taxpayer. Section 245D(4)(a) does not apply if the CFC does not derive income but where an economic or financial benefit still accrues to the taxpayer. This might be the case, for example, where the CFC holds a direct income interest in another CFC and income is derived by the other CFC. In these circumstances s.245D(4)(a) will not be satisfied because the CFC in relation to which the option holder is entitled to acquire things listed in s.245D(2) does not derive income. However, s.245D(4)(b) may apply because the value of the interest held by the CFC in the other CFC will be taken into account in determining whether the entitlement to acquire things in the CFC is exerciseable at market value.

6.32 The second situation in which s.245D(4) applies, set out in s.245D(4)(b), is where the consideration in money or money's worth payable by the option holder in order to exercise the option holder's entitlement to acquire the things listed in s.245D(2) is less than the market value of the things on any date on which the option holder may exercise the entitlement. This situation is similar to that described in s.245D(4)(a) because where the consideration payable by the option holder to acquire a thing is less than the market value of the thing, an economic or financial benefit may accrue to the taxpayer. The effect of this benefit may be to defeat the intent and application of Part IVA.

6.33 The third situation in which s.245D(4) applies is where the option holder, or any person associated with the option holder, directly or indirectly, and by one or a series of transactions, has provided financial assistance to the holder of the things that the option holder is entitled to acquire for the purpose of, or in connection with, the acquisition or holding of those things. The financial assistance may be by way of a loan, guarantee, the provision of security or otherwise. In these circumstances the entitlement to acquire is taken into account in calculating the taxpayer's income interest in the CFC because the provision of financial assistance together with the entitlement to acquire is equivalent to the acquisition of the things that the option holder is entitled to acquire.

Effect of s.245D(4)

6.34 If the conditions for s.245D(4) to apply are satisfied, it is provided that for the purposes of calculating the income interest of the taxpayer the option holder is deemed to hold the things that the option holder is entitled to acquire. For example, assume that a New Zealand resident is entitled to acquire an interest held by a non-resident in a CFC and that the interest held by the non-resident constitutes a 20 percent interest in each of the categories listed in s.245D(2). Assume also that the resident provided financial assistance to the non-resident to acquire the interest in the CFC. In terms of s.245D(4) the resident is the "taxpayer" and the "option holder". The resident provided financial assistance to the holder of the interest in connection with the acquisition of the interest. Therefore, s.245D(4)(c) is satisfied. The effect is that the resident is deemed to hold the 20 percent interests held by the non-resident for the purpose of calculating the resident's income interest in the CFC. This will increase the resident's income interest in the CFC by 20 percent.

Variations of income interests during accounting period: s.245D(5)

6.35 Section 245D(5) provides the method of calculating the income interest of a person in a CFC where the income interest varies during an accounting period of the CFC. Where such a variation occurs the person's income interest in the CFC for the accounting period is calculated by aggregating the amounts calculated in accordance with the following formula in respect of periods within the accounting period during which the income interest of the person remained unvaried:

$$a \times \frac{b}{c}$$

where:

a is the income interest of the person in the foreign company for the period during which the person's income interest remained unvaried;

b is the number of days from the first day of the period during which the income interest remained unvaried to the last day of that period;

c is the number of days in the accounting period.

6.36 Section 245D(5) applies subject to s.245A(2)(e). Section 245A(2)(e) provides that the income interest held by a person on a measurement day is also deemed to have been held by the person on each day preceding the measurement day which falls after the prior measurement day. The reference to s.245A(2)(e) makes it clear that where a person calculates income interests on a measurement day basis the effect of that section is that the person's income interests will remain constant between measurement days. Therefore, if a person calculates income interests on a measurement day basis s.245D(5) will apply only if the person has a different income interest on any of the measurement days that apply in relation to the accounting period of the CFC.

6.37 The formula in s.245D(5) establishes the person's income interest for the portion of the accounting period during which the person's income interest remained unvaried. The person's income interest for the accounting period is calculated by aggregating the amounts calculated in accordance with the formula in relation to the periods within the accounting period that the person's income interest remained unvaried.

6.38 The operation of s.245D(5) is illustrated by examples 3, 4 and 5 in Part 4 of this bulletin.

Income interests and changes of residence: s.245D(6)

6.39 Section 245D(6) applies where at any time after 1 April 1988 a person holding an income interest in a CFC becomes or ceases to be resident in New Zealand. In these circumstances, s.245D(6) provides that for the purposes of calculating attributed foreign income or attributed foreign loss the person is treated as not holding the income interest on any measurement day on which the person was not resident.

6.40 Section 245D(6) is consistent with the rule in s.242(c) that income derived from outside New Zealand by a non-resident is not assessable for income tax. If a person acquired an income interest in a CFC before becoming resident and that interest was still held after the person became resident, or if the person held an income interest before ceasing to be resident, the effect of s.245D(6) is that the income interest of the person will vary in terms of s.245D(5). The formula in s.245D(5) will therefore apply to determine the income interest of the person for any accounting period in relation to which the measurement days on which the person was non-resident are relevant. The effect of the formula in these circumstances will be to average down the person's income interest. If the income interest were not averaged down in this manner a portion of the income or loss derived by the CFC while the person was non-resident would be attributed to the person. This would be inconsistent with the principle embodied in s.242(c) that a non-resident is not taxable on foreign source income.

6.41 The effect of averaging down the income interest in a CFC of a person who becomes or ceases to be resident is to reduce the income or loss attributed to the person in respect of the person's interest in the CFC. To ensure that the income or loss is not further reduced by an apportionment of income or loss between the period when the person was resident and the period when the person was non-resident, s.245G(7) provides that where by virtue of s.245D(6) a person is treated as not holding an income interest on a measurement day on which the person was non-resident the attributed foreign income or loss of the person calculated under s.245G(2) is deemed to be derived by the person when resident in New Zealand.

6.42 Section 245D(6) applies for the purpose of calculating "attributed foreign income" or "attributed foreign loss". The attributed foreign income and attributed foreign loss of a person in a CFC is calculated in accordance with s.245G(2) by multiplying the income interest of a person in a CFC for an accounting period by the "branch equivalent income or loss" of the person in the CFC for that accounting period. Branch equivalent income or loss, calculated in accordance with s.245J, is the income derived by the CFC calculated according to New Zealand tax rules adjusted to take into account several modifications to provisions of the Income Tax Act. Section 245D(6) is therefore relevant in determining the amount of income or loss of a CFC that is attributed to a person. It does not apply for other purposes.

6.43 For example, if the person was a CFC before becoming resident, s.245D(6) would not prevent the income interests held by the CFC in other CFCs from being taken into account in calculating indirect income interests of residents in those other CFCs. Also, if a person becoming resident or ceasing to be resident was associated with a person resident in New Zealand s.245D(6) would not prevent the income interest of the person from being taken into account under s.245F(2) in determining whether the associated person held an income interest of 10 percent or greater.

6.44 Section 245D(6) applies where at any time after 1 April 1988 any person holding an income interest in a CFC becomes or ceases to be resident. The provision does not apply to periods before 1 April 1988 because the CFC regime took effect from 1 April 1988.

PART 7: VARIATIONS IN CONTROL OR INCOME INTERESTS

Overview of s.245E

7.1 Section 245E applies where the control or income interests of a person are calculated on a measurement day basis in accordance with s.245A(2)(e). In these circumstances, an advantage might be obtained by temporarily manipulating interests held in a foreign company around one or more measurement days. Such manipulation might take the form of a temporary reduction of the control or income interests held by a resident, thus preventing a foreign company from being a CFC or reducing the amount of income derived by a CFC that is attributed to a person. Alternatively, manipulation around a measurement day might be in the form of a temporary increase in the control or income interests held by a resident in a CFC in order to increase the amount of the CFC's losses that are attributed. Section 245E is intended to prevent manipulation of control or income interests in this manner. It applies in three broad situations:

(a) where there is a variation in the control or income interests held by a person before a measurement day by virtue of an acquisition or disposal of control or income interests before a measurement day and within 183 days of the variation there is a further acquisition or disposal that reverses the initial variation;

(b) where there is a variation in the control or income interests of a person in a foreign company around a measurement day by virtue of changes in the "foreign company aggregates" (ie the paid-up capital, nominal capital, rights to vote or participate in decision making, and rights to distributions of income or assets);

(c) where there is a variation in the control or income interests of a person in a foreign company around a measurement day by virtue of a combination of an acquisition or disposal of control or income interests and a variation in the foreign company aggregates.

7.2 Section 245E deals with temporary manipulations of control or income interests around measurement days. It does not deal with acquisitions and disposals of interests between measurement days. However, if an interest in a foreign company is acquired and disposed of between measurement days, any gain on disposal of the interest may be assessable by virtue of s.65(2)(e). That provision includes as assessable income profits or gains derived from the sale or other disposition of any personal property, or any interest in such property, if the business of the taxpayer comprises dealing in such property or if the property was acquired for the pupose of selling or otherwise disposing of it. It also includes as assessable income all profits or gains derived from the carrying on of any undertaking or scheme entered into or devised for the purpose of making a profit.

Definitions: s.245E(1)

Acquisition and disposal of control or income interests

7.3 The term "acquisition of control or income interests" is defined in s.245E(1) as meaning an acquisition by a person, directly or indirectly and whether by one transaction or a series of transactions, of any of the things, or an entitlement to acquire any of the things, listed in s.245C(4) or s.245D(2). The term "disposal of control or income interests" is defined as meaning a disposal by a person, whether directly or indirectly and whether by one transaction or a series of transactions, of any of the things or an entitlement to acquire any of the things listed in s.245C(4) or s.245D(2).

7.4 These two terms are relevant in relation to s.245E(2) and s.245E(4). Section 245E(2) applies where there is a manipulation of control or income interests around a measurement day by acquiring and disposing of control or income interests. Section 245E(4) applies where there is a manipulation of control or income interests around a measurement day by a combination of an acquisition or disposal of income interests and a variation in the foreign company aggregates.

7.5 Control or income interests can be manipulated around measurement days by acquiring and disposing of interests held by a person or by acquiring and disposing of an entitlement to acquire an interest. To ensure that both types of manipulation are dealt with, the definitions of "acquisition of control or income interests" and "disposal of control or income interests" apply to an acquisition or disposal of any of the things, or an entitlement to acquire any of the things, listed in s.245C(4) or s.245D(2).

7.6 The definitions do not refer to the definitions of "control interest" in s.245C and "income interest" in s.245D. Instead the two terms are defined by refer-

ence to the things listed in s.245C(4) or s.245D(2). The things listed in those provisions are the paid-up and nominal capital of the company, the total rights to vote or participate in decision making in relation to the company, and the rights to distributions of income or assets of the company.

Foreign company aggregates

7.7 Section 245E(1) provides that in relation to a foreign company the expression "foreign company aggregates" means the total of each of:

(a) the paid-up capital of the foreign company;

(b) the nominal capital of the foreign company;

(c) the rights to vote or participate in decision making concerning the distributions to be made by the foreign company (not being decision making undertaken by directors acting only in their capacity as directors), the constitution of the foreign company, any variation in the issued capital of the foreign company, or the appointment or election of directors of the foreign company;

(d) the rights to receive or have dealt with the income of the foreign company if distributed;

(e) the rights to receive or have dealt with the net assets of the foreign company, if distributed.

7.8 The definition of "foreign company aggregates" is relevant in relation to ss.245E(3) and (4). Section 245E(3) applies to the manipulation of control or income interests around measurement days by variations in the foreign company aggregates. Section 245E(4) applies to variations of control or income interests around measurement days by a combination of an acquisition or disposal of control or income interests and a variation in the foreign company aggregates.

Person

7.9 The term "person" is defined in s.245E as including any person, whether resident in New Zealand or otherwise. The definition also specifically includes a foreign company. This definition makes it clear that the variations in control or income interests described in s.245E(2), (3) and (4) may be variations in relation to interests held by a non-resident or by a foreign company. Variations of interests held by non-residents and foreign companies may affect the interest held by residents if the non-resident or foreign company is associated with a person resident in New Zealand. For example, a disposal of control interests in a foreign company by a non-resident will reduce the control interest of any resident associated with that non-resident. This may result in the company not being a CFC because the control interests of five or fewer residents in any category are reduced below 50 percent.

7.10 Variations in interests held by a foreign company in another foreign company may affect the control or income interests of residents in the other foreign company if the foreign company is a CFC. For example, a reduction in the direct income interest held by a CFC in another CFC on a measurement day will reduce the indirect income interests in that other CFC of residents who hold direct income interests in the first CFC. As the first CFC is a "person" for the purposes of s.245E, the rules contained in s.245E(2), (3) and (4) may apply to prevent the manipulation of the income interest by the CFC.

Variation in control or income interests

7.11 The expression "variation in control or income interests" is defined as meaning any increase or reduction in the control interest or income interest of any person in a foreign company, whether by one transaction or a series of transactions, that is attributable to an acquisition of control or income interests, a disposal of control or income interests, a reduction in any of the foreign company aggregates or an increase in any of the foreign company aggregates.

7.12 The expression "variation in control or income interests" is relevant in relation to the rules contained in s.245E(2), (3) and (4). Those provisions apply where there has been a variation in control or income interests that is attributable to an acquisition or disposal of control or income interests, a reduction or increase in foreign company aggregates or a combination of an acquisition or disposal of control or income interests and a reduction or increase in foreign company aggregates.

Acquisition and disposal of control or income interests: s.245E(2)

Description of the rule

7.13 Section 245E(2) applies where the following conditions are satisfied:

(a) there is a variation in control or income interests before a measurement day in relation to any person and any foreign company that is attributable to an acquisition of control or income interests or a disposal of control or income interests (referred to as the "variation") and within 183 days after the variation there is a further variation in control or income interests that is attributable to a disposal of control or income interests or an acquisition of control or income interests (referred to as the "subsequent variation"); and

(b) the variation reduces the person's control interest or income interest in the foreign company and the subsequent variation increases that person's control interest or income interest in the foreign company, or the variation increases the person's control interest or income interest in the foreign company and the subsequent variation reduces the person's control interest or income interest in the foreign company; and

(c) if not for the application of s.245E(2) the effect of the variation would be that a greater amount of attributed foreign loss or a lesser amount of attributed foreign income would be attributed to the person, to any person associated with the person or, if the person is a CFC, to any person holding an income interest in the CFC; and

(d) the variation and the subsequent variation are part of an arrangement the effect, or one of the effects, of which is to defeat the intent and application of Part IVA of the Income Tax Act.

7.14 If these conditions are satisfied, the variation, to the extent that it was reversed by the subsequent variation, is deemed not to have occurred in calculating the person's control interest or income interest in the foreign company on the measurement day.

Acquisition and disposal within 183 days

7.15 The first condition to satisfy for s.245E(2) to apply is that there must be a variation in control or income interests before a measurement day that is attributable to an acquisition or disposal of control or income interests (referred to as the variation) and within 183 days after the variation there must be a further variation in control or income interests that is attributable to a disposal or acquisition of control or income interests (referred to as the subsequent variation).

7.16 This contemplates two variations in control or income interests occuring around a measurement day, each being attributable to an acquisition or disposal of control or income interests. In practical terms, s.245E(1) will apply where an acquisition of control or income interests is followed by a disposal of control or income interests or where a disposal of control or income interests is followed by an acquisition of control or income interests. Where the two variations are acquisitions or disposals the second condition, that the subsequent variation reverses the first variation, will not be satisfied.

7.17 The subsequent variation must be within 183 days after the first variation. This means that the variation and the subsequent variation may be around two measurement days. For example, if the first variation occurs on 1 June 1990 and the subsequent variation occurs on 31 October 1990, the subsequent variation occurs 152 days after the original variation. If the other conditions of s.245E(2) are satisfied, the effect will be that the first variation will be ignored on the two measurement days falling within the 152 day period, 30 June 1990 and 30 September 1990, to the extent that it is reversed by the subsequent variation.

Subsequent variation reverses earlier variation

7.18 The second condition to satisfy for s.245E(2) to apply is that:

(a) the variation reduces the person's control interest or income interest in the foreign company and the subsequent variation increases the person's control interest or income interest in the foreign company; or

(b) the variation increases the person's control interest or income interest in the foreign company and the subsequent variation reduces the person's control interest or income interest in the foreign company.

7.19 Section 245E(2) therefore applies only if there is a reduction in the person's control interest or income interest followed by an increase in that interest or an increase in the person's control interest or income interest followed by a reduction in that interest. A reduction in control or income interests before a measurement day followed by a later increase may occur where the person is attempting to prevent a foreign company from being a CFC or to reduce the amount of income attributed from a CFC. An increase in control or income interests followed by a reduction in such interests may occur where a person is attempting to increase the attribution of losses from a CFC.

7.20 The variation and subsequent variation must increase or reduce the person's "control interest" or "income interest" in the foreign company. The expression "control interest" is defined in s.245C(3). In terms of that subsection, a person has a control interest in each of the categories of control interest listed in s.245C(4) that the person holds. The reference in s.245E(2) to "control interest" is therefore to a control interest in any of the categories of control interest listed in s.245C(4).

Effect of variation

7.21 The third condition to satisfy for s.245E(2) to apply is that if not for the application of s.245E(2) the effect of the variation would be that a greater amount of attributed foreign loss or a smaller amount of attributed foreign income would be attributed to the person, to any person associated with the person or, if the person is a CFC, to any person holding an income interest in the CFC.

7.22 Section 245E(2) does not apply if the variation results in a smaller amount of attributed foreign loss or a greater amount of attributed foreign income being attributed to a person. Thus, it would not apply, for example, if a person who acquired control and income interests in a foreign company before a measurement day disposed of those interests within 183 days after the acquisition and the effect of the acquisition was to increase the person's income interest in the foreign company and to increase the amount of attributed foreign income derived in respect of that interest.

7.23 The effect of the variation must be that a greater amount of attributed foreign loss or a lesser amount of attributed foreign income is attributed to the person, to a person associated with the person or, if the person is a CFC, to a person with an income interest in the CFC. Where the person in respect of whom the variation of control or income interests occurs is resident in New Zealand the effect of the variation may be to increase the attributed foreign loss or to reduce the attributed foreign income of the person. It may also increase the attributed foreign loss of a resident associated with the person because, for example, the effect of the variation is that a foreign company becomes a CFC and the associated person is therefore required to calculate attributed foreign loss in relation to the foreign company. Conversely, the variation may reduce the attributed foreign income of a person associated with the person in relation to whom the variation occurs because it may prevent a foreign company from being a CFC.

7.24 A variation in control or income interests in relation to a person may also affect the income interest of a person associated with the person because by virtue of s.245F(2) income interests of associated persons are aggregated in determining whether a person has an income interest of 10 percent or greater. Similarly, a variation in control or income interests held by a CFC in another foreign company may affect the control or income interests in that other foreign company of persons who hold control or income interests in the CFC. Such a variation would affect the indirect control interests or income interests in that other foreign company of any person holding a control or income interest in the CFC. Section 245E(2) may therefore apply to reverse the variation in relation to the CFC.

7.25 The application of s.245E(2) to a variation in relation to one person may affect the losses or income attributed to another person not associated with the person if the variation attempts to prevent a foreign company from being a CFC and the effect of applying s.245E(2) is that the foreign company is a CFC. For example, assume that two residents who are not associated, A and B, hold control interests in a foreign company in each category of 25 percent each. Assume further that A reduces his control interests in the company to 20 percent in each category before the measurement days relating to the accounting period of the foreign company ending on 30 June 1990 and within 183 days of each variation increases the control interests in each category to 25 percent again. If the conditions set out in s.245E(2) are satisfied, the effect of that provision will be to treat A as holding a 25 percent control interest in each category on each of the measurement days in question. Consequently, the foreign company will be a CFC, and A and B will be required to calculate attributed foreign income or loss in relation to their interests in the company.

Arrangement to defeat the intent and application of Part IVA

7.26 The fourth condition to satisfy for s.245E(2) to apply is that the variation and the subsequent variation must be part of an arrangement the effect, or one of the effects, of which is to defeat the intent and application of Part IVA. The intent of Part IVA is to attribute income and losses from foreign companies to residents where the control test in s.245C(1) is satisfied and where the residents have income interests of 10 percent or more. This intent will be defeated if the control test, or the 10 percent income attribution threshold, is artificially avoided by the manipulation of control or income interests around measurement days. The intent and application of Part IVA will not be avoided if in the course of normal commercial dealings there is a variation of control or income interests around a measurement day.

Effect of s.245E(2) in calculating control or income interests

7.27 If s.245E(2) applies the variation, to the extent that it is reversed by the subsequent variation, is deemed not to have occurred for the purpose of calculating the person's control interests or income interest in the foreign company on the measurement day before which the variation occurred.

7.28 The variation is deemed not to have occurred to the extent that it is reversed by the subsequent variation. Thus, if the variation is not completely reversed by the subsequent variation it remains effective to the extent that it is not reversed. The variation may be reversed by several subsequent variations. In this case the variation will be deemed not to have occurred to the extent that it is reversed by any subsequent variations which take place within 183 days after the variation. There may also be several variations before a measurement day and a reversal of these variations after the measurement day by one or more subsequent variations. In this case each variation is considered separately to determine whether it has been reversed by any subsequent variation.

7.29 In deeming the variation not to have occurred to the extent that it is reversed by the subsequent variation the effect of s.245E(2) is that on the measurement day in question the person in relation to whom the variation occurred is deemed to hold the control interests and income interest held before the variation occurred. For example, if an income interest of 20 percent in a CFC was reduced to an income interest of 9 percent before a measurement day and increased to 20 percent again after the measurement day the effect of s.245E(2) would be to treat the person as holding an income interest of 20 percent on the measurement day.

- Example 45

Facts: (i) A New Zealand resident, A, holds control interests and an income interest in a foreign company, Fco. On 15 March 1990 A holds control interests in Fco of 60 percent in each category and an income interest of 60 percent. A calculates control and income interests in Fco on measurement days in accordance with s.245A(2)(e).

(ii) On 15 March 1990 A disposes of a portion of its interest in Fco to a non-resident individual. After the disposition A holds control interests in Fco in each category of 45 percent.

(iii) On 31 July 1990 A acquires interests in Fco. The effect of the acquisition is that A holds control interests in Fco of 50 percent in each category. On 21 September 1990 A acquires further interests in Fco and the effect of this further acquisition is that A holds control interests in Fco of 60 percent in each category on that date.

(iv) On the assumption that Fco derives income, the effect of the variation is to reduce the income attributed to A in respect of A's interest in Fco. It is assumed that the variations were part of an arrangement to defeat the intent and application of Part IVA of the Income Tax Act.

Result: (i) The reduction of control interests on 15 March 1990 from 60 percent to 45 percent constitutes a variation in control or income interests that is attributable to a disposal of control or income interests. The increase in control interests from 45 percent to 50 percent constitutes a further variation in control or income interests that is attributable to an acquisition of control or income interests. This subsequent variation occurs 138 days after the initial variation: ie within the 183 day period allowed for by s.245E(2). The initial variation reduced A's control interests and income interest and the subsequent variation increased A's control interests and income interest. If not for the application of s.245E(2) a lesser amount of attributed foreign income would be attributed to A. The variation and subsequent variation are part of an arrangement the effect of which is to defeat the intent and application of Part IVA. Therefore, all of the conditions for s.245E(2) to apply are satisfied.

(ii) Applying s.245E(2), the variation in control and income interests from 60 percent to 45 percent is deemed not to have occurred to the extent that it was reversed by the subsequent variation from 45 percent to 50 percent. Consequently, on the 31 March 1990 and 30 June 1990 measurement days A is deemed to hold control interests and an income interest in Fco of 50 percent.

(iii) Section 245E(2) is applied separately to the second subsequent variation that occurred on 21 September 1990. That variation increased A's control interests and income interest in Fco from 50 percent to 60 percent. This reverses the reduction in A's control interests and income interest that occurred on 15 March 1990 to the extent that those interests were reduced from 60 percent to 50 percent. However, s.245E(2) applies only if the subsequent variation occurs within 183 days after the initial variation. In this case the subsequent variation on 21 September 1990 occurred 190 days after the initial variation on 15 March 1990. Therefore, to the extent that A's control and income interests were reduced from 60 percent to 50 percent by the initial variation, s.245E(2) does not apply to deem that initial variation not to have occurred.

(iv) Section 245E(2) applies only to reverse the initial variation on 15 March 1990 to the extent that that variation was reversed by the subsequent variation on 31 July 1990. A therefore holds control and income interests of 50 percent in Fco on the 31 March 1990 and 30 June 1990 measurement days.

Variations in foreign company aggregates: s.245E(4)

Description of rule

7.30 Section 245E(4) applies where variations in the foreign company aggregates of a foreign company result in a manipulation of control or income interests around a measurement day. For s.245E(3) to apply the following conditions must be satisfied:

(a) before a measurement day there is in relation to a person a variation in control or income interests in a foreign company that is attributable to a reduction or increase in any of the foreign company aggregates (referred to as the variation) and within 365 days after the variation there is a further variation in control or income

interests that is attributable to an increase or reduction in the foreign company aggregates (referred to as the subsequent variation);

(b) the variation reduces the person's control interest or income interest in the foreign company and the subsequent variation increases the person's control interest or income interest in the foreign company, or the variation increases the person's control interest or income interest in the foreign company and the subsequent variation reduces the person's control interest or income interest in the foreign company;

(c) if not for the application of s.245E(3) a greater amount of attributed foreign loss or a lesser amount of attributed foreign income would be attributed to the person, to any person associated with the person or, if the person is a CFC, to any person holding an income interest in the CFC;

(d) the variation and subsequent variation are part of an arrangement the effect, or one of the effects, of which is to defeat the intent and application of Part IVA of the Income Tax Act.

7.31 If these conditions are satisfied the variation, to the extent that it is reversed by a subsequent variation, is deemed not to have occurred in calculating the control and income interests of the person.

Explanation

7.32 The conditions to be satisfied are largely the same as those that apply in relation to s.245E(2). Those conditions are discussed above in paragraphs 7.15 to 7.26. There are two differences between s.245E(2) and s.245E(3). First, s.245E(2) applies to variations attributable to acquisitions and dispositions of control or income interests while s.245E(3) applies to variations attributable to increases or reductions in "foreign company aggregates". Second, s.245E(2) applies where the subsequent variation is within 183 days of the initial variation while s.245E(3) applies where the subsequent variation is within 365 days of the initial variation.

7.33 The expression "foreign company aggregates" is defined in s.245E(1) as the total of each of the paid-up capital and nominal capital of the foreign company, the rights to vote or to participate in decision making in relation to the company, and the rights to distributions of income and assets of the company. A change in any of the foreign company aggregates of a foreign company may increase or reduce the control interests or income interest of a person in the company. For example, if the foreign company issues a new class of shares before a measurement day this may dilute the control or income interests of a person on the measurement day by decreasing the percentage of the total paid-up capital or nominal capital held by the person, or by decreasing the voting rights or rights to distributions of income or assets attaching to the person's interest in the foreign company. The person's control or income interests may be increased again after the measurement day by the foreign company redeeming all shares in the class that was issued before the measurement day.

7.34 The foreign company aggregates of a foreign company may be increased before a measurement day in order to dilute control or income interests held by a person in the company. The effect of such a dilution may be that the foreign company is not a CFC because the control interests of five or fewer residents in the company are less than 50 percent. Or, the effect may be to reduce income interests of residents in a CFC in order to reduce the amount of income attributed from the CFC to such residents. Variations in foreign company aggregates may also be calculated to effect an increase in the attributed foreign loss of a resident holding an income interest in a foreign company. This result could be achieved by, for example, issuing a new class of shares to residents before a measurement day.

7.35 Section 245E(3) applies where the subsequent variation is within 365 days after the initial variation. The period within which the subsequent variation may occur is longer in the case of s.245E(3) than in the case of s.245E(2) because variations in foreign company aggregates might be expected to take place over a longer time frame than acquisitions and disposals of control and income interests.

- Example 46

Facts: (i) A New Zealand resident, A, holds control and income interests in a foreign company, Fco. On 20 March 1990 A holds control interests in Fco in each category of 55 percent and an income interest of 55 percent. On 20 March 1990 Fco issues a new class of shares to non-resident shareholders. Authority to increase the capital of Fco was obtained at a general meeting of Fco. The effect of the share issue is to reduce A's control interests in Fco to 45 percent in each category and to reduce A's income interest to 45 percent.

(ii) On 31 January 1991 Fco redeems the shares issued to the non-resident shareholders on 20 March 1990. The share redemption reduces Fco's share capital. The effect of the redemption is to increase the control interests and income interest of A in Fco to 55 percent.

(iii) On the assumption that Fco derives income, the effect of the share issue is to reduce the income

attributed to A in respect of A's interest in Fco. It is assumed that the variations (ie the share issue and the later redemption) were part of an arrangement to defeat the intent and application of Part IVA of the Income Tax Act.

Result: (i) The issue of a new class of shares on 20 March 1990 constitutes an increase in the foreign company aggregates of Fco. This increase reduces A's control interests and income interest in Fco. The share redemption on 31 January 1991 constitutes a reduction in foreign company aggregates. This reduction increases the control interests and income interests held by A in Fco. The reduction in foreign company aggregates on 31 January 1991 occurs 317 days after the initial variation in control or income interests caused by the increase in foreign company aggregates on 20 March 1990. If not for the application of s.245E(3), the effect of the initial variation would be to reduce the attributed foreign income of A in relation to A's interest in Fco. Both variations are part of an arrangement to defeat the intent and application of Part IVA. The conditions for s.245E(3) to apply are therefore satisfied.

(ii) Applying s.245E(3), the initial reduction in A's control and income interests from 55 percent to 45 percent is deemed not to have occurred to the extent that it is reversed by the subsequent variation. The subsequent variation, on 31 January 1991, increases A's control and income interests in Fco from 45 percent to 55 percent. Therefore, on the measurement days falling between the initial variation and the subsequent variation A holds control interests in each category and an income interest of 55 percent. These measurement days are 31 March 1990, 30 June 1990, 30 September 1990 and 31 December 1990.

Variations by a combination of acquisitions and dispositions and changes in foreign company aggregates: s.245E(4)

Description of rule

7.36 Section 245E(4) applies where there is a manipulation of control or income interests in a foreign company around a measurement day by virtue of a combination of an acquisition or disposal of control or income interests and a variation in the foreign company aggregates. Section 245E(4) applies if the following conditions are satisfied:

(a) there is a variation in control or income interests in a foreign company before a measurement day in relation to any person (referred to as the variation) that is attributable to an acquisition or disposal of control or income interests or a reduction or increase in any of the foreign company aggregates;

(b) within 365 days after the variation there is a further variation in the control or income interests (referred to as the subsequent variation) that, if the variation was caused by an acquisition or disposal of control or income interests, is attributable to an increase or reduction in the foreign company aggregates or, if the variation was caused by an increase or reduction in foreign company aggregates, is attributable to an acquisition or disposal of control or income interests;

(c) if not for the application of s.245E(4) the effect of the variation would be that a greater amount of attributed foreign loss or a lesser amount of attributed foreign income would be attributed to the person, to any person associated with the person or, if the person is a CFC, to any person with an income interest in the CFC; and

(d) the variation and the subsequent variation are part of an arrangement the effect, or one of the effects, of which is to defeat the intent and application of Part IVA.

7.37 If these conditions are satisfied the variation, to the extent that it was reversed by the subsequent variation, is deemed not to have occurred in calculating the person's control or income interests in the foreign company on the measurement day.

Explanation

7.38 Control or income interests can be manipulated around measurement days by combining an acquisition or disposal of a control or income interest with an increase or reduction of foreign company aggregates. Examples of how this might be done are:

(a) a person disposes of interests in a foreign company before a measurement day in order to reduce the amount of attributed foreign income derived by the person and after the measurement day the foreign company reduces its capital, thus increasing the person's control and income interests to their original level;

(b) a person acquires interests in a foreign company before a measurement day in order to increase the amount of attributed foreign losses and after the measurement day the company increases its capital, thus reducing the person's interests to their original level;

(c) before a measurement day a foreign company increases its capital to reduce the control or income interests of a person in the company, the objective being to reduce the attributed foreign

income derived by the person, and after the measurement day the person acquires more shares in the company to increase the person's control and income interests in the company to their original level;

(d) before a measurement day a foreign company reduces its capital to increase the control or income interests of a person, the objective being to increase attributed foreign losses, and after the measurement day the person disposes of shares in the company to reduce the person's interests to their original level.

These variations would fall within the terms of s.245E(4), provided that the subsequent variations were within 365 days of the initial variations and the variations were part of a scheme or arrangement the effect of which was to defeat the intent and application of Part IVA.

- Example 47

Facts: (i) A New Zealand resident, A, holds control interests and an income interest in Fco, a foreign company. On 25 September 1990 A holds control interests in Fco in each category of 30 percent. No other resident holds control interests in Fco. On 25 September 1990 A acquires more shares in Fco. The effect of this acquisition is to increase the control interests held by A in Fco to 50 percent.

(ii) On 10 October 1990 Fco increases its capital and issues further shares to non-resident shareholders. The effect of the increase is to reduce the control and income interests held by A in Fco to 30 percent.

(iii) Fco sustains a loss in the accounting period to which the 30 September 1990 measurement day relates. The acquisition on 25 September 1990 and the increase in capital and issue of shares on 10 October 1990 are part of an arrangement the effect of which is to defeat the intent and application of Part IVA.

Result: (i) The first variation, the acquisition of shares on 25 September 1990, was reversed by the subsequent variation, the increase in the capital of the company. The subsequent variation was within 365 days of the first variation. The effect of the variation is that Fco is a CFC. A will therefore be required to calculate attributed foreign loss in respect of his or her income interest in Fco. The effect of the variation is therefore to increase A's attributed foreign loss. The two variations are part of an arrangement to defeat the intent and application of Part IVA. The conditions for s.245E(4) to apply are therefore satisfied.

(ii) Applying s.245E(4), the initial variation is deemed not to have occurred to the extent that it was reversed by the subsequent variation. The initial variation, the increase in control and income interests from 30 percent to 50 percent, is reversed in full by the subsequent variation. Therefore, A holds control interests and an income interest in Fco of 30 percent on the 30 September 1990 measurement day.

Acquisition from or disposal to resident: s.245E(5)

Description of exception

7.39 Section 245E(5) provides that ss.245E(2) and (4) do not apply where the person acquired a control interest or income interest in a CFC from, or disposes of a control interest or income interest in a CFC to, a person who:

(a) at the time of acquisition or disposal is resident in New Zealand; and

(b) is liable to income tax on any attributed foreign income that the person might derive; and

(c) immediately prior to the acquisition or immediately after the disposal has an income interest of 10 percent or greater in the CFC.

Double disallowance of attributed foreign losses

7.40 The first situation in which s.245E(5) applies is where a person acquires a control or income interest in a CFC from a resident who is liable to income tax on attributed foreign income and who immediately prior to the acquisition has an income interest of 10 percent or greater in the CFC. If not for the exception in these circumstances the effect of s.245E where a CFC sustains a loss, and where a resident acquires an interest in a CFC before a measurement day from another resident, may be that no resident has an attributed foreign loss in respect of the interest in the CFC. This could occur because the person disposing of the control or income interest before the measurement day would not hold the control or income interests disposed of, and s.245E(2) or (4) would deem the person acquiring the interests not to hold them.

7.41 If s.245E(5) applies the effect is that s.245E(2) and (4) do not deem the person acquiring the control or income interests not to hold those control or income interests. Consequently, the person acquiring the control or income interests may calculate attributed foreign losses in respect of those interests. This means that there is no double disallowance of attributed foreign losses with respect to the acquired control or income interests.

7.42 Section 245E(5) does not apply where the control or income interests are acquired from a resident who is not liable to tax on attributed foreign income. In these circumstances, there is no double disallowance of attributed foreign losses because the person from whom the interests were acquired would not have sustained an attributed foreign loss if he or she had not disposed of the interests. The effect of the transaction is therefore to utilise losses that could not otherwise have been utilised. Also, s.245E(5) does not apply if prior to the acquisition the person from whom the control or income interests were acquired did not hold an income interest of 10 percent or greater in the CFC. Again, in this situation there is no double disallowance of losses because the person from whom the interests were acquired would not have had an attributed foreign loss in respect of those interests.

Double counting of attributed foreign income

7.43 The second situation where s.245E(5) applies is where a person disposes of a control interest or income interest in a CFC to a person resident in New Zealand who is liable to tax on any attributed foreign income that they might derive and who immediately after the disposition has an income interest of 10 percent or greater in the CFC. The effect of s.245E(5) in these circumstances is to ensure that the application of s.245E(2) and (4) do not result in double counting of attributed foreign income. If a resident disposes of control or income interests to another resident before a measurement day and the effect is to reduce the amount of attributed foreign income that would be attributed to the resident disposing of the interests, s.245E(2) or (4) may deem that resident to hold those interests. However, those provisions do not deem the person to whom the interests are disposed not to hold those interests. Consequently, the effect of applying s.245E(2) or (4) may be that both the resident disposing of the interests and the resident acquiring the interests has attributed foreign income in respect of the same interests. In cases where double attribution of income may occur if ss.245E(2) or (4) are applied, s.245E(5) provides that those provisions do not apply.

7.44 For s.245E(5) to apply in the case of a disposal of control or income interests, the person to whom the interests are disposed of must be resident in New Zealand and must be liable to tax on attributed foreign income. If the person acquiring the interests is not resident in New Zealand or is not liable to tax on attributed foreign income there is no double counting of attributed foreign income in respect of the interests. Therefore, it is appropriate to apply s.245E(2) or (4) to deem the person disposing of the interests to still hold them. For section 245E(5) to apply the person to whom the interests are disposed of must have an income interest of 10 percent or greater in the foreign company immediately after the disposal. A person acquiring the interests who does not have an income interest of 10 percent or greater in the CFC does not derive attributed foreign income in respect of the acquired interests. Therefore, there is no double taxation of attributed foreign income in respect of the same interest in a CFC and it is appropriate to apply s.245E(2) and (4).

Section 245E(5) as an exception to s.245E(2) and (4)

7.45 Section 245E(5) applies as an exception to s.245E(2) and (4). Therefore, s.245E(5) applies only where s.245E(2) or (4) would otherwise operate to deem a person to hold control or income interests not actually held by the person on a measurement day, or to deem a person not to hold control or income interests which are actually held on a measurement day. Sections 245E(2) and (4) do not apply if the effect of the variation in relation to a person before a measurement day is to increase the person's attributed foreign income or to reduce the person's attributed foreign loss. Consequently, s.245E(5) does not apply in these circumstances. For example, if a non-resident disposes of an interest in a CFC to a resident before a measurement day, and the effect of the disposal is to increase the attributed foreign income of the resident, s.245E(2) and (4) do not apply if the resident's interests in the CFC are reduced after the measurement day. Therefore, s.245E(5) does not apply.

Section 245E and entitlements to acquire interests: s.245E(6)

7.46 Section 245E(6) provides that nothing in s.245E shall be construed as limiting the circumstances in which a person is regarded as being entitled to acquire anything pursuant to s.245A(2)(b). The objective of this rule is to ensure that s.245E is not used to read down the rules in s.245A(2)(b) as to when a person is deemed to be entitled to acquire an interest in a foreign company.

Changes of residence around a measurement day: s.245E(7)

7.47 Section 245E(7) applies where a company resident in New Zealand becomes a foreign company and within 183 days of becoming a foreign company becomes a company resident in New Zealand again. In these circumstances the company is deemed to be resident in New Zealand for the purposes of Part IVA of the Income Tax Act at all times while it was a foreign company. The objective of this rule is to prevent resident companies from avoiding attribution of income in relation to interests held by them in CFCs by manipulating their residence around a measurement day.

7.48 If a resident company becomes a foreign company before each measurement day it will be

deemed not to hold an income interest in any CFC on those measurement days. Consequently, the company would not be required to calculate attributed foreign income in respect of its interests in CFCs. The company itself may become a CFC if there is a group of five or fewer residents whose aggregate control interests in any category is 50 percent or more. If this was the case residents holding income interests in the company would be required to calculate attributed foreign income in respect of those interests and in respect of interests held in underlying CFCs. However, if the company did not become a CFC when it became a foreign company attribution of income from CFCs in which the company held an interest would be avoided. Section 245E prevents this type of avoidance.

PART 8: PERSONS NOT REQUIRED TO CALCULATE ATTRIBUTED FOREIGN INCOME OR LOSS

Application of s.245F

8.1 Section 245F(1) provides that any person who holds an income interest in a CFC does not calculate attributed foreign income or attributed foreign loss in relation to an accounting period of a CFC in two situations. The first is where at all times in the accounting period the person is resident outside New Zealand. The second is where the income interest of the person for the accounting period is not an income interest of 10 percent or greater. For the purposes of determining whether a person has an income interest of 10 percent or greater in a CFC, s.245F(2) provides that the person is deemed to hold all the income interests held by persons associated with that person.

8.2 "Attributed foreign income" and "attributed foreign loss" are calculated in accordance with s.245G. That section is discussed in Part 9 of this bulletin.

8.3 Section 245F(1) applies only for the purposes of calculating attributed foreign income or attributed foreign loss. The rule that a non-resident does not hold an income interest for the purpose of calculating attributed foreign income or loss does not apply for the purposes of the rule in s.245F(2). That subsection provides that in determining whether a person has an income interest of 10 percent or greater in a CFC the person is deemed to hold income interests held by persons associated with that person. This rule applies in relation to all associated persons, whether or not they are resident in New Zealand.

Income interests and non-residents

8.4 Section 245F(1)(a) provides that a person is not required to calculate attributed foreign income or loss in respect of an income interest in a foreign company for any accounting period where at all times in the accounting period (or, in the case of an accounting period commencing before 1 April 1988, at all times in that part of the accounting period that falls on or after 1 April 1988) the person is resident outside New Zealand.

8.5 Section 245F(1)(a) applies where a person is resident outside New Zealand at all times during the accounting period of a CFC. The effect of this rule is that non-residents do not calculate attributed foreign income or loss. Also, a person who becomes resident in New Zealand after the end of the accounting period of a CFC but before the end of the person's income year does not calculate attributed foreign income or loss in relation to the accounting period of the CFC. This rule has a different effect from the rule in s.245D(6) that a person becoming or ceasing to be resident does not have an income interest on any measurement day on which the person is non-resident. This is because s.245D(6) applies in calculating income interests but s.245F(1)(a) applies in relation to the calculation of attributed foreign income or loss. The difference is illustrated in the following example:

- Example 48

Facts: A non-resident, A, becomes resident in New Zealand on 1 March 1991. A holds 100 percent of the interests listed in s.245C(4) and s.245D(2) in Fco. Fco's accounting period ends on 28 February 1991. A's income year ends on 31 March 1991. A calculates control and income interests in Fco on a measurement day basis in accordance with s.245A(2)(e).

Result: (i) Fco is a CFC in relation to the accounting period ending on 28 February 1990 because a resident, A, holds control interests in Fco in at least one of the categories of control interest listed in s.245C(4) of 50 percent or more. A holds control interests of 100 percent in each category of interest from 1 January 1991 until 28 February 1991 by virtue of holding control interests of 100 percent in each category on the 31 March 1991 measurement day.

(ii) By s.245D(6), A does not hold an income interest in Fco on any measurement day on which A was non-resident. A therefore does not hold an income interest in Fco on the 31 December 1990 measurement day and on all preceding measurement days. However, A is resident in New Zealand on the 31 March 1991 measurement day. Therefore, by s.245A(2)(e) A is deemed to hold an income interest of 100 percent in Fco

from 1 January 1991 until 31 March 1991. In relation to Fco's accounting period ending on 28 February, A holds an income interest in Fco of 100 percent from 1 January 1991 until 28 February 1991. Applying the formula in s.245D(5), A has an income interest for the accounting period ending on 28 February 1991 of 16.16 percent: ie

$$100\% \times \frac{59}{365} = 16.16\%.$$

Therefore, if only s.245D(6) is applied, A will be required to calculate attributed foreign income or loss in relation to A's income interest of 16.16 percent in Fco.

(iii) The requirement to calculate attributed foreign income is removed by s.245F(1)(a). In terms of that provision, A was resident outside New Zealand during the entire accounting period of Fco that ended on 28 February 1991. Therefore, A is not required to calculate attributed foreign income or loss for the accounting period of Fco ending on 28 February 1991.

8.6 In example 48 both s.245D(6) and s.245F(1)(a) apply. However, both sections need not apply in all cases. For example, if a person becomes resident in New Zealand during the accounting period of a CFC s.245D(5) may apply to reduce the person's income interest in the CFC but s.245F(1)(a) will not apply because the person was resident for part of the CFC's accounting period. Also, s.245D(6) applies where a person becomes resident or ceases to be resident. Therefore, if the person is resident outside New Zealand on all measurement days that apply in relation to a particular accounting period of a CFC, s.245D(6) will not apply but pursuant to s.245F(1)(a) the person will not be required to calculate attributed foreign income or loss.

8.7 The language in parentheses in s.245F(1)(a) applies where an accounting period of a CFC commenced before 1 April 1988. In this situation any person holding an income interest in the CFC is not required to calculate attributed foreign income or loss if the person was resident outside New Zealand at all times during the part of the accounting period falling on and after 1 April 1988. Thus, the exception applies if the person was resident for part of the accounting period falling before 1 April 1988 so long as the person was not resident for any part of the period falling on and after that date.

Income interest not an income interest of 10 percent or greater

8.8 Section 245F(1)(b) provides that a person is not required to calculate attributed foreign income or attributed foreign loss in respect of an income interest in a CFC for any accounting period where the person does not have an income interest of 10 percent or greater. Section 245F(2) provides that in determining whether an income interest of any person in a CFC for any accounting period is an income interest of 10 percent or greater, but not for any other purpose, the person is deemed to hold all the income interests for that accounting period held by any persons associated with that person.

8.9 The effect of s.245F(1)(b) is that only persons holding an "income interest of 10 percent or greater" in a CFC calculate attributed foreign income or attributed foreign loss. The expression "income interest of 10 percent or greater" is defined in s.245A(1) as meaning:

(a) an income interest calculated under s.245D that is equal to or greater than 10 percent; or

(b) an income interest equal to or greater than 10 percent after the application of s.245F(2); or

(c) an income interest in respect of which a person is required to calculate attributed foreign income or attributed foreign loss by virtue of s.245H(2).

8.10 It is clear from the definition that a person may have an "income interest of 10 percent or greater" while holding an income interest calculated in terms of s.245D of less than 10 percent. This can occur because in determining whether a person has an income interest of 10 percent or greater the income interest actually held by a person in a CFC is aggregated with income interests held by persons associated with the person: s.245F(2). A similar situation can obtain where the aggregate income interests of residents in a CFC is more than 100 percent and the income interest of a resident is reduced to below 10 percent by operation of the formula in s.245H(1).

8.11 The rule in s.245F(1)(b) that any person not holding an income interest of 10 percent or greater does not calculate attributed foreign income or attributed foreign loss provides a de minimis rule for the attribution of income and losses from a CFC. The objective of this rule is to ease the compliance costs of persons holding minor interests in CFCs: *Report of the Consultative Committee on International Tax Reform and Full Imputation Part* 2 July 1988, para 4.2.1. Although persons holding income interests that are not income interests of 10 percent or greater are required to calculate their income interests, they are relieved of the obligation to calculate branch equivalent income or loss under s.245J and to comply with the other provisions that apply where attribution of income is required.

8.12 The object of the rule in s.245F(2) is to prevent residents from fragmenting their income interests among associated persons in order to avoid the 10

percent income attribution threshold. Section 245F(2) applies only for the purpose of determining whether the income interest of a person in a CFC is an income interest of 10 percent or greater. Once it has been established that a person's income interest is an income interest of 10 percent or greater, s.245F(1)(b) will not apply and the person will be required to calculate attributed foreign income or attributed foreign loss. However, s.245F(2) applies only for the purpose of determining whether the person holds an income interest of 10 percent or greater. Therefore, income or losses are attributed from the CFC to the person on the basis of the income interest actually held by the person.

8.13 By way of example, if a resident, A, holds an income interest in a CFC of 5 percent and B, a person associated with A, holds an income interest in CFC of 5 percent, A is deemed to hold B's 5 percent income interest in determining whether A has an income interest of 10 percent or greater. A therefore holds an income interest of 10 percent in CFC. This constitutes an income interest of 10 percent or greater and A is required to calculate attributed foreign income or loss in relation to the interest in the CFC. However, A calculates attributed foreign income or loss on the basis of the income interest actually held by A: ie on the basis of the 5 percent income interest held by A in CFC.

8.14 Where s.245F(2) applies any person who holds an income interest in a CFC is deemed to hold all the income interests which any persons associated with that person hold. Interests held by associated persons that are CFCs are excluded from this rule. This is because an income interest held by a CFC in another CFC will be taken into account by residents holding an income interest in the CFC as an indirect income interest in the other CFC

PART 9: ATTRIBUTION OF INCOME AND LOSSES

Overview of s.245G

9.1 Section 245G sets out the method for calculating "attributed foreign income" and "attributed foreign loss" in relation to an income interest in a CFC. Attributed foreign income calculated by a person in accordance with s.245G is included in the person's assessable income by virtue of s.65(2)(ea). Attributed foreign loss may be deducted from or set off against attributed foreign income derived by the person in accordance with the rules in s.245M and s.245N.

Requirement to calculate attributed foreign income or loss: s.245G(1)

9.2 Section 245G(1) provides that where a person holds an income interest in a CFC, the attributed foreign income or attributed foreign loss of the person with respect to the interest is the income or loss calculated under s.245G for any accounting period of the CFC that ends within the income year of the person who holds the income interest. For example, if the accounting period of a CFC ends on 30 June 1990 and the income year of a resident holding an income interest in the CFC ends on 31 March 1991, the attributed foreign income or loss calculated in respect of the accounting period of the CFC ending on 30 June 1990 will be taken into account in calculating the assessable income of the resident for the income year ending 31 March 1991.

9.3 The meaning of "income year" in the context of s.245G is modified by s.245A(2)(f). By virtue of that provision, where a person returns income to a balance date other than 31 March in accordance with s.15 of the Income Tax Act, the year ending with that balance date is deemed to be the person's income year. The effect of this rule is discussed in paragraphs 3.142 to 3.147 of this bulletin.

9.4 Section 245G(1) applies subject to s.245F. The reference to s.245F makes it clear that the exceptions contained in s.245F override any requirement in s.245G(1) to calculate attributed foreign income. Section 245F is discussed in Part 8 of this bulletin.

Calculation of attributed foreign income or loss: s.245G(2)

Calculation

9.5 Section 245G(2) sets out the method for calculating attributed foreign income or attributed foreign loss. It provides that the attributed foreign income or attributed foreign loss of a person in respect of an income interest in a CFC is calculated in relation to an accounting period by multiplying the income interest of the person in the CFC for the accounting period and the "branch equivalent income or loss" of the CFC calculated in relation to the person for that accounting period.

9.6 The "branch equivalent income or loss" of a CFC for an accounting period is calculated in accordance with s.245J. That section is discussed in Part 12 of this bulletin. In broad terms, branch equivalent income or loss is calculated on the same basis that assessable income is calculated for New Zealand resident companies. However, the calculation of branch equivalent income or loss differs in a number of respects from the calculation of assessable income, and the

application of the Income Tax Act is specifically modified in a number of respects by s.245J. Branch equivalent income or loss of a CFC is calculated in relation to each person holding an income interest in the CFC. While in some cases the branch equivalent income or loss in relation to a CFC may be the same for each person who holds income interests in the CFC, in others it may differ.

9.7 Section 245G(2) applies subject to the other provisions in s.245G and subject to s.245H. The other provisions of s.245G modify s.245G(2) by providing a transitional rule for the calculation of branch equivalent income or loss in relation to an accounting period of a CFC that commenced before 1 April 1988 (s.245G(3)), by limiting the amount of attributed foreign loss sustained by a person in certain circumstances (s.245G(4)), and by providing rules for the separate attribution of taxable distributions and foreign investment fund income or losses derived or sustained by a CFC. The application of s.245H is discussed in Part 10 of this bulletin.

Treatment of attributed foreign income or loss

9.8 A person will derive attributed foreign income in relation to an income interest in a CFC where the result of multiplying the person's income interest and the branch equivalent income or loss calculated in relation to the person is a positive amount. The attributed foreign income thus calculated is included in the person's assessable income by virtue of s.65(2)(ea). This attributed foreign income is treated in the same manner as other assessable income derived by the person. Therefore, attributed foreign income is aggregated with other income derived by the taxpayer and, after allowable deductions and carried forward losses are taken into account, forms part of the taxable income of the taxpayer. Attributed foreign income can therefore be offset against losses sustained by the taxpayer from other income earning activities.

9.9 Attributed foreign income is assessable income. Therefore, by virtue of s.104, and subject to s.106, any expenses incurred in gaining or producing the attributed foreign income are deductible. Deductible expenses would include interest payable in gaining or producing attributed foreign income: s.106(1)(h)(i). This would include interest payable on amounts borrowed to purchase an interest in a CFC where the person is required to calculate attributed foreign income or loss in respect of that interest.

9.10 A person will have an attributed foreign loss in relation to an income interest in a CFC where the result of multiplying the person's income interest in the CFC by the branch equivalent income or loss of the CFC for the accounting period is a negative amount. The treatment of attributed foreign losses is governed by s.245M and s.245N.

Accounting period of CFC commencing before 1 April 1988: s.245G(3)

Description

9.11 Section 245G(3) sets out a transitional rule for calculating branch equivalent income or loss which applies where the accounting period of a CFC commences before 1 April 1988. It provides that in these circumstances income interests in the CFC are calculated on the basis of the part of the accounting period of the CFC falling on and after 1 April 1988 being a separate accounting period. The branch equivalent income or loss of the CFC for that separate accounting period is calculated, at the option of any person required to calculate attributed foreign income or loss, in accordance with one of two methods. The first method is based on the following formula:

$$a \times \frac{b}{c}$$

where -

a is the branch equivalent income or loss calculated in relation to the CFC and the accounting period without regard being had to s.245G(3);

b is the number of days in the accounting period that fall after 1 April 1988; and

c is the number of days in the accounting period.

9.12 Under the second method branch equivalent income or loss is calculated on the basis of the income or loss actually derived in the part of the accounting period falling on or after 1 April 1988.

9.13 Section 245G(3) effectively contains two rules: one relating to the calculation of income interests, and the other relating to the calculation of branch equivalent income or loss. The income interest and branch equivalent income or loss calculated under s.245G(3) are taken into account in calculating attributed foreign income or attributed foreign loss under s.245G(2). Section 245G(3) therefore does not directly provide a method for calculating attributed foreign income or loss in relation to an accounting period of a CFC commencing before 1 April 1988. However, by providing rules for calculating income interests and branch equivalent income or loss it determines the amount of attributed foreign income or loss calculated under s.245G(2).

Calculation of income interest

9.14 The first rule set out in s.245G(3) is that for the purposes of s.245G where the accounting period of a CFC commences before 1 April 1988 the income

interests of persons in the CFC are calculated on the basis of the part of the accounting period falling on and after 1 April 1988 being a separate accounting period. Therefore, interests held by a person before 1 April 1988 are not taken into account in calculating the person's income interest.

9.15 The effect of s.245G(3) in relation to the calculation of income interests is to treat the part of the accounting period falling after 1 April 1988 as a separate accounting period. Thus, if the income interest held by a person during separate accounting period did not vary, that unchanged income interest would be the person's income interest for that separate accounting period. If the person's income interest did vary during the separate accounting period the income interest for the period would be calculated in accordance with s.245D(5). However, as the portion of the accounting period falling after 1 April 1988 is treated as a separate accounting period, item c in the s.245D(5) formula would be the number of days in the accounting period falling after 1 April 1988.

- Example 49

Facts: The accounting period of a controlled foreign company, CFC, commenced on 1 October 1987 and ended on 30 September 1988. A New Zealand resident, A, held an interest in CFC during that period. From 1 October 1987 until 12 July 1988 that interest constituted 50 percent of the things listed in s.245D(2). From 13 July 1988 until after 30 September 1988 the interest constituted 30 percent of the things listed in s.245D(2). A's income interest in CFC is calculated on a measurement day basis.

Result: (i) Section 245G(3) applies in relation to the accounting period of CFC commencing on 1 October 1987 because that accounting period commenced before 1 April 1988.

(ii) The portion of the accounting period falling on and after 1 April 1988 (1 April 1988 to 30 September 1988) is treated as a separate accounting period in calculating A's income interest for the purposes of s.245G. A holds an income interest in CFC of 50 percent on the 30 June 1988 measurement day and 30 percent on the 30 September measurement day. These interests are deemed to be held respectively from 1 April 1988 to 30 June 1988 and from 1 July 1988 to 30 September 1988.

(iii) A's income interest in CFC varies during the separate accounting period commencing on 1 April 1988 and ending on 30 September 1988. Therefore, A's income interest in relation to that period is calculated in accordance with s.245D(5). Given that there were 91 days between 1 April 1988 and 30 June 1988 and 92 days between 1 July 1988 and 30 September 1988, s.245D(5) is applied as follows:

- 1 April 1988 to 30 June 1988

$$50\% \times \frac{91}{183} = 24.86\%$$

- 1 July 1988 to 30 September 1988

$$30\% \times \frac{92}{183} = 15.08\%$$

- income interest for accounting period

$$24.86\% + 15.08\% = 39.94\%$$

Calculation of branch equivalent income or loss

9.16 Where the accounting period of a CFC commences before 1 April 1988 the branch equivalent income or loss of the CFC for the separate accounting period (ie the part of the accounting period falling on and after 1 April 1988) is calculated on the basis of one of two alternative methods. Any person required to calculate attributed foreign income or attributed foreign loss chooses the method to be used. The first method is based on a formula that allocates branch equivalent income or loss to the portion of the accounting period falling on and after 1 April 1988 on a basis that reflects the proportion that the number of days in the accounting period falling after 1 April 1988 bears to the total number of days in that accounting period.

9.17 In applying the formula set out in s.245G(3)(a), item a is the branch equivalent income or loss of the CFC calculated without regard to s.245G(3). That is, item a is the branch equivalent income or loss of the CFC for the entire accounting period, and not only for the portion of the accounting period falling on and after 1 April 1988. Item c in the formula is the total number of days in the accounting period: ie the days falling both before and after 1 April 1988.

9.18 The second method for calculating branch equivalent income or loss in relation to the part of the accounting period falling after 1 April 1988 is to calculate the income or loss on the basis of income or loss actually derived or sustained on and after that date.

- Example 50

(i) The facts assumed in Example 49 are also assumed in this example. A New Zealand resident, A, thus has an income interest in a controlled foreign company, CFC, in relation to the separate accounting period of the CFC that

commences on 1 April 1988 and ends on 30 September 1988. This income interest is calculated as in Example 49 to be 39.94 percent.

(ii) A decides to calculate branch equivalent income or loss in relation to CFC's accounting period commencing on 1 October 1987 on the basis of the formula in s.245G(3)(a). For that accounting period the branch equivalent income or loss of CFC is NZ$1million. The portion of this amount that is treated as being derived in the separate accounting period from 1 April 1988 to 30 September 1988 is calculated as follows:

$$\$1{,}000{,}000 \times \frac{183}{366} = \$500{,}000$$

(Note: 1988 was a leap year. Therefore there were 366 days in the accounting period commencing on 1 October 1988)

(iii) The attributed foreign income derived by A in relation to A's income interest in CFC is calculated in accordance with s.245G(2) as:

$$\$500{,}000 \times 39.94\% = \$199{,}700$$

Reduction of attributed foreign losses: s.245G(4)

Description

9.19 Section 245G(4) limits the attributed foreign loss of a person in relation to an income interest in a CFC in two situations:

(a) first, where the person suffers no, or substantially no, economic or financial loss due to any factor including any right of the person or any other person to sell any thing or the right of any other person to require that person or any other person to sell any thing; and

(b) second, where any person would have an attributed foreign loss in excess of the economic or financial loss suffered by the person due to any factor including the nature of the things taken into account in calculating the person's income interest under s.245D.

9.20 If s.245G(4) applies the effect is that the person is deemed to have no attributed foreign loss to the extent that the person suffers no, or substantially no, economic loss or to the extent that the attributed foreign loss exceeds the economic or financial loss suffered by the person.

9.21 The objective of s.245G(4) is to limit attributed foreign losses to the economic or financial losses suffered by a person in relation to an income interest in a CFC. A person owning shares in a CFC that sustains a loss may suffer no or little economic loss in relation to those shares because the person may have an option to require another person to buy those shares (ie a put option). Also, because five categories of interest are taken into account in calculating income interests, opportunities arise for structuring interests in a CFC that has made a loss so as to maximise attribution of those losses to resident shareholders. The effect of s.245G(4) in these types of cases is to require an analysis of the economic or financial loss suffered by the person. Where appropriate, the attributed foreign loss calculated under s.245G(2) is reduced to the level of the economic or financial loss.

9.22 Section 245G(4) applies "notwithstanding the foregoing provisions of this section". Therefore, s.245G(4) may reduce an attributed foreign loss calculated under s.245G(2).

No or substantially no economic or financial loss

9.23 The first situation in which s.245G(4) applies is where a person holding an income interest in a CFC has an attributed foreign loss but suffers no, or substantially no, economic or financial loss. Section 245G applies in these circumstances where the person suffers no, or substantially no, economic or financial loss "due to any factor or factors". In particular, it is provided that s.245G(4) applies where a person suffers no, or substantially no, economic or financial loss due to:

(a) Any right of the person to sell any thing. A person may suffer no, or substantially no, economic or financial loss by virtue of a right to sell any thing to another person where, for example, the person holds shares in a loss company together with an option to sell those shares (ie a put option) to another person. In these circumstances, the loss of the person in relation to the shares will be limited by the existence of the put option.

(b) Any right of any other person to sell any thing. A person may suffer no, or substantially no, economic or financial loss by virtue of a right of any other person to sell any thing where, for example, the person holds an interest in a CFC, the CFC holds shares in a loss company and the CFC has an option to sell those shares. The economic or financial loss of the person is limited in these circumstances because the economic or financial loss of the CFC is limited.

(c) Any right of any other person to require that person to sell any thing. A person may suffer no, or substantially no, economic or financial loss by virtue of a right of any other person to require

the person to sell any thing where, for example, the person holds shares in a loss CFC and another person holds an option to acquire those shares. The economic or financial loss of the person may be limited in these circumstances because the exercise price of the option indicates that the option holder is likely to exercise the option. This would be the case where the exercise price is less than the market value of the shares.

(d) Any right of any other person to require any other person to sell any thing. A person may suffer no, or substantially no, economic or financial loss by virtue of a right of any other person to require any other person to sell any thing where, for example, a CFC holds an interest in a loss CFC and another person can require the CFC to sell that interest. The economic or financial loss of the person may be limited in these circumstances because the economic or financial loss of the CFC is limited.

9.24 These cases are examples of situations where s.245G(4) applies because a person having an attributed foreign loss suffers no, or substantially no, economic or financial loss. The provision applies in any other circumstances where a person having an attributed foreign loss suffers no economic or financial loss. An example would be where a person acquired an interest in a CFC in anticipation of the CFC sustaining a loss and the acquisition price of the interest reflected the anticipated loss.

Attributed foreign loss in excess of economic or financial loss

9.25 The second situation in which s.245G(4) applies is where prior to the application of s.245G(4) a person would have an attributed foreign loss in excess of the economic or financial loss suffered by the person due to any factor, including the nature of the things taken into account in calculating the person's income interest under s.245D. This second situation differs from the first in that the question is whether the attributed foreign loss is in excess of the economic or financial loss whereas in the first situation the question is whether the person suffers no, or substantially no, economic loss. The second situation is broader in scope than the first because it contemplates any situation where the attributed foreign loss of a person would be greater than the economic or financial loss suffered by the person. This would include cases where the person suffered no, or substantially no, economic or financial loss or where the person suffered an economic or financial loss but that loss was less than the attributed foreign loss.

9.26 Section 245G(4) specifically applies where the attributed foreign loss would be in excess of the economic or financial loss suffered by a person because of the nature of the things taken into account in calculating the person's income interest pursuant to s.245D. In calculating income interests under s.245D five categories of interest are taken into account, and the direct income interest of a person is the highest percentage of the interests held by the person in those categories. This provides opportunities to increase attribution of losses from a CFC beyond the level of economic or financial loss suffered by the persons to whom the losses are attributed by splitting the different categories of interest among different persons.

9.27 For example, a CFC may issue shares to a resident that constitute 60 percent of the nominal capital and 5 percent of the paid-up capital of the CFC, and that carry rights to distributions of 5 percent of the income and assets of the CFC, but no voting rights. In these circumstances the resident holds an income interest of 60 percent in the CFC. However, if the CFC sustains a loss the attribution of 60 percent of the losses of the CFC to the resident would result in the attributed foreign losses exceeding the economic or financial losses suffered by the resident. As the resident stands to gain only 5 percent of the income or assets of the CFC it may be appropriate to limit the resident's attributed foreign loss to 5 percent of the loss sustained by the CFC.

9.28 This does not mean that the entitlement to distributions of income or assets categories of interest is the yardstick for measuring economic or financial loss. In cases where a loss-making CFC was unlikely to make distributions it would be possible artificially to inflate losses attributable to residents by increasing their interests in the entitlement to distributions of income or assets categories. Therefore, it is necessary to measure the actual economic or financial loss suffered by the person rather than focusing on particular categories of interest.

Effect of s.245G(4)

9.29 Where a person has an attributed foreign loss but suffers no, or substantially no, economic or financial loss, the effect of s.245G(4) is that the person is deemed not to have an attributed foreign loss. Where a person has an attributed foreign loss that exceeds the economic or financial loss suffered by the person the effect of s.245G(4) is that the attributed foreign loss is limited to the economic or financial loss suffered by the person.

Application of s.245G(4) and s.245H

9.30 Section 245H applies where the aggregate income interests of residents used to calculate attributed foreign income or loss is greater than 100

percent. In these circumstances, the section operates by reducing the income interests of persons required to calculate attributed foreign income or loss so that the aggregate income interests of such persons is only 100 percent. The effect of this section is to limit the attribution of income or losses of a CFC to residents to 100 percent of that income or those losses. Therefore, s.245H may operate to limit the attributed foreign losses calculated by a person.

9.31 Section 245H operates prior to s.245G(4) because it applies for the purposes of calculating attributed foreign income or attributed foreign loss under s.245G(2). Section 245G(4), on the other hand, applies after an attributed foreign loss has been calculated under s.245G(2). Therefore, s.245H may apply to limit the total attributed foreign losses of residents to 100 percent of the loss sustained by a CFC and s.245G(4) may then apply to limit the attributed foreign losses calculated under s.245G(2) to the economic or financial losses suffered by the residents.

Taxable distributions derived by CFCs: s.245G(5)

9.32 Section 245G(5) applies where pursuant to s.245J(24) any taxable distribution is not taken into account in calculating the branch equivalent income or loss of any person in relation to a CFC. This is the case where the taxable distribution is received from a trust which is a non-qualifying trust in relation to the distribution. Where s.245G(5) applies the attributed foreign income of the person in respect of the taxable distribution is calculated by multiplying the taxable distribution by the income interest of the person in the CFC for the accounting period in which the taxable distribution was received. The amount thus calculated is liable for income tax at the rate applying to taxable distributions from non-qualifying trusts. The operation of s.245G(5) is discussed in the appendix to Taxpayer Information Bulletin No.5 at paragraphs 8.59 and 8.60.

Foreign investment fund income or loss of a CFC: s.245G(6)

Description

9.33 Section 245G(6) applies where pursuant to s.245J(25) any foreign investment fund income or loss is not taken into account in calculating the branch equivalent income or loss of any person in relation to a CFC. It provides that in these circumstances the foreign investment fund income or loss is attributed to the person by multiplying the foreign investment fund income or loss by the person's income interest in the CFC for the accounting period in which the foreign investment fund income or loss was derived or incurred. The amount thus attributed is deemed to be foreign investment fund income derived or foreign investment fund loss incurred by the person. Consequently, the rules governing the treatment of foreign investment fund income and losses set out in ss.245R and 245T apply to those attributed amounts. This ensures that the rules applying to the offsetting of foreign investment fund income and losses apply rather than the more restrictive rules applying to attributed foreign income and losses. It also ensures that the quarantining of foreign investment fund losses under s.245R cannot be avoided by offsetting the losses against other income derived by a CFC.

Application

9.34 Section 245G(6) applies where pursuant to s.245J(25) foreign investment fund income or a foreign investment fund loss derived or incurred by a CFC is not taken into account in calculating the branch equivalent income or loss of any person in relation to the CFC. Section 245J(25) provides that foreign investment fund income derived, or a foreign investment fund loss incurred, by a CFC is excluded from the branch equivalent income or loss of the CFC. Section 245G(6) therefore applies in all cases where a CFC derives foreign investment fund income or foreign investment fund loss.

9.35 Foreign investment fund income and foreign investment fund loss are calculated in accordance with s.245R. That section is not discussed in this bulletin. However, generally the foreign investment fund regime is designed to tax residents on interests in offshore funds located in low tax jurisdictions where deferral of New Zealand tax can be achieved by accumulation of income in the fund, or where avoidance of New Zealand tax can occur by accumulation of income and its conversion into a tax free capital gain on realisation of the interest in the fund. Foreign investment fund income and foreign investment fund loss are calculated in accordance with s.245R(3). In terms of that provision, foreign investment fund income or loss is calculated in relation to an income year by deducting from the aggregate of the market value of the interest in the foreign investment fund at the end of the income year and consideration received in relation to the interest during the year the aggregate of the market value of the interest at the beginning of the income year and consideration paid in relation to the interest during the income year.

9.36 The amount of foreign investment fund income or loss derived by a CFC that is attributed to persons holding an income interest in it is calculated by multiplying the foreign investment fund income or loss by the income interest of the person in the CFC for the accounting period of the CFC in which the foreign investment fund income or loss was derived or incurred. The amount thus attributed is treated as

foreign investment fund income or foreign investment fund loss. Consequently, the rules applying to foreign investment fund income and losses in s.245R(4) to (10), and the rules set out in s.245T in relation to the grouping of foreign investment fund income and losses, apply.

CFC holding interest in foreign investment fund resident in jurisdiction not listed in Seventeenth Schedule

9.37 Section 15 of the Income Tax Amendment Act (No 5) 1988 provides that Part IVA of the Income Tax Act applies from 1 April 1988. Part IVA contains the CFC and foreign investment fund regimes. The application of Part IVA from 1 April 1988 is limited to some extent by the transitional provisions in s.245Y. In relation to the CFC regime, s.245Y(1) provides that for the purpose of calculating attributed foreign income or loss in relation to an income interest in a CFC resident in a country or territory not listed in the Seventeenth Schedule to the Act the person is deemed to acquire that interest on 1 April 1990. The effect of this provision is that calculation of attributed foreign income or loss is not required until after 1 April 1990 where a person holds an income interest in a CFC that is not resident in a country listed in the Seventeenth Schedule.

9.38 In relation to the foreign investment fund regime, s.245Y(7) provides that where a person holds an interest in a foreign investment fund that is resident in a country or territory not listed in the Seventeenth Schedule the person is deemed for the purposes of calculating foreign investment fund income or loss to have acquired that interest on 1 April 1989. The effect of this provision is that persons who hold an interest in a foreign investment fund that is not resident in a jurisdiction listed in the Seventeenth Schedule are not required to compute foreign investment fund income until after 1 April 1989. Residents holding income interests in CFCs, and interests in foreign investment funds, that are resident in a jurisdiction listed in the Seventeenth Schedule are required to calculate attributed foreign income or loss or foreign investment fund income or loss from 1 April 1988.

9.39 Where a resident holds an income interest in a CFC that is not resident in a jurisdiction listed in the Seventeenth Schedule, s.245Y(1) provides that attributed foreign income or loss is not calculated in relation to that interest until after 1 April 1990. However, s.245Y(1) specifically provides that this rule does not apply for the purpose of attributing foreign investment fund income or a foreign investment fund loss pursuant to s.245G(6). Therefore, if a CFC that is not resident in a jurisdiction listed in the Seventeenth Schedule holds an interest in a foreign investment fund, foreign investment fund income or loss is attributed to residents holding an income interest in the CFC before 1 April 1990 although other income or loss derived or incurred by the CFC is not attributed until after 1 April 1990. The date from which foreign investment fund income or loss is attributed in this situation depends on the residence of the foreign investment fund. The residence of the CFC is irrelevant. If the foreign investment fund is resident in a jurisdiction listed in the Seventeenth Schedule, foreign investment fund income or loss is attributed through the CFC from 1 April 1988. If the foreign investment fund is resident in a jurisdiction not listed in the Seventeenth Schedule foreign investment fund income or loss is attributed from 1 April 1989: s.245Y(7).

9.40 The definition of an interest in a foreign investment fund set out in s.245R(1) is relevant in this context. In terms of paragraph (c) of that definition, a person does not hold an interest in a foreign investment fund in relation to an income year if the foreign entity is resident in a jurisdiction listed in the Fifteenth Schedule to the Act at all times during that year (ie Australia, Canada, France, Japan, the United Kingdom, the United States and the Federal Republic of Germany). Paragraph (j) of the definition provides that this exception does not apply if a foreign entity or class of foreign entities is listed in Part B of the Sixteenth Schedule or if the Commissioner has determined by virtue of s.245S that interests in the foreign entity are interests in a foreign investment fund.

9.41 Therefore, if a CFC holds an interest in a foreign entity that is resident in a jurisdiction listed in the Fifteenth Schedule, attribution of foreign investment fund income or loss will not generally be required because the foreign entity will usually not be a foreign investment fund. Such a foreign entity will be a foreign investment fund only if it is listed as such in the Sixteenth Schedule to the Act or if the Commissioner has made a determination that it is a foreign investment fund.

Attribution of foreign investment fund income or loss where CFC resident in jurisdiction listed in Fifteenth Schedule

9.42 Section 245P(1) provides that no person shall have any attributed foreign income or attributed foreign loss in respect of an income interest in a CFC for any accounting period where at all times during the period the CFC is resident in a jurisdiction listed in the Fifteenth Schedule to the Act. These jurisdictions are Australia, Canada, France, Japan, the United Kingdom, the United States and the Federal Republic of Germany. Paragraph (b) of the proviso to s.245P(1) provides that nothing in s.245P(1) prevents foreign investment fund income or foreign investment fund loss being attributed to a person pursuant to s.245G(6). Therefore, where a CFC resident in a jurisdiction listed in the Sixteenth Schedule holds an

interest in a foreign investment fund, s.245G(6) applies and foreign investment fund income or loss is attributed to residents with income interests in the CFC. This is the case even though other income derived or loss sustained by the CFC is not attributed to such residents.

Summary of attribution of foreign investment fund income and loss under s.245G(6)

9.43 The date of attribution of foreign investment fund income or losses through CFCs can be summarised as follows:

		Residence of foreign investment fund or entity		
		17th Schedule	non-17th Schedule	15th Schedule*
Residence of CFC holding interest	17th Schedule	1/4/88 (s.15 Income Tax Amendment Act (No 5) 1988	1/4/89 (s.245Y(7))	after 1/4/89 if listed in 16th Schedule or if determination under s.245S (s.245Y(7)); s.245R(1)
	non-17th Schedule	1/4/88 (s.15 ITAA (No.5) 1988; s.245Y(1))	1/4/89 (s.245Y(7))	as above (s.245R(1); s.245Y(7))
	15th Schedule	1/4/88 (as above and s.245P(1))	1/4/89 (as above and s.245P(1))	as above (s.245R(1); s.245Y(7); s.245P(1))

Note: Where the foreign entity is resident in a jurisdiction listed in the 15th Schedule, foreign investment fund income or loss will not be attributed unless the entity is listed in the Sixteenth Schedule as a foreign investment fund or unless the Commissioner has determined that the entity is a foreign investment fund under s.245S. Where an entity is listed in the Sixteenth Schedule, or where a determination is made that an entity resident in the Fifteenth Schedule is a foreign investment fund, the date from which attribution of foreign investment fund income or loss is required in relation to the entity will depend upon the effective date of the amendment to the Sixteenth Schedule or the effective date of the determination.

Non-resident on measurement day: s.245G(7)

9.44 Section 245G(7) provides that where pursuant to s.245D(6) any person is treated as not holding an income interest on any measurement day on which the person was not resident in New Zealand, the attributed foreign income or loss of the person calculated under s.245G(2) is deemed to be derived by the person when resident in New Zealand. Section 245D(6) is discussed in paragraphs 6.39 to 6.44 of this bulletin. The objective of s.245G(7) is to ensure that where the income interest of a person in relation to an accounting period of a CFC is reduced to reflect the fact that the person is resident in New Zealand for only part of the accounting period, the person does not claim a further benefit by arguing that the attributed foreign income derived in relation to that accounting period must be apportioned between the time that the person was resident and the time that the person was non-resident.

PART 10: AGGREGATE INCOME INTERESTS GREATER THAN 100 PERCENT

10.1 Section 245H applies where the aggregate income interests of persons resident in New Zealand used to calculate attributed foreign income or attributed foreign loss in respect of a CFC would be more than 100 percent. In these circumstances, s.245H(1) provides that for the purpose of calculating the attributed foreign income or loss of each person in the CFC the income interest of each person in the CFC is calculated in accordance with the following formula:

$$\frac{a}{b} \times 100$$

where -

a is the income interest of the person calculated before applying s.245H;

b is the aggregate of the income interests calculated before applying s.245H of all persons

resident in New Zealand who are required to calculate attributed foreign income or loss pursuant to s.245G(2).

10.2 Aggregate income interests of residents in a CFC may exceed 100 percent because five categories of interest are taken into account under s.245D in calculating income interests, and the direct income interest of each person in a CFC is the highest of the percentages that the person holds in those categories. For example, if A holds 50 percent of the paid-up capital and nominal capital of a CFC but no voting rights, while B holds 50 percent of the paid-up capital and nominal capital and 100 percent of the voting rights, A will have an income interest of 50 percent in the CFC while B will hold an income interest of 100 percent. The aggregate income interests of A and B will be 150 percent. Section 245H therefore applies to reduce the income interests held by A and B as follows:

A's income interest

$$\frac{50}{150} \times 100 = 33.33\%$$

B's income interest

$$\frac{100}{150} \times 100 = 66.67\%$$

10.3 Section 245H applies where the aggregate income interests used to calculate attributed foreign income or loss would exceed 100 percent. Income interests held by persons who are not required to calculate attributed foreign income or loss are not taken into account. Section 245F provides that persons who do not hold an income interest in a CFC of 10 percent or greater are not required to calculate attributed foreign income or loss. Thus, income interests held by persons who do not hold an income interest of 10 percent or greater before the application of s.245H are not taken into account in applying s.245H.

10.4 Section 245H(2) provides that s.245F(1)(b) does not apply where as a result of s.245H(1) the income interest held by a resident is reduced below 10 percent. In cases where a person holds an income interest in a CFC of 10 percent or more before the application of s.245H(1), but an income interest of less than 10 percent after the application of that provision, the effect of s.245H(2) is to negate the rule in s.245F(1)(b) that a person holding an income interest of less than 10 percent is not required to calculate attributed foreign income.

PART 11: CHANGE OF CFC'S ACCOUNTING DATE

Description

11.1 Section 245I provides rules allowing persons with interests in foreign companies to elect to change the accounting year of a CFC. Such an election may be made only with the consent of the Commissioner. If the Commissioner consents, s.245I(1) provides that an accounting period is deemed to commence on the day immediately succeeding the last day of the preceding old accounting year and to end with the last day of the new accounting year. The proviso to s.245I applies if the new accounting period ends on a date later than that previously used. In these circumstances, for the purposes of determining when attributed foreign income is derived, the accounting period in which the change of accounting year occurred is deemed to end on the date on which the old accounting year would have ended had the change not occurred.

11.2 Section 245I(2) lists several factors that the Commissioner may take into account in determining whether to approve an election made under s.245I(1). It provides that the Commissioner may have regard to whether the election:

(a) results from a change in ownership of the foreign company;

(b) results from the requirements of the law of any country or territory in which the foreign company is resident or carries on business;

(c) results from the requirement to have consistency in the accounting year balance dates of a group of companies;

(d) would result in a postponement of liability to income tax on attributed foreign income.

Election

11.3 If an election made under s.245I(1) is approved, an accounting year of the foreign company is deemed to commence on the day immediately succeeding the last day of the preceding accounting year of the foreign company and to end with the last day of the new accounting year. For example, if an election to change the accounting year of a foreign company from 31 October to 31 July is approved, and the election is made in the accounting year ending 31 October 1990, the foreign company is deemed to

have a short accounting year from 1 November 1989 to 31 July 1990. Thereafter, the accounting year runs from 1 August to 31 July. If an election is made to change the accounting year of a foreign company from 30 June to 31 October and the election is made in the accounting year ending 30 June 1991, the foreign company will have a long accounting year from 1 July 1990 to 31 October 1991. Thereafter, the accounting year runs from 1 November to 31 October.

11.4 Section 245I refers to a change in the "accounting year" of a foreign company while income interests, branch equivalent income or loss and attributed foreign income and attributed foreign losses are calculated on the basis of an "accounting period" of a foreign company. The definition of "accounting period" in s.245A(1) provides that the accounting period of a foreign company means its accounting year. Therefore, a change in the accounting year of a foreign company in terms of s.245I(1) results in a change in the accounting period of the company.

11.5 The "accounting period" definition also provides that where pursuant to the adoption of a new accounting year for a foreign company under s.245I the branch equivalent income or loss of the company is calculated on the basis of a period of other than 12 months, that other period is the accounting period of the foreign company. Therefore, in the example given in paragraph 11.3 the foreign company will have an accounting period from 1 November 1989 to 31 July 1990. In the second example the foreign company will have an accounting period from 1 July 1990 to 31 October 1991. The question of whether the foreign company is a CFC is then determined under s.245C in relation to those accounting periods. If the foreign company is a CFC in relation to those periods, income interests, branch equivalent income or loss and attributed foreign income or loss is then determined in relation to those periods.

Proviso to s.245I(1)

11.6 The proviso to s.245I(1) applies where the new accounting year ends on a date later than that previously used and where attributed foreign income is derived by any person in relation to that period. In these circumstances it provides that in determining in which income year the attributed foreign income is derived for the purposes of s.245G(1), the accounting period in which the change occurred is deemed to end on the date on which the old accounting year would have ended had the change not occurred. The proviso thus applies only for the purposes of determining in which income year of a person holding an income interest in the foreign company the attributed foreign income is derived. It does not apply in calculating the income interest of the person. That income interest is calculated in relation to the accounting year of the foreign company established under s.245I(1). Also, it does not apply in determining the branch equivalent income or loss of the foreign company or the attributed foreign income or losses of shareholders in the company. Those amounts are determined on the basis of the accounting year of the foreign company established under s.245I(1).

11.7 By way of example, if during the accounting period of a foreign company ending on 30 June 1991 an election was made to change the company's accounting year from 30 June to 31 October, the foreign company would have a long accounting period from 1 July 1990 to 31 October 1991. If any person derived attributed foreign income in relation to that long accounting period of the company, the accounting period would be deemed to end on 30 June 1991 for the purposes of applying s.245G(1) to determine in which income year the person derived the attributed foreign income. Thus, if the person returned income to a balance date of 31 March the attributed foreign income derived in relation to the long accounting period would be deemed to be derived in the income year ending 31 March 1992 because the accounting period of the foreign company ended within that income year on 30 June 1991.

11.8 However, if pursuant to s.15 the person returned income to a balance date of 30 September the attributed foreign income in relation to the long accounting period would be deemed to be derived in the income year ending on 31 March 1991. This is because pursuant to s.245A(2)(f) 30 September 1991 is deemed to be the person's income year for the purpose of applying s.245G(1). The long accounting period of the foreign company (ie from 1 July 1990 to 31 October 1991) is deemed to end on 30 June 1991. This falls within the income year ending on 30 September 1991. Therefore, in terms of s.245G(1) the attributed foreign income is derived in the income year ending 30 September 1991. However, s.245A(2)(f) does not change the income year of the person for other purposes. Consequently, by virtue of s.15 the attributed foreign income is derived in the income year ending 31 March 1991.

11.9 The proviso to s.245I(1) applies only in relation to attributed foreign income. It does not apply in relation to attributed foreign losses. Therefore, if in the example given in the preceding paragraph the person had an attributed foreign loss in relation to the foreign company that loss would be incurred in the income year ending 31 March 1992. This is because the long accounting period of the company (ie from 1 July 1990 to 31 October 1991) ends within the accounting year of the person ending on 30 September 1992. Therefore, by s.15 the attributed foreign loss is deemed to be incurred in the income year ending on the preceding 31 March, 31 March 1992.

11.10 The proviso to s.245I(1) applies only where the new accounting year would end on a date that is

later than the date previously used. This would be the case, for example, if during the accounting period of a CFC ending on 30 September 1990 its accounting year was changed to end on 31 March 1991. The accounting period ends on a later date in this case because instead of finishing on 30 September 1990 it continues until 31 March 1991. However, if during the accounting period of the CFC ending on 30 September 1990 the accounting period of the CFC was changed to end on 30 June 1990 the accounting period would end on an earlier date than previously used. The proviso to s.245I(1) would not apply in this case.

Commissioner's approval

11.11 Section 245I(2) sets out a list of factors that the Commissioner may have regard to in determining whether to approve an election made pursuant to s.245I(1). It is expressly stated that the listed factors do not limit the factors that the Commissioner may have regard to.

11.12 The first factor is whether the election results from a change in the ownership of the foreign company. This factor may be relevant where a person acquires an interest in a foreign company and wishes to change the accounting period of the company to match the person's own income or accounting year. It would not apply where the person disposes of an interest in a CFC and then seeks to reduce attribution of income from the CFC by electing to have a new accounting period commence from the date of disposition. The fact that the person does not hold an income interest in the CFC for its entire accounting period is recognised in these circumstances by the adjustment to the person's income interest in accordance with the formula in s.245D(5). Section 245I is not intended to provide an alternative method of recognising that the person does not hold an income interest in the CFC for its entire accounting period.

11.13 The second factor is whether the election results from the requirements of the taxation or other law of any country or territory in which the foreign company is resident or carries on business. This factor may be relevant, for example, where the accounting year of a foreign company is changed to comply with the law of another country or territory in which the company is resident or does business and where a resident with an interest in the company elects to change the accounting year of the company for the purposes of Part IVA to ensure consistency with the company's actual accounting year.

11.14 The third factor is whether the election results from the requirement to have consistency in accounting year balance dates of a group of companies. Thus, if two CFCs resident in the same jurisdiction constituted a group of companies for the purposes of the law of that jurisdiction, it may be necessary in terms of that law to change the accounting years of one or both of the companies to comply with a requirement for consistency of balance dates among members of a group of companies. In these circumstances, the change in the accounting year of either or both of the CFCs to comply with the consistency requirement may be taken into account in determining whether to approve an election under s.245I(1) by a resident with an interest in the CFCs.

11.15 The fourth factor is whether the election would, if approved, result in a postponement of liability to income tax on attributed foreign income in any income year for any person holding an income interest of 10 percent or greater in the foreign company. The postponement of liability may occur in any income year. Where postponement of liability to tax in relation to attributed foreign income does occur that may indicate that approval should not be given to a change in the CFC's accounting year. However, the fact that postponement of liability occurs does not necessarily mean that the election will not be approved. The postponement of liability to tax is only one factor which the Commissioner may take into account in determining whether to approve an election. Other factors that are taken into account by the Commissioner, such as a change in ownership of the foreign company, may indicate that an election should be approved notwithstanding that a postponement in tax liability will occur if the approval is granted. The following example illustrates how a postponement of tax liability in respect of attributed foreign income might arise through a change in the accounting year of a foreign company.

- Example 51

Facts: A New Zealand resident, A, holds control interests in a controlled foreign company, CFC, of 100 percent in each category of control interest. A returns income to 31 March each year. The accounting year of CFC ends on 31 December. In February 1991 A elects to change CFC's accounting year to the year ending 30 June.

Result: (i) If the election is approved an accounting year of CFC will be deemed to commence on 1 January 1991 and to end on 30 June 1991. The accounting year succeeding that accounting year will commence on 1 July 1991 and end on 30 June 1992.

(ii) The effect of an approval will not result in a postponement of tax liability in relation to income derived by CFC in the period from 1 January 1991 to 30 June 1991. That income is attributed to A and included in A's assessable income for the income year ending 31 March 1992: s.245G(1). However, there is a postpone-

ment of liability in relation to the income derived by CFC between 1 July 1991 and 31 December 1991. If the election was not approved this income would be attributed to A in the income year ending 31 March 1992 because the accounting period of CFC would have ended on 31 December 1991. However, the effect of an approval would be that the income would be derived by CFC in its accounting period ending on 30 June 1992. That accounting period ends within the income year ending on 31 March 1993. Therefore, the liability to tax on the income would be postponed from the 1992 income year to the 1993 income year.

(iii) The postponement of liability that occurs in this example would be a factor indicating that the election should not be approved. However, if other factors are present that indicate that there is good reason for changing CFC's accounting year (such as the factors listed in s.245I(2)(a) to (c)) those factors may indicate that an approval should be granted nothwithstanding the postponement in tax liability.

PART 12: BRANCH EQUIVALENT INCOME OR LOSS

Overview of s.245J

12.1 Section 245J sets out the rules for calculating "branch equivalent income or loss" of a CFC for an accounting period. The branch equivalent income or loss thus calculated is taken into account under s.245G in calculating the attributed foreign income or loss of any person holding an income interest of 10 percent or greater in the CFC. Branch equivalent income or loss of a CFC is calculated in relation to each person holding an income interest of 10 percent or greater in the CFC. Often, the branch equivalent income or loss of a CFC will be the same in relation to every person holding an income interest in the CFC. However, the operation of some of the rules in s.245J may result in different branch equivalent income or loss figures being calculated in relation to different persons. This might occur, for example, by virtue of the rules applying to the value of premises, plant, machinery, equipment, and trading stock (s.245J(4)), the rules applying to financial arrangements (s.245J(5)) and the rules applying to dividends derived by CFCs (s.245J(9)).

12.2 The general rule for calculating branch equivalent income or loss is set out in s.245J(1). By virtue of that provision, the branch equivalent income or loss of a CFC for an accounting period is the assessable income or loss that would be calculated in accordance with the Income Tax Act if the foreign company were resident in New Zealand at all times in the accounting period. The rules set out in s.245J(2) to (25) modify particular provisions of the Income Tax Act for the purpose of calculating branch equivalent income or loss or provide specific rules governing the calculation of branch equivalent income or loss.

Assumption that CFC resident in New Zealand: s.245J(1)

Application of s.245J(1)

12.3 Section 245J(1) provides that for the purposes of Part IVA of the Income Tax Act the branch equivalent income or loss of a CFC for an accounting period is an amount equal to the assessable income or loss that would be calculated in accordance with the Income Tax Act in relation to the company if the company was resident in New Zealand at all times during the accounting period and was subject to the provisions of the Income Tax Act.

12.4 Section 245J(1) applies for the purposes of Part IVA only. The CFC remains a foreign company for the purposes of the other parts of the Act. Thus, the CFC itself is liable to tax only on New Zealand source income. This will be the case where the CFC is not resident in New Zealand because non-residents are taxable on New Zealand source income only (s.242). It will also be the case where the CFC is resident in New Zealand pursuant to s.241(6) but is treated as being resident in another country for the purposes of a double taxation agreement between New Zealand and that other country and, in terms of that agreement, is not subject to New Zealand tax on all of its income.

Application of New Zealand tax rules

12.5 The branch equivalent income or loss of a CFC for an accounting period is the assessable income or loss of the CFC that would be calculated in accordance with the Income Tax Act if the CFC were resident in New Zealand at all times during the accounting period. Section 245J(1) provides that branch equivalent income or loss is calculated in accordance with the Income Tax Act on the assumption that the CFC is resident in New Zealand. Section 245J(2) provides that for the purposes of s.245J the provisions of the Income Tax Act apply subject to the succeeding subsections of s.245J. The combined effect of s.245J(1) and (2) is that the provisions of the Income Tax Act are applied on the basis of the CFC being resident in New Zealand, however those provisions are modified where required by s.245J. In many respects there will be no modification of the provisions which apply in calculating assessable income or loss. For example, the provisions governing the deductibility of expenses and the inclusion of amounts in assessable income are generally applied

without modification. In other cases there is considerable modification of the rules contained in the Income Tax Act. For example, s.245J(18) provides that losses of a CFC are not carried forward in calculating branch equivalent income or loss.

12.6 The calculation of branch equivalent income or loss by applying the Income Tax Act on the basis of the CFC being resident in New Zealand brings into effect the rules that apply in calculating assessable income but which are not expressly stated in the Income Tax Act. The rules governing tax accounting issues (eg when amounts are derived as income or incurred as expenses and inventory accounting rules) and the general exclusion of capital gains from assessable income, except in special cases such as profits on land sales and the accruals regime, fall into this category.

12.7 The income tax system of a foreign country or territory where a CFC is liable to tax will often differ considerably from the rules that apply in calculating assessable income or loss under the Income Tax Act. For example, the rules may differ as to which amounts are included in assessable income, which amounts qualify as deductible expenses, the rates of depreciation that apply and when amounts are assessable or deductible. Also, the foreign jurisdiction may provide a wide range of tax incentives that are not available in calculating assessable income under the Income Tax Act. The rules that apply under the income tax rules of the foreign country or territory are largely ignored in calculating branch equivalent income or loss. Questions of assessability or deductibility are therefore determined in relation to each item by applying New Zealand income tax rules, except to the extent that those rules are modified by s.245J.

12.8 All income derived by a CFC is taken into account in calculating its branch equivalent income or loss. This includes income derived from within New Zealand and from outside New Zealand.

Cases where foreign law relevant in calculating branch equivalent income or loss

12.9 There are two exceptions to the general proposition that foreign tax rules are not relevant in calculating branch equivalent income or loss. The first is in relation to the cost of premises, plant, machinery, equipment and trading stock at the beginning of an accounting period of a CFC. Section 245J(4)(b) provides that a person who did not have attributed foreign income or loss in respect of the immediately preceding accounting period of the CFC may calculate the cost of the asset according to either of two optional bases. The first method is to use the historical cost less depreciation or such other value used for the purposes of income tax calculations in the country in which the CFC is resident. The second method is to use the value that would have been used for the purposes of the Income Tax Act if the CFC had at all times been resident in New Zealand and subject to the Act. Foreign tax rules may therefore be relevant in calculating opening values of depreciable assets and trading stock of a CFC where a person required to calculate attributed foreign income or loss was not required to make such a calculation in respect of the immediately preceding accounting period of the CFC.

12.10 The second case where foreign income tax rules are relevant in calculating branch equivalent income or losses is in relation to the treatment of loss transfers between foreign companies. Section 245J(20)(b) provides that where a CFC has made a payment to another person resident in the same country as the CFC in consideration for the transfer from the other person to the CFC of the ability to utilise losses for income tax purposes, and that payment is deductible under the tax law of the country in which the CFC is resident, the payment is deductible in calculating the assessable income of the foreign company. In applying this provision, the question of whether the payment to transfer losses is deductible is determined under the tax law of the jurisdiction in which the CFC making the payment is resident.

12.11 Foreign law (although not foreign income tax law) is relevant in calculating branch equivalent income or loss in two other situations. The first is in applying s.245J(12). That subsection modifies s.78(2)(b) of the Income Tax Act so that where the liability in relation to amounts deducted in calculating branch equivalent income or loss of a CFC is subsequently cancelled by operation of legislation of another jurisdiction which is similar in intent and application to the Bankruptcy Act 1908, the Insolvency Act 1967, or the Companies Act 1955 the amount thus cancelled is included in the branch equivalent income or loss of the CFC. Foreign law is relevant in this context in determining whether a liability has been cancelled in accordance with legislation similar to the Bankruptcy Act, the Insolvency Act or the Companies Act.

12.12 The second respect in which foreign law other than foreign income tax law is relevant in calculating branch equivalent income or loss is in applying s.245J(16). That section provides that s.140B of the Income Tax Act applies to value added or other taxes imposed by other jurisdictions which have a similar intent and application to the goods and services tax charged under the Goods and Services Tax Act 1985. The characteristics of a tax imposed by a foreign country are established under the law of that country. Whether the tax is similar to goods and services tax is then determined on the basis of whether those characteristics are similar to the characteristics possessed by the New Zealand goods and services tax.

Application of s.245J: s.245J(2)

12.13 Section 245J(2) provides that for the purpose of s.245J, but not for any other purpose, the provisions of the Income Tax Act apply subject to the succeeding subsections of s.245J. The combined effect of s.245J(1) and (2) is that the branch equivalent income or loss of a CFC is calculated by applying the Income Tax Act on the basis that the CFC is resident in New Zealand, subject to the specific provisions of s.245J.

Currency translation: s.245J(3)

Description

12.14 Section 245J(3) provides that the income or loss of the CFC for the accounting period is calculated in the currency in which the CFC prepares its financial accounts. If the CFC does not prepare financial accounts the income or loss is calculated in the currency of the country in which the company is resident. The amount of income or loss thus calculated is converted into New Zealand currency at the average of the close of trading spot exchange rates for the 15th day of each complete month falling within that period. The proviso to s.245J(3) sets out an alternative method of translating amounts denominated in a foreign currency into New Zealand currency for the purposes of calculating the branch equivalent income or loss of a CFC. It provides that the person calculating the income or loss of the CFC may elect to make the calculation in New Zealand currency.

Calculation of income or loss in foreign currency

12.15 Section 245J(3) provides that the income or loss of a CFC for an accounting period is calculated in the currency in which the CFC prepares its financial accounts, or, if it does not prepare such accounts, in the currency of the country in which the CFC is resident. The income or loss of the CFC is therefore calculated in a foreign currency and the amount thus calculated is then converted into New Zealand currency. Items of income and expenditure are not translated into New Zealand currency on an individual basis unless an election is made in terms of the proviso to s.245J(3).

12.16 Where a CFC derives income in several jurisdictions it will be necessary to translate that income into the currency in which the CFC prepares its financial accounts or into the currency of the country in which the CFC is resident. As branch equivalent income or loss of a CFC is calculated on the assumption that the CFC is resident in New Zealand, these currency translations are made according to the rules which normally apply in calculating the income of New Zealand residents. Where the income is subject to the accruals regime set out in s.64B to s.64M of the Income Tax Act, the rules governing the translation of accruals income and expenditure will apply. In other cases general currency translation rules will apply. For example, if a CFC which prepares its financial accounts in Hong Kong dollars has a branch office in the United States and another branch office in Singapore, the income derived by the CFC from the United States and Singapore is translated into Hong Kong dollars in accordance with the New Zealand rules that apply in relation to the translation of foreign branch income.

Conversion into New Zealand currency

12.17 Section 245J(3) provides that the income or loss of the CFC that is calculated in the currency of the country in which the CFC prepares its financial accounts or in which the CFC is resident is converted into New Zealand currency at the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the accounting period of the CFC. The expression "close of trading spot exchange rate" is defined in s.245A(1). That definition is discussed in Part 3 of this bulletin.

Election to calculate income or loss of CFC in New Zealand currency

12.18 A person may make an election in relation to an accounting period of a CFC to calculate the CFC's income or loss in New Zealand Currency: s.245J(3) proviso. An election is made in relation to an accounting period of a CFC. Therefore, an election must be made each year in relation to the accounting period of the CFC that ends within the income year of the person making the election. An election is made separately in relation to each CFC. The election is made by any person calculating branch equivalent income or loss. Thus, the branch equivalent income or loss of a CFC may differ as between different persons required to calculate such income or loss because some persons make an election in terms of the proviso to s.245J(3) while others do not.

12.19 Where an election is made under the proviso to s.245J(3), income and expenses are converted into New Zealand currency on an item by item basis. That is, income and expenses are converted into New Zealand currency at the exchange rate prevailing between the New Zealand currency and the foreign currency in which the income or expenses are denominated at the time that the income is derived or the expenses incurred. If the CFC derives income denominated in several currencies, that income is converted directly from those currencies into New Zealand currency where such a conversion is possible. If a direct conversion is not possible it may be necessary to make a conversion using a cross rate with the United States dollar or with another currency if such a cross rate is not available. If the income derived or expenditure incurred by the CFC

is subject to the accruals taxation regime contained in s.64B to s.64M, the rules for converting such income or expenditure into New Zealand currency apply. In other cases the amounts are converted directly into New Zealand currency at the exchange rates prevailing when the income was derived or the expenditure was incurred.

Valuation of assets: s.245J(4)

Description

12.20 Section 245J(4) sets out the method for determining the "cost" of premises, plant, machinery, equipment and trading stock at the beginning of an accounting period of a CFC. Two methods are prescribed. The first method, set out in s.245J(4)(a), applies where the person calculating branch equivalent income or loss had attributed foreign income or loss in relation to the CFC for the immediately preceding accounting period. In these circumstances, the cost of the asset is its value at the end of the immediately preceding period used for calculating attributed foreign income or loss.

12.21 The second valuation method, set out in s.245J(4)(b), applies where the person did not have attributed foreign income or loss in relation to the CFC for the immediately preceding accounting period. In these circumstances, the person calculating branch equivalent income or loss has an option to use either of two methods of valuation. The first is to use the historical cost of the asset less accumulated depreciation or any other value used for the purposes of income tax calculations in the country in which the CFC is resident. The second method is to use the value that would be used for the purposes of the Income Tax Act at the beginning of the period if the CFC had at all times been resident in New Zealand and subject to the provisions of the Act.

12.22 Those calculating branch equivalent income or loss in relation to a CFC may adopt different valuation methods. Consequently, the application of s.245J(4) may result in the branch equivalent income or loss of a CFC being a different amount for different persons.

Valuation where attributed foreign income or loss in preceding accounting period

12.23 Section 245J(4)(a) applies where a person calculating branch equivalent income or loss for an accounting period had attributed foreign income or attributed foreign loss in respect of an income interest in a CFC for the immediately preceding accounting period of the CFC. In these circumstances, the value of the premises, plant, machinery, equipment or trading stock at the beginning of the accounting period in which the branch equivalent income or loss is calculated is taken as the value of the asset at the end of the immediately preceding accounting period.

12.24 Section 245J(4)(a) provides for an opening value of assets at the beginning of an accounting period of a CFC without prescribing the rules governing depreciation to be taken in respect of the accounting period or the method of valuation to be adopted in respect of trading stock. Depreciation is taken in accordance with the provisions in the Income Tax Act governing depreciation, except as modified by s.245J(6)(e). Trading stock is valued on the basis of the methods prescribed in s.85. Rules governing the valuation of livestock apply to the extent that they would apply if the CFC were resident in New Zealand at all times during the accounting period. Standard values for specified livestock calculated in accordance with paragraph (a) of the definition of "standard value" in s.86 may be used where the livestock is specified livestock as defined in s.2. In other cases, normal trading stock valuation rules apply unless the Commissioner agrees to a standard value for such other livestock pursuant to paragraph (b) of the s.86 "standard value" definition.

Valuation where no attributed foreign income or loss in preceding accounting period

12.25 Section 245J(4)(b) provides the method of valuing premises, plant, machinery, equipment or trading stock at the beginning of an accounting period where the person calculating branch equivalent income or loss of a CFC did not have attributed foreign income or loss in relation to the CFC in the immediately preceding accounting period. Section 245J(4)(b) operates to provide an opening value of the asset. The depreciation allowed in relation to the asset is determined in accordance with the provisions governing depreciation in the Income Tax Act. Income derived in relation to trading stock is determined in accordance with the rules governing trading stock.

12.26 The first method that the person may choose is the historical cost of the asset, less accumulated depreciation, or other value used for the purposes of income tax calculations in the country in which the CFC is resident: s.245J(4)(b)(i). In the case of a depreciable asset this option allows the opening value to be calculated on the basis of the depreciated value of the asset for the purposes of the tax law of the country where the CFC is resident. Where there is no such depreciated value, for example because the country of residence taxes solely on a territorial basis and the asset in question is not used in income earning activities within the country, this method cannot be used. In the case of trading stock, the opening value determined under this method is the opening value used for the purposes of income tax calculations in the CFC's country of residence in respect of the accounting period in question.

12.27 The value determined under s.245J(4)(b)(i) cannot be higher than the market value of the asset. However, the value may be lower than market value where, for example, accelerated depreciation has been taken in the country of the CFC's residence in relation to the asset.

12.28 The second method of establishing an opening value under s.245J(4)(b) is to use the value that would be used for the purposes of the Income Tax Act at the beginning of the accounting period of the CFC in relation to which the branch equivalent income or loss is calculated if the CFC had at all times been resident in New Zealand. In the case of depreciable assets this involves establishing the original value of the asset that would have been used for New Zealand depreciation purposes, and then deducting the aggregate amount of depreciation that would have been allowed under the Income Tax Act up to the end of the immediately preceding accounting period of the CFC.

Opening value where new CFC established

12.29 Section 245J(4) applies only if the CFC had an accounting period immediately preceding the accounting period in which the person is required to calculate branch equivalent income or loss. It does not apply where a new CFC is established and it is necessary to calculate branch equivalent income or loss in relation to the initial accounting period of the CFC. In these circumstances, there is no choice as to the method of valuation to be adopted. The opening value of depreciable assets is the value that would apply under the Income Tax Act in calculating the assessable income of a company resident in New Zealand and subject to the Income Tax Act. The opening value of trading stock is determined in accordance with s.85 or in accordance with the special rules applying to livestock where those rules apply. Trading stock may be valued by the person calculating branch equivalent income or loss at its cost price, market selling value or replacement value.

Financial arrangements: s.245J(5)

12.30 Section 245J(5) sets out two methods of calculating the acquisition price of a financial arrangement held by a CFC. The first method applies if the person calculating branch equivalent income or loss had attributed foreign income or loss in respect of the immediately preceding accounting period of the CFC. In these circumstances, s.245J(5) provides that the acquisition price of the financial arrangement at the beginning of the accounting period is the value of the financial arrangement that was used for the purposes of calculating attributed foreign income or loss at the end of the immediately preceding accounting period. The second method applies where the person did not have attributed foreign income or loss in respect of the immediately preceding accounting period. In these circumstances, the acquisition price is, at the option of the person, either the market value or the "adjusted base price" of the financial arrangement.

12.31 Where the CFC is an issuer of a financial arrangement, the "adjusted base price" of the financial arrangement is calculated as the acquisition price of the financial arrangement together with accrued expenditure incurred by the CFC less consideration paid by the CFC in relation to the financial arrangement for all prior periods. Where the CFC is a holder of a financial arrangement, the "adjusted base price" of the financial arrangement is the acquisition price of the financial arrangement together with accrued income derived by the CFC less consideration derived by the CFC in prior periods. The "acquisition price" referred to is the original acquisition price of the financial arrangement in relation to the CFC. The terms "accrued expenditure incurred" and "accrued income derived" are not defined. However, they mean the expenditure that would have been incurred and the income that would have been derived if branch equivalent income had been calculated by the person in relation to the CFC in all prior accounting periods.

Provisions of Income Tax Act not to apply: s.245J(6)

Interest or redemption payment from lending to New Zealand Government or local or public authority

12.32 Section 245J(6)(a) provides that s.61(18) does not apply in calculating branch equivalent income or loss of a CFC. Section 61(18) provides an exemption from income tax for interest or a redemption payment derived by a person resident outside New Zealand in respect of:

(a) money lent to the Government of New Zealand; or

(b) money lent to a local or public authority for the purpose of an activity, other than a commercial activity, carried on in New Zealand by the local or public authority where the amounts payable in respect of the money lent are exempt from tax pursuant to an approval given by the New Zealand Government.

The exemption applies where the interest or redemption payment is payable out of New Zealand.

12.33 The effect of s.245J(6)(a) is that interest or redemption payments described in s.61(18) that are derived by a CFC are included in the branch equivalent income or loss of the CFC and are taken into account in calculating the attributed foreign income or loss of persons holding an income interest in the

CFC. Thus, although interest payable on money lent by a CFC resident in Hong Kong to the New Zealand Government, for example, may be exempt from income tax in the hands of the CFC, the interest is included in the branch equivalent income or loss of the Hong Kong CFC and is attributed to residents. Section 245J(6)(a) also ensures that s.61(18) cannot be read as excluding from branch equivalent income or loss interest or redemption payments derived by a CFC in respect of money lent to a foreign government or local or public authority.

Income derived by society or association established to make district improvements

12.34 Section 245J(6)(b) provides that s.61(33) does not apply in calculating the branch equivalent income or loss of a CFC. Section 61(33) provides an exemption from income tax for income derived by any society or association which in the opinion of the Commissioner is established for the purpose of beautifying or developing any city, borough or other district so as to attract trade, tourists, visitors or population or to create, increase, expand or develop amenities for the general public. The effect of s.245J(6)(b) is that where a CFC is established for any of the purposes mentioned in s.61(33), the income derived by the CFC is included in the branch equivalent income or loss of the CFC. The rationale for not extending the s.61(33) exemption to the calculation of branch equivalent income or loss of a CFC is that the objective of s.61(33) is to encourage the improvement of New Zealand cities, boroughs or districts and not those of other jurisdictions.

Application of accruals rules

12.35 Section 245J(6)(c) provides that s.64M(e) does not apply in calculating the branch equivalent income or loss of a CFC. Section 64M(e) provides that the accruals taxation rules contained in s.64B to s.64M of the Income Tax Act do not apply to the determination of -

(i) income or expenditure in relation to a financial arrangement of a person not resident in New Zealand where the financial arrangement does not relate to a business carried on by the person through a fixed establishment in New Zealand; or

(ii) non-resident withholding income.

12.36 The effect of s.64M(e) is that non-residents do not apply the accruals rules in calculating New Zealand source income unless they hold a financial arrangement that relates to a business carried on through a fixed establishment in New Zealand. As s.245J(6)(c) overrides s.64M(e), the accruals legislation applies in full in calculating branch equivalent income or loss.

Attributed foreign income and foreign investment fund income

12.37 Section 245J(6)(d) provides that ss.65(2)(ea) and (eb) do not apply in calculating branch equivalent income or loss. Sections 65(2)(ea) and (eb) require attributed foreign income and foreign investment fund income respectively to be included in assessable income. The effect of excluding these provisions is that where a CFC holds an interest in another CFC or in a Foreign Investment Fund, branch equivalent income does not include attributed foreign income or losses, or Foreign Investment Fund income or losses. Income derived by a CFC is attributed to residents holding an income interest in the CFC. This is the case whether the residents hold an income interest in the CFC directly or whether the interest is held indirectly through interposed CFCs. Because income derived by a CFC is attributed directly in this manner, it is necessary to exclude attributed foreign income from the branch equivalent income or loss of a CFC to avoid double counting of income derived by a CFC in which residents hold an indirect interest through other CFCs.

12.38 Foreign investment fund income and foreign investment fund losses are attributed through CFCs directly as foreign investment fund income or foreign investment fund loss: s.245J(25); s.245G(6). Section 245J(6)(d) makes it clear that foreign investment fund income is not included in branch equivalent income or loss, thus ensuring that there is no double counting of foreign investment fund income derived by CFCs.

First year depreciation

12.39 Section 245J(6)(e) provides that s.112 does not apply in calculating the branch equivalent income or loss of a CFC. Section 112 provides for depreciation to be allowed in relation to certain assets in the first year such assets are used in the production of assessable income. Depreciation allowed under this provision is at a higher rate than would otherwise be the case. Section 112 is being phased out. However, s.245J(6)(e) ensures that no depreciation deductions can be claimed under this provision in calculating the branch equivalent income or loss of a CFC. The rationale for preventing s.112 from applying is that first year depreciation at higher rates was designed to assist income earning activities in New Zealand and not those carried on outside New Zealand.

Expenditure on land used for farming or forestry and expenditure in relation to an aquaculture business

12.40 Sections 245J(6)(f), (g) and (h) provide respectively that ss.127, 127A and 128 do not apply in calculating the branch equivalent income or loss of a CFC. Those latter sections permit deductions for

certain expenditure incurred in income years ending before 31 March 1991 in relation to farming, forestry and aquaculture businesses. The expenditure in question is capital in nature and would not ordinarily be deductible in calculating assessable income. The objective of ss.127, 127A and 128 was to provide assistance to farming, forestry and aquaculture businesses carried on in New Zealand. Therefore, it would not be appropriate to permit deductions under those sections in calculating the branch equivalent income or loss of a CFC as that would result in the provision of assistance to activities carried on outside New Zealand.

Income equalisation

12.41 Section 245J(6)(i) provides that ss.175 to 186 do not apply in calculating branch equivalent income or loss. Those sections provide an "income equalisation" system for persons carrying on a farming, fishing or forestry business whereby income is smoothed between years of high and low income by means of deductible deposits being made to an interest bearing income equalisation account in years of high income and taxable refunds being made in years of low income. The objective of the income equalisation scheme is to provide assistance to persons carrying on farming, fishing or forestry businesses in New Zealand. Section 245J(6)(i) ensures that such assistance is not provided in relation to activities carried on outside New Zealand by preventing ss.175 to 186 from applying in calculating branch equivalent income or loss of a CFC.

Part IVA

12.42 Section 245J(6)(j) provides that Part IVA of the Income Tax Act, except for s.245J and s.245R, do not apply in calculating the branch equivalent income or loss of a CFC. Part IVA contains the controlled foreign company and foreign investment fund regimes. One consequence of not applying Part IVA in calculating branch equivalent income or loss is that where a CFC holds an interest in another CFC the first CFC does not have attributed foreign income or an attributed foreign loss in relation to the interest in the second CFC. Any income or loss of the second CFC is attributed through directly to residents holding an income interest in the second CFC rather than being taken into account in calculating the branch equivalent income or loss of the CFC.

12.43 The exclusion of Part IVA in calculating branch equivalent income or loss does not apply to s.245J and s.245R. The reference to s.245J applying is necessary because branch equivalent income or loss is calculated in accordance with that provision. The reference to s.245R ensures that a CFC may hold an interest in a foreign investment fund and may therefore derive foreign investment fund income or incur a foreign investment loss. This is necessary to ensure that s.245J(25) applies. That section provides that foreign investment fund income or loss derived by a CFC is not taken into account in calculating the branch equivalent income or loss of the CFC and, pursuant to s.245G(6), is attributed directly to residents holding income interests in the CFC.

12.44 Section 245J(6)(j) applies in conjunction with s.245J(6)(d) where a CFC holds an interest in a foreign investment fund. Section 245J(6)(j), by preserving the application of s.245R, recognises that a CFC may hold an interest in a foreign investment fund and derive foreign investment fund income or loss. This ensures that s.245J(25) can be applied. However, together with s.245J(25), s.245J(6)(d) ensures that foreign investment fund income is not included in the branch equivalent income or loss of a CFC.

Modification of provisions which apply in calculating branch equivalent income or loss: s.245J(7)

Income from use or occupation of land

12.45 Section 245J(7)(a) provides that for the purposes of s.74 any business carried on by a CFC is assumed to be carried on in New Zealand. Section 74 provides that the assessable income of any person includes profits or gains from the use or occupation of land and from the extraction, removal or sale of any minerals, timber or flax. These provisions largely apply in calculating branch equivalent income or loss of a CFC by virtue of s.245J(1) and (2). However, several provisions in s.74 refer specifically to a forestry business conducted on land in New Zealand. Section 245J(7)(a) ensures that those provisions can apply in relation to a forestry business carried on outside New Zealand by assuming such a business to be carried on in New Zealand for the purposes of s.74.

Supplementary depreciation for plant and machinery

12.46 Section 245J(7)(b) provides that for the purposes of s.113A any business carried on by a CFC is assumed to be carried on in New Zealand. Section 113A provides that where capital expenditure has been incurred in acquiring, installing, or extending any plant and machinery to be used in two shifts per day (ie an average of not less than 16 hours per working day) or three shifts per day (ie normally in operation for 24 hours per working day) the Commissioner may allow a deduction by way of supplementary depreciation in respect of the plant or machinery. The supplementary depreciation is available in the first five years in which the plant and machinery is used in the production of assessable income and is in addition to depreciation allowed under s.108.

12.47 By its terms, s.113A is limited to businesses carried on in New Zealand. However, s.113A is not an incentive provision but rather recognises the additional wear and tear on plant and machinery used in two or three shifts. Therefore, if a CFC carries on a business outside New Zealand in which plant or machinery is used in two or three shifts it is appropriate to allow supplementary depreciation (subject to the limits contained in s.113A and at the rates specified in that section) in calculating the branch equivalent income or loss of the CFC. Section 245J(7)(b) achieves this by assuming that a business carried on by a CFC is deemed to be carried on in New Zealand for the purposes of s.113A.

Expenditure on improvements in relation to farming, forestry and aquaculture

12.48 Section 245J(7)(c) provides that for the purposes of ss.128A to 128C of the Income Tax Act any business carried on by a CFC is deemed to be carried on in New Zealand. Sections 128A and 128B provide that a taxpayer carrying on a farming business or forestry business on any land owned by the taxpayer in New Zealand may deduct certain expenditure incurred in preparing or developing the land. Section 128C provides that a taxpayer carrying on a business of aquaculture in New Zealand may deduct certain expenditure incurred in preparing or developing the business. By their terms, these sections are limited to businesses carried on on land in New Zealand or businesses which are carried on in New Zealand. The effect of s.245J(7)(c) is that where a CFC carries on a farming or forestry business on land outside New Zealand, or carries on an aquaculture business outside New Zealand, ss.128A to 128C apply in calculating branch equivalent income or loss of the CFC.

Petroleum mining operations

12.49 Section 245J(7)(d) provides that for the purpose of ss.214D to 214N and s.214P any business carried on by a CFC is deemed to be carried on in New Zealand. This ensures that the new taxation regime for petroleum mining operations set out in ss.214D to 214P applies to petroleum mining operations carried on by CFCs. Section 245J(22A) also has this effect.

12.50 Section 245J(7)(d) was inserted by s.13 of the Income Tax Amendment Act (No.2) 1990 with effect from the income year commencing on 1 April 1990. The treatment of petroleum mining operations carried on by CFCs in prior income years is governed by s.245J(22) prior to its amendment by the Income Tax Amendment Act (No.2) 1990.

Transactions between associated persons: s.245J(8)

Description and rationale

12.51 Section 245J(8) applies where it appears to the Commissioner that by virtue of any transaction between a CFC and any person associated with the CFC the branch equivalent income of the CFC is less than might be expected, or the branch equivalent loss is greater than might be expected. In these circumstances, s.22 applies with any necessary modifications in determining the branch equivalent income or loss of the CFC. For the purposes of determining whether a person and a CFC are associated, the rules defining associated persons relationships set out in ss.8 and 245B apply.

12.52 The objective of s.245J(8) is to allow the Commissioner to make adjustments to the branch equivalent income or loss of a CFC where profit or loss shifting transactions have been entered into between a CFC and a person associated with the CFC. Such transactions might occur, for example, to defeat the foreign tax credit quarantining rules in s.245K or the loss quarantining rules in s.245M.

12.54 Where profit or loss shifting transactions are entered into between CFCs and their associates, s.245J(8) may be used to adjust the income or loss of the CFCs in question. Section 245J(8) applies only where the branch equivalent income of a CFC is less, or the branch equivalent loss of a CFC is greater, than might be expected because of a "transaction" between the CFC and a person associated with the CFC. The transaction might involve, for example, transfer pricing on the sale of goods or the provision of services.

Associated persons

12.55 Section 245J(8) applies where the transaction in question is between a CFC and a person associated with the CFC. The rules set out in s.8 and s.245B apply in determining whether the CFC and a person with whom the CFC entered into a transaction are associated. Both sets of rules treat two companies as associated where there is a commonality of shareholding or control. Those rules may apply to make two CFCs associated. A CFC may also be associated with other persons. For example, if a CFC is a settlor of a trust the CFC and the trustees of the trust will be associated: s.245B(i) (assuming that the proviso to s.245B(i) does not apply). Also, a CFC will be associated with a person other than a company who holds 25 percent or more of the paid-up capital of the CFC or 25 percent or more of the nominal value of the allotted shares of the CFC: s.8(1)(b).

Application of s.22 control test

12.56 Where the branch equivalent income of a CFC is less, or the branch equivalent loss is greater, than might be expected by virtue of a transaction between a CFC and a person associated with the CFC, s.22 applies with any necessary modifications in calculating the branch equivalent income or loss of the CFC. This means that s.22 operates to adjust the income or loss of the CFC. It does not mean that the control test set out in s.22 must also be satisfied before s.22 applies. The requirements for the application of s.22 are satisfied where a transaction is entered into between a CFC and an associated person. To suggest that the control test in s.22 must also be satisfied would be to impose a further requirement to the application of s.22 when s.245J(8) already states that s.22 applies. The reference to s.22 is therefore only to incorporate the adjustment mechanism contained in that section.

Modifications to s.22

12.57 For the purposes of s.245J(8), s.22 is applied "subject to any necessary modifications". Section 22(3) applies to allow the Commissioner to adjust the income of the CFC and s.22(4) applies to allow the Commissioner to adjust the loss of the CFC.

12.58 The effect of modifying s.22(3) for the purposes of s.245J(8) is that the income of the CFC is such amount as the Commissioner determines being, at the option of the Commissioner, either -

(a) such proportion of the total receipts of the business of the CFC as the Commissioner determines; or

(b) such proportion of the total purchase money paid or payable (whether in cash or by the granting of credit) in the conduct of the business of the CFC as the Commissioner determines.

12.59 The effect of modifying s.22(4) for the purposes of s.245J(8) is that the Commissioner may determine the amount of the loss incurred by the CFC in such manner as the Commissioner considers fair and reasonable.

Dividends derived by CFC: s.245J(9)

Description

12.60 Section 245J(9) provides that s.63 of the Income Tax Act does not apply in calculating the branch equivalent income or loss of a CFC and that all dividends derived by a CFC are assessable income. An exception to this rule is set out in the proviso to s.245J(9). By that proviso, dividends are exempt if derived in any accounting period from shares held by the CFC in another CFC where the person has an income interest of 10 percent or greater in the other CFC:

(a) for an accounting period of the other CFC that ends within the same income year of the person calculating branch equivalent income or loss as the accounting period of the CFC deriving the dividend; or

(b) for an accounting period of the other CFC that ends within the income year of the person calculating branch equivalent income or loss that immediately precedes the income year in which the accounting period of the CFC deriving the dividend ends.

Inclusion of dividends in income

12.61 Section 245J(9) provides that dividends are included in the assessable income of a CFC for the purposes of calculating branch equivalent income or loss. The rationale of this rule is that, generally, dividends derived by a CFC will not, except in the circumstances described in the proviso to s.245J(9), be paid from profits that have been subject to New Zealand tax. Therefore, it is not appropriate to exempt such dividends because there is no incidence of double or multiple taxation of corporate income as it passes through a tier of companies.

Exemption of dividends

12.62 The proviso to s.245J(9) exempts dividends derived by a CFC in two situations. In both cases the exemption applies where a CFC derives a dividend from another CFC. In the first situation, dividends derived by a CFC from another CFC are exempt where the person calculating branch equivalent income or loss in relation to the CFC deriving the dividend holds an income interest of 10 percent or greater in the CFC paying the dividend for an accounting period of that CFC that ends in the same income year that the accounting period of the CFC deriving the dividend ends. In this case the dividend may have been paid out of income taken into account by the person in calculating branch equivalent income or loss of the CFC paying the dividend. If so, this income will already have been taxed as attributed foreign income in respect of the person's income interest in the CFC paying the dividend. Double taxation of this income is therefore avoided by exempting the dividend in the hands of the CFC deriving the dividend for the purposes of calculating the branch equivalent income or loss of that CFC.

12.63 The second situation in which dividends derived by a CFC from another CFC are exempt is where the person calculating branch equivalent income or loss held an income interest of 10 percent or greater in the CFC paying the dividend in the income year of the person immediately preceding the in-

come year in which the accounting period of the CFC deriving the dividend ends. In this case it is appropriate to exempt the dividend because it may have been paid out of income that the person included in the branch equivalent income or loss of the CFC paying the dividend in the accounting period of that CFC that ended in the person's preceding income year.

- Example 52

Facts: (i) A New Zealand resident, A, furnishes a return of income to the year ending 31 March. A holds an interest in a controlled foreign company, CFC1, and CFC1 holds shares in another controlled foreign company, CFC2. The accounting period of CFC1 ends on 31 December and the accounting period of CFC2 ends on 30 October.

(ii) For the accounting periods of CFC1 ending on 31 December 1991 and 31 December 1992 A holds an income interest in CFC1 of 50 percent and 18 percent respectively. CFC1 remains a controlled foreign company for the accounting period ending 31 December 1992 because the interest disposed of by A (ie the disposal which reduced A's income interest from 50 percent to 18 percent) was acquired by a resident. In the accounting periods of CFC2 ending 31 October 1991 and 31 October 1992 CFC1 holds shares in CFC2. It is assumed that A holds an income interest of 20 percent and 9 percent in CFC2 for those accounting periods.

(iii) CFC2 pays a dividend of $1 million to CFC1 on 30 November 1991 and a dividend of $2 million on 30 November 1992.

Result:

Dividend paid on 30 November 1991

(i) The dividend paid by CFC2 on 30 November 1991 is derived by CFC1 in the accounting period of CFC1 ending 31 December 1991. That accounting period ends within the income year of A ending on 31 March 1992. A holds an income interest of 20 percent in CFC2 for the accounting period of CFC2 ending on 31 October 1991.

(ii) Therefore, the dividend is not included in the branch equivalent income or loss of CFC1 for the accounting period ending on 31 December 1991 because:

(A) the accounting period of CFC2 ending on 31 October 1991 and the accounting period of CFC1 ending on 31 December 1991 both end within the income year of A which ends on 31 March 1992; and

(B) for the accounting period of CFC2 ending on 31 October 1991 A holds an income interest of 10 percent or greater in CFC2.

Dividend paid on 30 November 1992

(iii) The dividend paid by CFC2 on 30 November 1992 is derived by CFC1 in the accounting period of CFC1 ending on 31 December 1992. That accounting period ends within the income year of A ending on 31 March 1993. A holds an income interest of 9 percent in CFC2 for the accounting period of CFC2 ending 31 October 1992. The dividend is not exempt on the basis that A had an income interest in CFC2 of 10 percent or greater for the accounting period of CFC2 that ends within the same income year that the accounting period of CFC1 ends. This is because for the accounting period of CFC2 ending on 31 October 1992 A held only an income interest of 9 percent in CFC2.

(iv) However, for the accounting period of CFC2 ending within A's preceding income year (ie the accounting period ending on 31 October 1991) A held an income interest in CFC2 of 20 percent. Therefore, A does not include the $2 million dividend derived by CFC1 on 30 November 1992 in CFC1's branch equivalent income or loss.

12.64 The proviso to s.245J(9) applies only where the person calculating branch equivalent income or loss in relation to a CFC deriving a dividend holds an income interest of 10 percent or greater in the CFC paying the dividend for the relevant accounting period of that CFC. Therefore, the branch equivalent income or loss of a CFC deriving a dividend from another CFC may not be the same for all persons who hold an income interest in the CFC deriving the dividend because some of those persons may have an income interest of 10 percent or greater in the CFC paying the dividend while others do not.

Benefits from money advanced: s.245J(10)

12.65 Section 245J(10) provides that for the purposes of s.65(2)(ja)(i) of the Income Tax Act where money advanced is borrowed by a CFC the money advanced is assumed to be used in relation to a business carried on in New Zealand by the CFC. Section 65(2)(ja)(i) provides that the value of any benefit from money advanced is included in assessable income where -

(a) the money advanced is used or is to be used in relation to any business carried on in New Zealand by the borrower; and

(b) the borrowing was a commercial transaction under which interest on the money advanced

would in the opinion of the Commissioner have been payable at commercial rates, having regard to the nature and term of the loan, if not for the benefit from the money advanced.

Profits or gains from activities of associated persons: s.245J(11)

12.66 Section 245J(11) provides that s.67 and s.191(4A) do not apply to treat profits or gains as income if those profits or gains would not be income but for the nature of activities undertaken by persons associated with the CFC if those persons are resident outside New Zealand. Section 67 provides that a taxpayer derives an assessable profit or gain on the disposition of land if at the time of acquiring the land the taxpayer, or a person associated with the taxpayer, carried on a business of dealing in land, developing or dividing land into lots or erecting buildings. The effect of s.245J(11) in relation to s.67 is that where at the time of acquisition of land by a CFC a person associated with the CFC carried on a business of dealing in land, developing or dividing land into lots or erecting buildings, the disposal of the land by the CFC will not be income merely by virtue of the business carried on by the associated person if that associated person is resident outside New Zealand.

12.67 Section 191(4A) provides that where s.191(4) applies to a specified group of companies a profit or gain derived by a company in the group which would not otherwise be treated as income is deemed to be assessable income where, if the group were one company, the profit or gain would have been assessable income of that company. The effect of this provision is that activities of some members of a group of companies may determine whether profits or gains of other members of the group are assessable. For example, if one member of a group of companies is in the business of buying and selling shares, and another member of the group realises a parcel of shares in circumstances where the gain would ordinarily constitute a capital gain, the effect of s.191(4A) is to treat that gain as assessable income.

12.68 The effect of s.245J(11) in relation to s.191(4A) is that where several CFCs satisfy the specified group definition in s.191(4), the actions of one CFC do not affect the question of whether profits or gains derived by another CFC are income for the purposes of calculating the branch equivalent income or loss of the CFC deriving the gain. This exception applies only if the two CFCs are associated in terms of s.245B.

Cancellation of liability: s.245J(12)

12.69 Section 245J(12) provides that for the purposes of s.78(2)(b) of the Income Tax Act, in calculating the branch equivalent income or loss of a CFC reference to the Bankruptcy Act 1908, the Insolvency Act 1967 or the Companies Act 1955 shall include any legislation of a country, territory, state or province other than New Zealand where that legislation has a similar intent and application as those New Zealand Acts.

12.70 Section 78(1) provides that where expenditure or loss incurred by a taxpayer has been taken into account in calculating assessable income and the taxpayer's liability in relation to that expenditure is subsequently remitted or cancelled, the amount thus remitted or cancelled is included in the assessable income of the taxpayer. One of the circumstances in which a liability is deemed to be cancelled is where the taxpayer has been released from that liability by operation of the Bankruptcy Act, the Insolvency Act or the Companies Act or by deed of composition with creditors: s.78(2)(b).

12.71 The effect of s.245J(12) in relation to s.78 is that a liability is deemed to be cancelled by operation of the Bankruptcy Act, the Insolvency Act or the Companies Act where it is cancelled by operation of legislation of a country, territory, state or province other than New Zealand which is of similar intent and application as those New Zealand Acts. Consequently, where expenditure or loss incurred by a CFC has been taken into account in calculating branch equivalent income or loss of the CFC, and the liability of the CFC is subsequently cancelled by operation of legislation similar in intent and application to the New Zealand Acts listed in s.78(2)(b), the expenditure is treated as income of the CFC.

Spreading of income on acquisition of land by Government: s.245J(13)

12.72 Section 245J(13) provides that for the purposes of s.82(1) of the Income Tax Act references to the Crown shall be assumed to include the Government of any country or territory other than New Zealand. Section 82(1) provides that where a taxpayer derives income from the disposition of land acquired by the Crown, the Commissioner may, on application by the taxpayer, apportion the income between that income year and any number of subsequent income years not exceeding 3. The income apportioned in this manner is deemed to have been derived in the income years to which it is apportioned.

12.73 The effect of s.245J(13) in relation to s.82(1) is that where a CFC derives income from the acquisition of land by the government of another country or territory, any person calculating branch equivalent income or loss in relation to the CFC may apply to the Commissioner to apportion the income to the accounting period of the CFC in which the income was derived and the three accounting periods succeeding that period.

Recovery of excess depreciation: s.245J(14)

12.74 Section 245J(14) applies where in relation to an asset an allowance for depreciation has been deducted in calculating the branch equivalent income or loss of a CFC. In these circumstances, the CFC is assumed, for the purposes of s.117 of the Income Tax Act, to have been allowed a deduction in respect of the depreciation allowance and the cost of the asset less such allowances in prior periods is assumed to be the amount to which the value of the asset has been reduced by such deductions.

12.75 The effect of s.245J(14) in relation to s.117 is to allow the depreciation recovery provisions to operate where a CFC sells or otherwise disposes of an asset in respect of which depreciation deductions have been claimed in calculating branch equivalent income or loss of the CFC. Section 245J(14) deems the depreciation deductions taken in calculating the branch equivalent income or loss of the CFC to have been allowed to the CFC. Thus, where the CFC sells or otherwise disposes of an asset in respect of which it is deemed to have taken depreciation deductions for an amount in excess of the depreciated value of the asset an amount calculated in accordance with s.117 is included in the income of the CFC.

12.76 Section 245J(14) applies where depreciation has been deducted by any person in calculating the branch equivalent income or loss of a CFC for the purposes of calculating the attributed foreign income or loss of such person. The person who claimed the depreciation deduction in calculating branch equivalent income or loss may not hold an income interest in the CFC when the asset in respect of which depreciation deductions were claimed is sold or disposed of. Section 245J(14) still applies in these circumstances and the depreciation recovery income is included in the branch equivalent income or loss of the CFC in calculating the attributed foreign income or loss of any person holding an income interest of 10 percent or greater in the CFC in the accounting year when the asset is disposed of.

Recovery of interest deductions: s.245J(15)

12.77 Section 245J(15) applies where interest payable by a CFC in relation to land has been deducted in calculating branch equivalent income or loss of the CFC. In these circumstances, the CFC is assumed, for the purposes of s.129 of the Income Tax Act, to have been allowed a deduction for the interest. Section 129 provides that where land is sold within 10 years of acquisition, and in calculating the assessable income of the taxpayer a deduction has been allowed for interest, the excess of the consideration received on sale over certain expenditure incurred in relation to the land is assessable to the extent of the interest deductions allowed.

12.78 The effect of s.245J(15) in relation to s.129 is that where interest deductions are taken in calculating the branch equivalent income or loss of a CFC, the CFC is deemed to have been allowed the deductions. Therefore, where a CFC disposes of land within 10 years of acquisition, and interest decuctions were taken in calculating the branch equivalent income or loss of the CFC, the CFC is deemed to derive income to the extent that the consideration received on sale exceeds the expenditure listed in s.129. The consideration is income to the extent of the interest deductions assumed to have been taken by the CFC.

12.79 Section 245J(15) applies where interest deductions have been taken in calculating the branch equivalent income or loss of a CFC for any period and in calculating the attributed foreign income or attributed foreign loss of any person. Therefore, s.245J(15) may apply where the persons holding an income interest in a CFC at the time land is sold by the CFC did not hold an income interest in the CFC in relation to earlier accounting periods when interest deductions were taken in calculating branch equivalent income or loss.

Treatment of value added taxes: s.245J(16)

12.80 Section 140B of the Income Tax Act sets out the treatment for income tax purposes of goods and services tax imposed under the Goods and Services Tax Act 1985. Section 245J(16) modifies s.140B so that it applies with respect to taxes similar to goods and services tax that are imposed by another country. It provides that for the purposes of s.140B of the Income Tax Act references to output tax, input tax, or goods and services tax payable include respectively in relation to any value added or other tax in a country other than New Zealand which has similar intent and application to goods and services tax -

(a) such value added or other tax charged by the person in respect of a supply of goods and services; and

(b) such value added or other tax charged by any other person in respect of a supply of goods or services made to the person; and

(c) such value added or other tax payable to or by the revenue authorities of that country.

12.81 Section 140B sets out rules for the treatment of goods and service tax for income tax purposes. The effect of s.245J(16) in relation to those rules is as follows:

(a) the rule in s.140B(2) that the assessable income of a person does not include any amount of output tax charged in respect of a supply of goods and services by the person, or any amount

of goods and services tax payable to the person by the Commissioner, is modified so that branch equivalent income or loss does not include value added or similar taxes charged by the CFC in respect of a supply of goods and services or such tax payable by revenue authorities to the CFC;

(b) the rule in s.140B(3) that in calculating the assessable income of any person, input tax charged in relation to the supply of goods and services tax charged to the person, or for goods and services tax payable by the person to the Commissioner, shall not be allowed as a deduction is modified so that in calculating the branch equivalent income or loss of a CFC no deduction is allowed for value added or similar taxes charged by another person to the CFC in respect of a supply of goods and services to the CFC or for value added or similar taxes payable to the revenue authorities of another country;

(c) the rules relating to trading stock in s.140B(5) apply with respect to value added or similar taxes so that:

(i) in relation to the supply or replacement of trading stock of a CFC, the terms "cost price" and "cost" in ss.85(4), 86, 86A, 86B, 86C, 86D, 86H and 88 are net of value added or similar tax charged to the CFC by any other person in respect of a supply or replacement of trading stock;

(ii) the "average market value", "market selling value" and "market value" of trading stock of a CFC are net of any value added or similar taxes that would be charged by the CFC on sale or other disposition of the trading stock by the CFC where the sale or other disposition is subject to a value added or similar tax; and

(d) the rules relating to depreciation and depreciation recovery in ss.140B(6) and (7) apply with respect to value added or similar taxes paid or charged by a CFC.

12.82 Section 245J(16) applies only to value added taxes and other taxes similar in "intent and application" to goods and services tax charged under s.8(1) of the Goods and Services Tax Act. A tax will be similar in intent to goods and services tax where it is imposed on the sale or other disposition of goods or services. A tax will be similar in application to goods and services tax where the collection mechanism is similar to goods and services tax. This is the case with European-style value added taxes for example. Single stage sales taxes, such as manufacturing, wholesale or retail sales taxes, are not similar in application to goods and services taxes. Normal income tax rules apply in relation to the treatment of such taxes.

Subsidies and grants: s.245J(17)

12.83 Section 245J(17) sets out two rules for the treatment of subsidies or grants made to a CFC by a foreign government. The first rule modifies s.169 of the Income Tax Act to provide that the reference to the Executive Government of New Zealand in that section includes the government of any country or territory other than New Zealand. The second rule provides that to the extent that s.169 does not apply to payments of subsidies or grants made to a CFC by a government of any country other than New Zealand, or by an instrument or department of such government, the subsidies or grants are assessable income of the CFC.

12.84 Section 169 applies to payments made to a taxpayer by, among others, any department or instrument of the Executive Government of New Zealand where the payment is in the nature of a subsidy or grant in respect of any business carried on by the taxpayer. The effect of s.169 is to reduce deductible expenditure in relation to which a grant is made, or to reduce the depreciable basis of an asset where a grant was made in relation to expenditure incurred in acquiring that asset, and to exclude the grant from the taxpayer's assessable income. The effect of s.245J(17) in relation to s.169 is that the rules applying to the reduction in deductible expenditure and the depreciable basis of assets to the extent of a government grant, and the exclusion of such grants from income, apply with respect to grants made by a foreign government to a CFC.

12.85 To the extent that s.169 does not apply to payments of subsidies or grants made to a CFC by a government of a country other than New Zealand, or by any instrument or department of such government, the subsidies or grants are assessable income. These subsidies or grants are therefore taken into account in calculating the branch equivalent income or loss of the CFC.

Carry forward and grouping of losses: s.245J(18) and (19)

12.86 Section 245J(18) provides that in calculating branch equivalent income or loss of a CFC for an accounting period, the CFC is not entitled to carry forward losses from prior accounting periods pursuant to s.188. Section 245J(19) provides that in calculating branch equivalent income or loss of a CFC, the CFC is not entitled to make any notices of election under s.191(5) or payments pursuant to s.191(7).

12.87 Losses incurred by CFCs are attributed to residents in accordance with s.245G. The treatment

of such losses is then governed by s.245M and s.245N. Subject to certain limitations, those sections permit attributed foreign losses to be carried forward by persons holding interests in a CFC. One consequence of not allowing CFCs to carry forward losses is that losses incurred by a CFC before it is subject to the CFC legislation cannot be offset against income derived by the CFC after it becomes subject to the legislation. This treatment is consistent with the treatment of income derived by a CFC before it becomes subject to the legislation. Section 245Y(2) provides an exception to the rule that losses incurred by a CFC before it becomes subject to the CFC regime cannot be attributed. That provision is discussed in Part 19 of this bulletin.

12.88 Section 245J(19) provides that where CFCs form part of a group of companies, losses incurred by any CFC in the group cannot be offset against income derived by other CFCs in the group. Losses incurred by a CFC are attributed individually to residents holding income interests in the CFC by virtue of s.245G.

Treatment of payments for loss transfers: s.245J(20)

Description

12.89 Section 245J(20)(a) provides that a gain derived by a CFC is assessable income where it is derived from transferring to another person the ability to utilise losses for income tax purposes. Section 245J(20)(b) provides that a payment made by a CFC to another person resident in the same jurisdiction as the CFC is deductible where it is made in consideration for the transfer from the other person to the CFC of the ability to utilise losses of the other person for income tax purposes, and where the payment is deductible under the law of the country or territory in which the CFC is resident.

Gains on transfer of losses

12.90 Where losses have been transferred by a CFC to another person and the CFC derives a gain by virtue of that transfer, the result under the CFC regime (if not for s.245J(20)(a))), and in the foreign country, would be:

(a) the loss would be attributed to residents who hold income interests in the CFC;

(b) in the foreign country the loss would not be available for carry forward (assuming that the country has loss carry forward rules in its income tax law) so that the CFC may derive income and pay foreign tax in its next accounting period;

(c) the income derived by the CFC in the next accounting period would be attributed to residents holding an income interest in the CFC, but this attributed foreign income would be offset by attributed foreign losses carried forward from the preceding year;

(d) if the income in the second year exceeded the losses carried forward, New Zealand tax liability may be removed by virtue of the credit allowed for the foreign taxes. If the income did not exceed the losses, the foreign taxes would be available for crediting against tax payable on other attributed foreign income or for carry forward in terms of s.245K and s.245L.

12.91 In these circumstances, residents who held an income interest in the CFC would obtain a benefit from the loss although it was transferred by the CFC. The fact that the New Zealand tax system would recognise the loss while the foreign one would not means that residents may obtain an advantage from both the loss and from foreign tax credits which arise in future years. Section 245J(20)(a) removes this double benefit by making the New Zealand treatment of the loss consistent with the foreign treatment. This is achieved by treating the gain derived by the CFC on transfer of the losses as income. Consequently, the foreign tax credits arising in the foreign country in later years in respect of income derived by the CFC are used to reduce New Zealand tax payable on income derived by the CFC in those later years, rather than being available for crediting against income derived from other CFCs.

Payments in consideration for losses

12.92 Section 245J(20)(b) provides that a payment made by a CFC to another person in consideration for the transfer from the other person to the CFC of the ability to utilise losses is deductible in calculating branch equivalent income or loss where:

(a) the other person is resident in the same country or territory as the CFC; and

(b) the payment is deductible under the taxation law of the country or territory in which the CFC is resident.

12.93 This treatment is consistent with s.245J(20)(a) which applies where a payment is made by another person to a CFC to utilise a loss of the CFC. The payment must be to a person resident in the same country as the CFC to support the loss ring-fencing rules contained in s.245M.

12.94 It is appropriate to allow a deduction for the payment described in s.245J(20)(b) as the tax paid in the CFC's country of residence will be lower as a result of the payment, thus reducing the foreign tax

credit that would otherwise be available to the New Zealand resident shareholders of the CFC. However, if the country in which the CFC is resident does not allow a deduction for the payment, it is not appropriate to allow a deduction in calculating branch equivalent income or loss (and s.245J(20)(b) does not allow a deduction) as the tax paid by the CFC will be higher because no deduction is allowed. Therefore, if a deduction was allowed in calculating branch equivalent income or loss resident shareholders of the CFC would receive the double benefit of the deduction and a higher foreign tax credit because no deduction was allowed for the purposes of the foreign tax calculations.

Insurance other than life insurance: s.245J(21)

Description

12.95 Section 245J(21) applies where a CFC carries on the business of insurance or guarantee against loss, damage, or risk of any kind, except life insurance. The general rule is that s.208(1) of the Income Tax Act, as modified by s.245J(21), applies in calculating the branch equivalent income or loss of the CFC. Where the CFC insures or guarantees against any loss, damage, or risk of any person associated with the CFC, the assessable income of the CFC also includes amounts derived in providing insurance or guarantee to the associated person except to the extent that these amounts constitute reinsurance premiums which have not been deductible by virtue of s.208(1). Further, no deduction is allowed in respect of reinsurance premiums paid by the CFC where those premiums are not included in income derived from New Zealand by the reinsurer.

Application of s.208

12.96 In calculating the branch equivalent income or loss of a CFC carrying on a business of insurance other than life insurance, s.245J(21)(a) provides that s.208(1) applies as if the words "the country or territory in which the controlled foreign company is resident" were substituted for the words "New Zealand" wherever they appear in s.208(1) and in paragraphs (e), (f), (g), (h), (k), (l) and (m) of s.243(2).

12.97 The amendments to s.208(1) and s.243(2) ensure that the taxation treatment of income derived through a CFC carrying on a business of insurance other than life insurance is the same as that applying to resident companies carrying on such businesses. The effect of the amendments is:

(a) the rule in s.208(1)(a) is modified so that the branch equivalent income or loss of a CFC does not include income derived from an insurance business carried on out of the country or territory in which the CFC is resident except to the extent that the income of the business carried on outside that country or territory consists of -

(i) income derived as the owner of land in the country or territory in which the CFC is resident;

(ii) income derived from any mortgage of land in the country or territory in which the CFC is resident;

(iii) income derived from shares in or membership of a company resident in the same country or territory as the CFC, or from debentures issued by a company resident in the same country or territory as the CFC or by a local or public authority;

(iv) income derived from debentures or other securities issued by the government of the country or territory in which the CFC is resident;

(v) income derived from the sale or other disposition of any property situated in the country or territory in which the CFC is resident;

(vi) income being interest or a redemption payment derived in respect of money lent in the country or territory in which the CFC is resident; and

(vii) income being interest or a redemption payment derived in respect of money lent outside the country or territory in which the CFC is resident to -

. a person resident in the country or territory in which the CFC is resident, except where the money lent is used for the purposes of a business carried on through a fixed establishment outside that country; or

. a person who is not resident in the country or territory in which the CFC is resident if the money is lent for the purposes of a business carried on in that country or territory through a fixed establishment;

(b) the rule in s.208(1)(b) is modified so that no deduction is allowed in calculating branch equivalent income or loss for premiums paid on risks reinsured with persons or companies where the premiums are paid out of the country or territory in which the CFC is resident, or where such premiums are otherwise not included in income derived from the country or territory in which the CFC is resident by those persons or companies. Amounts recovered in respect of losses on risks so reinsured are not taken into

account in calculating branch equivalent income or loss.

Insuring against risks of associated persons

12.98 Section 245J(21)(b) applies where the CFC carrying on the business of insurance or guarantee against loss, damage or risk insures or guarantees risks of persons associated with the CFC, other than insurance or guarantee which is life insurance. It provides that in addition to the amounts specified in s.245J(21)(a) the assessable income of the CFC includes amounts derived in relation to the provision of insurance or guarantee to the associated person, except to the extent that such amounts consist of premiums paid on risks reinsured by persons resident in New Zealand where those persons have been denied a deduction for such premiums under s.208(1)(b). It is further provided that no deduction is allowed from the income of the CFC in respect of premiums paid on risks reinsured with persons or companies where the premiums for reinsurance are not included in income derived from New Zealand by those persons or companies. Where amounts are recovered in respect of losses on risks so reinsured the amounts thus recovered are not income of the CFC.

12.99 The object of s.245J(21)(b) is to provide a method of calculating branch equivalent income or loss of so-called "captive" insurance companies which insure risks of associated persons. The application of s.208, as modified by s.245J(21)(a), would, in many cases, not result in the income of captive insurance companies being taxed.

12.100 Section 245J(21)(b) applies where the CFC insures or guarantees risks of associated persons. A person and a CFC are associated for these purposes if they are associated in terms of s.8 or s.245B. The amounts included in the CFC's income under s.245J(21)(b) are in addition to the amounts included under s.245J(21)(a). The additional amounts included in assessable income are only amounts derived in relation to the provision of insurance or guarantee for associated persons. Amounts not included in income by virtue of s.245J(21)(a), and which do not relate to the insurance or guarantee of risks of associated persons, are not included in income. Amounts consisting of premiums paid on risks reinsured by persons resident in New Zealand who have been denied a deduction for such premiums under s.208(1)(b) are not included in the income of the CFC. As a deduction has already been denied for these amounts, it is not appropriate to tax them by operation of the CFC regime.

12.101 Reinsurance premiums are not deductible in calculating the branch equivalent income or loss of the CFC. The exception is where the reinsurance premiums are included in income derived from New Zealand by the persons or companies reinsuring the risks. In these circumstances the reinsurance premiums are assessable in New Zealand. Therefore, it is appropriate to permit a deduction for such premiums in calculating branch equivalent income or loss. Amounts recovered in respect of losses of risks so reinsured are not included in income of the CFC. As reinsurance premiums are not deductible,it would not be appropriate to include amounts recovered in respect of losses on reinsured risks in the CFC's income.

CFC carrying on mining activities: s.245J(22)

12.102 Section 245J(22) ensures that the provisions governing the taxation of mining activities apply to mining operations carried on by CFCs. Prior to 1 October 1990 s.245J(22) applied to both mineral and petroleum mining activities. From 1 October 1990 onwards s.245J(22) applies only to mineral mining activities and s.245J(22A) applies to petroleum mining activities.

12.103 Section 245J(22) provides that ss.215 to 222 of the Income Tax Act apply, with any necessary modifications, in calculating the branch equivalent income or loss of a CFC where the CFC carries on activities outside New Zealand that are substantially of the same nature as the activities governed by those sections. Sections 215 to 222 contain the provisions governing the taxation of mineral mining activities. Taxpayers with interests in CFCs that carry on mineral mining activities are therefore taxed in the same manner as taxpayers who carry on mineral mining activities in New Zealand.

Petroleum mining operations: s.245J(22A)

12.104 Section 245J(22A) ensures that the petroleum mining taxation regime contained in ss.214D to 214L applies to petroleum mining operations carried on by CFCs. Section 245J(22A) incorporates specifically the rules governing the application of the new petroleum mining regime set out in s.214N. These provide that the new regime applies to:

a petroleum mining development expenditure incurred on or after 1 October 1990;

b assessable income derived from the disposal of petroleum mining assets or interests in petroleum mining entities on or after 1 October 1990, with the amount of income being limited to the difference between the consideration received and the value on 1 October 1990 of the assets or interests disposed of;

c farm-out arrangements entered into on or after 1 October 1990.

The treatment of petroleum mining development expenditure incurred, and income earned, before 1 October 1990, and farm-out arrangements entered into before 1 October 1990, is governed by s.245J(22) prior to its amendment by the Income Tax Amendment Act (No.2) 1990. In terms of that provision, the the old petroleum mining taxation regime contained in ss.214A to 214C applied to the expenditure, income or arrangement.

12.105 Section 245J(22A) provides that ss.214D to 214L and s.214N apply with any necessary modifications, including the modifications required by s.214M, where a CFC carries on petroleum mining operations outside New Zealand. The modifications required by s.214M include determining the equivalent things under a foreign regime for the licensing and conduct of petroleum mining operations of a prospecting licence, a mining licence, the extension of a mining licence to a specified term or whether a licence has been revoked. These items are relevant in applying the provisions set out in ss.214D to 214L.

Specified leases: s.245J(23)

12.106 Section 245J(23) provides that no leases (as defined in s.222A(1)) entered into by a CFC before the first day of any accounting period in relation to which the CFC was a CFC are treated as "specified leases" (as defined in s.222A(1)) in calculating the branch equivalent income or loss of the CFC. An exception to this rule is provided where a lease is entered into between the company that becomes a CFC and another CFC or a person resident in New Zealand.

12.107 Leases entered into by a foreign company before it becomes a CFC are not recharacterised as specified leases when the foreign company becomes a CFC because they will generally have been entered into in ignorance of the specified lease provisions in the Income Tax Act. Consequently, if the CFC is the lessor of an asset, branch equivalent income or loss is calculated by allowing a deduction for depreciation and by including the rental payments in income. If the CFC is the lessee of an asset it can claim a deduction for rental payments made under the lease.

12.108 A lease entered into by a foreign company before it becomes a CFC is a specified lease if it was entered into between the foreign company and another CFC or a person resident in New Zealand. In these circumstances the lease will be treated as a specified lease in calculating the branch equivalent income or loss of the other CFC or in calculating the assessable income of the resident. Therefore, to achieve symmetry of treatment it is necessary to treat the lease as a specified lease in calculating the branch equivalent income or loss of the foreign company that becomes a CFC.

Taxable distributions from non-qualifying trusts: s.245J(24)

12.109 Section 245J(24) provides that where a CFC has received a taxable distribution to which s.227(4) of the Income Tax Act would apply if the CFC were a taxpayer, the taxable distribution is not taken into account in calculating the branch equivalent income or loss of the CFC and s.245G(5) applies with respect to the taxable distribution. The object of this provision is to ensure that a distribution from a non-qualifying trust that would be taxable at a higher rate if distributed directly to a resident cannot be converted to attributed foreign income (which is taxable at normal rates) by way of a distribution to a CFC. The operation of s.245G(5) is discussed in the appendix to Taxpayer Information Bulletin No.5 at paragraphs 8.59 and 8.60.

Foreign investment fund income and loss: s.245J(25)

12.110 Section 245J(25) applies where a CFC derives foreign investment fund income or incurs foreign investment fund loss. In these circumstances it is provided that the foreign investment fund income or loss is not taken into account in calculating the branch equivalent income or loss of the CFC and that s.245G(6) applies to such income or loss. The effect of this provision, together with s.245G(6), is that foreign investment fund income and loss derived by a CFC is attributed to persons holding an income interest in the CFC as foreign investment fund income and loss. The amounts thus attributed are treated in the same manner as foreign investment fund income or loss derived or incurred in respect of a direct interest in a foreign investment fund. Section 245G(6) is discussed in paragraphs 9.33 to 9.43 of this bulletin.

PART 13: FOREIGN TAX CREDITS

Overview

13.1 The rules governing the allowance of a credit for foreign taxes against New Zealand tax payable on attributed foreign income are set out in ss.245K and 245L. Section 245K sets out the general rules that apply in relation to foreign tax credits. Section 245L provides special rules permitting the grouping of foreign tax credits among a group of companies in certain circumstances.

13.2 Section 245K entitles a person who derives attributed foreign income in respect of an income interest in a CFC to a credit against New Zealand tax for the income tax paid or payable by the CFC in New Zealand or in any other country. Although a

credit is allowed for New Zealand tax paid by the CFC, the credit allowed under s.245K will generally be referred to in this bulletin as a foreign tax credit.

Entitlement to foreign tax credit: s.245K(1)

Description

13.3 Section 245K(1) provides that any person who derives attributed foreign income in respect of an income interest in a CFC is allowed, in respect of income tax payable in New Zealand, a credit calculated pursuant to s.245K for income tax paid or payable by the CFC in New Zealand or in any other foreign country in respect of the attributed foreign income. For this purpose, withholding taxes paid or payable on behalf of the CFC are creditable, but withholding tax paid or payable by the CFC on amounts that are not income derived by the CFC are not creditable. Income tax paid or payable is converted to New Zealand currency either by applying the close of trading spot exchange rate applicable when the income tax was paid or became payable, or by applying the average of the close of trading spot exchange rates for the 15th day of each month falling within that period: s.245K(1) first proviso. Amended assessments may be made where the amount of the foreign tax credit cannot be determined by the time the person is required to file a return of income: s.245K(1) second proviso.

Creditable taxes

13.4 Section 245K(1) allows a credit for "income tax" paid by the CFC in New Zealand or in any other country in respect of attributed foreign income. Section 245A(1) provides that the term "income tax" has the meaning assigned by s.293(1). Section 293(1) defines "income tax" in relation to tax paid to a country or territory outside New Zealand as meaning any tax, whether imposed by a central, state or local government, which in the opinion of the Commissioner is substantially of the same nature as income tax imposed under Part IV of the Income Tax Act or as non-resident withholding tax imposed under Part IX of that Act. "Income tax" does not include additional tax for late payment of tax or any interest, penalty or additional tax imposed under penal provisions of a foreign country or territory. In relation to New Zealand, the term "income tax" means income tax imposed under Part IV of the Income Tax Act, but it does not include any additional tax for late payment of tax or any interest, penalty or additional tax imposed under the Income Tax Act.

13.5 Thus, a tax imposed by another country or territory qualifies as an income tax if:

(a) it is a tax, whether imposed by a central, state, or local government; and

(b) it is substantially of the same nature as income tax imposed under Part IV of the Income Tax Act or non-resident withholding tax imposed under Part IX of that Act; and

(c) it is not additional tax for late payment of tax, or interest, penalty or additional tax imposed under the penal provisions of a country or territory.

13.6 A levy imposed by a foreign country or territory is a tax if it requires a compulsory payment and is levied pursuant to an authority of the foreign country or territory to levy taxes. A tax will be substantially of the same nature as income tax imposed under Part IV if it is imposed on net income. Net income is income remaining after expenses or allowances incurred in gaining or producing gross income have been deducted. A tax imposed on gross receipts is not substantially similar to income tax imposed under Part IV. However, such a tax may be substantially similar to non-resident withholding tax imposed under Part IX.

13.7 Sales taxes, excise taxes, royalty payments, taxes imposed on a percentage of output (whether in terms of quantity or value) and rates, for example, are not substantially similar to income tax.

13.8 A tax is substantially similar to non-resident withholding tax imposed under Part IX if it is imposed on gross income derived by a non-resident of one jurisdiction from sources within another jurisdiction, where the income subject to the tax is similar to the income subject to Part IX (ie dividends, interest and royalties) and where the tax is imposed in substitution for an income tax or in satisfaction of a liability to pay income tax.

13.9 Section 245K(1) provides that the income tax paid or payable by a CFC which is available for a credit includes any withholding tax paid or payable on behalf of the CFC but does not include withholding tax paid or payable by the CFC on amounts that are not income derived by the CFC. Thus, where a CFC derives income, and a withholding tax has been deducted by the person paying the income to the CFC, the withholding tax is available for crediting under s.245K. However, where a CFC pays an amount to another person and deducts a withholding tax from that amount, the tax thus deducted is not creditable because the amounts from which the tax is deducted are not income of the CFC.

13.10 Section 245K(1) allows a credit for income tax paid or payable in New Zealand in respect of attributed foreign income, as well as for income tax paid or payable to another country or territory. Income derived from New Zealand sources by a CFC is included in the branch equivalent income or loss of the CFC, and is therefore taken into account in calculating the attributed foreign income or loss of

residents holding income interests in the CFC. The CFC may pay New Zealand income tax on such income, or such income may be subject to non-resident withholding tax. Double New Zealand taxation of this income is avoided by allowing a credit against tax payable on attributed foreign income for New Zealand tax paid or payable by the CFC in respect of which the attributed foreign income is calculated.

Allowance of credit

13.11 A credit is allowed under s.245K(1) for income tax "paid or payable" by the CFC. Income tax is payable where it has fallen due for payment, but where payment has not been made. Income tax falls due for payment after an assessment has been made of the amount of income tax payable.

13.12 Section 245K(1) allows a credit "calculated pursuant to [s.245K]". The amount of tax available for crediting, and the extent to which a credit can be taken, is thus determined under the rules set out in the other provisions of s.245K.

Conversion to New Zealand currency

13.13 The first proviso to s.245K(1) sets out two methods for converting income tax paid or payable by a CFC to New Zealand currency where such tax is not paid or payable in New Zealand currency. The person calculating the tax credit available under s.245K in relation to attributed foreign income may choose either method of conversion. The first method is to apply the close of trading spot exchange rate applicable on the date when the income tax was paid or became payable. The second method is to apply the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the period. The period referred to in the second method of conversion is the accounting period of the CFC for which the person derives the attributed foreign income in relation to which the credit is claimed.

13.14 The expression "close of trading spot exchange rate" is defined in s.245A(1). That definition is discussed in paragraphs 3.13 to 3.41 of this bulletin.

Credit unable to be calculated when return filed

13.15 The second proviso to s.245K(1) applies where the credit allowable under s.245K cannot be determined prior to the time at which the person is required to file a return of income for the income year in which the person derives the attributed foreign income. In these circumstances, if the person makes a written request to the Commissioner within four years after the end of the income year in which the attributed foreign income was derived, the Commissioner is required to determine the amount of the allowable credit and issue amended assessments or determinations in relation to the income year in which the attributed foreign income was derived or subsequent years to reflect the determination of the amount of the credit.

13.16 The second proviso applies where the amount of the credit cannot be calculated at the time that the person who derives attributed foreign income is required to furnish a return. This will be the case, for example, where the CFC is subject to a tax investigation in a foreign country and assessments have not been made by the time residents holding interests in the CFC are required to file returns. The proviso does not apply where an item of income that is treated as assessable for the purposes of calculating branch equivalent income or loss in one year is not assessable for the purposes of applying foreign tax rules until a later year.

13.17 A request can only be made under the second proviso to s.245K(1) within four years from the end of the income year in relation to which the claim for a credit against tax payable on attributed foreign income is made. Where a request is made, the Commissioner is required to determine the amount of the credit and issue any amended assessment, determination of loss or determination of tax credit under s.245K that is necessary to reflect the determination of the credit. An amended assessment or determination is required only if necessary to reflect the determination of the credit made by the Commissioner.

13.18 The second proviso to s.245K(1) does not permit a general carry back of foreign tax credits. Where the foreign tax paid in relation to attributed foreign income exceeds New Zealand tax payable on that income the excess is offset against tax payable on attributed foreign income derived in relation to other CFCs resident in the same jurisdiction as the CFC in relation to which the tax was paid, or is available for carry forward to subsequent years. The second proviso only permits foreign tax paid in a later income year to be credited against New Zealand tax paid in an earlier year where the amount of the foreign tax was uncertain in that earlier year.

Calculation of tax available for credit: s.245K(2)

General rule

13.19 Section 245K(2) provides a method for determining the amount of the tax paid by the CFC which is available for crediting under s.245K against New Zealand tax payable on attributed foreign income. The amount calculated under this provision is available as a credit, but the question of when the

amount thus calculated is actually credited is determined under the other subsections in s.245K (particularly under s.245K(3))

13.20 Section 245K(2) provides that the amount of income tax paid or payable by a CFC in respect of the attributed foreign income of a person for an accounting period of the CFC is calculated by multiplying the income tax paid or payable by the CFC in any country or territory, including New Zealand, in respect of that period and the person's income interest in the CFC. For example, if a resident holds a 15 percent income interest in a CFC for the accounting period of the CFC ending on 30 June 1991, and the CFC pays income tax of $100 in relation to that period, the foreign tax payable in relation to the attributed foreign income derived from the CFC is calculated as 15% x $100 = $15.

Income derived from more than one country or territory

13.21 The proviso to s.245K(2) applies where a CFC derives income from sources in two or more countries or territories during an accounting period and the CFC is not liable to tax on income derived from one or more of those countries or territories. In these circumstances, the proviso limits the amount of the income tax paid or payable by the CFC for the purposes of s.245K(2). Persons calculating the credit available against New Zealand tax payable on attributed foreign income then multiply their income interests in the CFC by the amount of the tax deemed to have been paid by the CFC in terms of the proviso. The amount thus calculated is the tax paid by the CFC which is available for crediting.

13.22 Where the proviso to s.245K(2) applies the income tax paid or payable by the CFC is deemed to be the amount calculated in accordance with the following formula:

$$a \times \frac{b}{c}$$

where -

a is the income tax paid or payable in respect of the accounting period by the CFC;

b is the income of the CFC in that accounting period from sources on which the CFC was liable to income tax;

c is the total income of the CFC in the accounting period.

The effect of the formula is to limit averaging of foreign tax rates to maximise the crediting of foreign taxes.

Allowance of credit against New Zealand tax: s.245K(3)

Description

13.23 Section 245K(3) provides four rules that apply where a person is entitled to a foreign tax credit under s.245K in respect of New Zealand tax payable on attributed foreign income derived in relation to an interest in a CFC:

(a) First, the credit is allowed against income tax payable on that attributed foreign income.

(b) Second, to the extent that a credit is not allowed under (a), the excess credit is allowable against New Zealand tax payable on attributed foreign income derived in respect of any other CFC in that income year. This rule applies only if the other CFC is resident in the same country as the CFC in respect of which the credit arose.

(c) Third, to the extent that the credit cannot be deducted or set off under (a) or (b), that excess credit may be carried forward to the next income year. In that income year the credit is allowable against tax payable on attributed foreign income derived from the CFC in relation to which the credit originally arose. This rule applies only if the CFC remains resident in the same country. The carried forward credit is also allowed against tax payable on attributed foreign income derived from any other CFC. This rule applies if that other CFC is resident in the same country as that in which the CFC in respect of which the credit arose was resident in the year in which the credit originally arose.

(d) Fourth, if any excess credit remains after the application of the above rules that excess is carried forward indefinitely until it has been utilised in accordance with the rules described in paragraph (c).

Credit against income tax payable on attributed foreign income

13.24 Section 245K(3)(a) provides that the credit is limited to New Zealand tax payable on the attributed foreign income. Any excess credit is available for offsetting income tax payable on other attributed foreign income in accordance with s.245K(3)(b) or for carry forward in accordance with s.245K(3)(c). The credit is limited to the amount of the New Zealand tax payable on the attributed foreign income to prevent the foreign tax credit offsetting New Zealand tax payable on other income.

Credit allowed against tax payable on other attributed foreign income

13.25 To the extent that the credit is not allowed under s.245K(3)(a), s.245K(3)(b) provides that it is allowed against income tax payable on attributed foreign income derived in the income year in respect of any other CFC. The credit can be offset in this manner only if the other CFC is resident in the same country or territory as the CFC in respect of which the credit arises.

13.26 The CFCs must be resident in the same country in the accounting period in which the tax giving rise to the credit was paid or was payable. Excess credits cannot be offset against New Zealand tax payable on attributed foreign income derived in relation to CFCs resident in other jurisdictions. The reason for this limitation is that otherwise tax paid by a CFC resident in a relatively high tax jurisdiction would shelter New Zealand tax payable on income derived by a CFC resident in a tax haven. The limitation of the credit to a country by country basis reduces opportunities to average tax rates between high and low tax jurisdictions and to therefore reduce New Zealand tax payable on low tax jurisdiction income.

13.27 The residence of CFCs is determined in accordance with s.245Q. That section is discussed in Part 17 of this bulletin. The effect of s.245Q is to allocate residence of a CFC to one country or territory for each accounting period. That is, if the CFC changes its residence during an accounting period the effect of s.245Q will be to deem the CFC to be resident in only one country or territory for that period. For the credit to be offset in accordance with s.245K(3)(b) both CFCs must be resident in the same country or territory in the accounting period in which the tax giving rise to the credit was paid or was payable. Where the CFCs have different accounting periods, the other CFC must be resident in the same country or territory as the CFC in relation to which the credit arises for its entire accounting period in terms of s.245Q.

13.28 For example, assume that CFC1 has an accounting period ending on 31 December, CFC2 has an accounting period ending 30 June and CFC1 is resident in country X for its accounting period ending 31 December 1992. Excess credits arising in relation to attributed foreign income derived from CFC1 can be offset against tax payable on attributed foreign income derived from CFC2 if CFC2 is resident in country X for its accounting period ending 30 June 1992. CFC2 must be resident in country X for the accounting period ending 30 June 1992 in terms of s.245Q. Therefore, if CFC2 is resident in country X and country Y for that period, and in terms of s.245Q CFC2 is resident in country Y for the purposes of Part IVA, s.245K(3)(b) will not apply. However, if CFC2 is resident in country X for part of the accounting period ending 30 June 1992, and is resident in country Y for the remainder of that period, s.245K(3)(b) will apply if CFC2 is treated as being resident in country X for the entire accounting period pursuant to s.245Q.

Carry forward of credits

13.29 Section 245K(3)(c) provides for the carry forward of tax credits if such credits are not deducted or set off under ss.245K(3)(a) or (b). Such excess credits are carried forward to the income year immediately succeeding the income year in which the credit was initially allowable. In that succeeding income year the credit is allowed against income tax payable in New Zealand on attributed foreign income derived in that succeeding income year with respect to -

(i) the CFC in relation to which the credit originally arose, if that CFC is still resident in the same country or territory that it was resident in when the tax giving rise to the credit was paid or was payable; or

(ii) any other CFC resident in the same country or territory that the CFC in relation to which the credit originally arose was resident in when the tax giving rise to the credit was paid or was payable.

13.30 The carried forward excess credit may be offset against tax payable on attributed foreign income derived in respect of the CFC in relation to which the credit originally arose if that CFC is still resident in the same country or territory that it was resident in when the tax giving rise to the credit was paid or was payable. However, the excess credit is not lost if that CFC does change its residence, or if it is wound up or ceases to derive income. The excess credit can still be offset against attributed foreign income derived in respect of any other CFC resident in the country or territory that the CFC paying the tax giving rise to the credit was resident in for the accounting period when that tax was paid.

- Example 53

Facts: (i) A New Zealand resident company, NZco, holds income interests in two controlled foreign companies, CFC1 and CFC2. The accounting periods of both controlled foreign companies end on 31 December, and NZco returns income to a 31 March balance date.

(ii) For the accounting periods of CFC1 and CFC2 ending on 31 December 1992 and 1993 NZco holds an income interest of 55 percent in CFC1 and 50 percent in CFC2. CFC1 and CFC2 are resident in the same country, country X, for

their accounting periods ending on 31 December 1992. For the accounting periods ending 31 December 1993 CFC1 is resident in country Y and CFC2 remains resident in country X.

(iii) The branch equivalent income and the foreign tax paid by each controlled foreign company for the accounting periods is:

	CFC1		CFC2	
	income $	tax $	income $	tax $
year ending 31/12/1992	1,000,000	400,000	500,000	100,000
year ending 31/12/1993	1,200,000	410,000	300,000	90,000

(iv) For the income years ending 31 March 1993 and 31 March 1994 NZco derived assessable income from New Zealand sources of $2 million and $2.5 million respectively.

Result:

Calculation of assessable income

(i) NZco's total assessable income for the income years ending 31 March 1993 and 1994 is calculated as:

year ending 31/3/1993

attributed foreign income from CFC1	$1,000,000 x 55% =	550,000
attributed foreign income from CFC2	$500,000 x 50% =	250,000
income from New Zealand sources		2,000,000
Total		$2,800,000

year ending 31/3/1994

attributed foreign income from CFC1	$1,200,000 x 55% =	660,000
attributed foreign income from CFC2	$300,000 x 50% =	150,000
income from New Zealand sources		2,500,000
Total		$3,310,000

Calculation of tax payable: income year ending 31/3/1993

(ii) Assuming a 33 percent tax rate for companies resident in New Zealand, NZco would be liable to tax of $924,000 (33% x $2,800,000 = $924,000) before the allowance of a foreign tax credit under s.245K.

(iii) The credits allowable in respect of the tax payable on attributed foreign income derived by NZco from CFC1 and CFC2 are calculated as:

	CFC1	CFC2
s.245K(2) calculation	$400,000 x 55% = $220,000	$100,000 x 50% = $50,000
New Zealand tax on attributed foreign income	$550,000 x 33% = $181,500	$250,000 x 33% = $82,500
credit under s.245K(3)(a)	$181,500	$50,000
excess credit	$ 38,500	-
New Zealand tax to pay after allowance of credit	-	$82,500 - $50,000 = $32,500

(iv) By s.245K(3)(b), the excess credit of $38,500 allowable in relation to the attributed foreign income derived from CFC1 can be credited against New Zealand tax payable on attributed foreign income derived from CFC2. The excess credit therefore reduces New Zealand tax payable on attributed foreign income derived from CFC2 to zero. The excess credit remaining for carry forward is $38,500 - $32,500 = $6,000.

(v) The total amount credited against New Zealand tax by virtue of s.245K is $263,500: ie $181,000 credited against attributed foreign income derived from CFC1 and $82,500 credited against attributed foreign income derived from CFC2. The total New Zealand tax payable is therefore $924,000 - $263,500 = $660,500. An excess credit of $6,000 is carried forward to the income year ending 31/3/1994 to be offset against tax payable in that year in accordance with s.245K(3)(c).

Calculation of tax payable: income year ending 31/3/1994

(vi) Assuming a 33 percent tax rate for companies resident in New Zealand, NZco would be liable to tax of $1,092,000 (33% x $3,310,000 = $1,092,000) before the allowance of a foreign tax credit under s.245K.

(vii) The credits allowable in respect of the tax payable on attributed foreign income derived by NZco from CFC1 and CFC2 are calculated as:

	CFC1 (resident in country Y)	CFC2 (resident in country X)
s.245K(2) calculation	$410,000 x 55% =$225,500	$90,000 x 50% =$45,000
New Zealand tax on attributed foreign income	$660,000 x 33% =$217,800	$150,000 x 33% =$49,500
credit under s.245K(3)(a)	$217,800	$45,000
excess credit	$ 7,700	-
New Zealand tax to pay after allowance of credit	-	$49,500 - $45,000 = $4,500

(viii) The excess credit of $7,700 which arises in relation to CFC1 in the income year ending 31 March 1994 cannot be offset against the New Zealand tax of $4,500 to pay in relation to the attributed foreign income from CFC2 because CFC1 is not resident in country X in that income year. The excess credit must therefore be carried forward by NZco and credited against tax payable on attributed foreign income derived in relation to CFCs resident in country Y in future years.

(ix) By s.245K(3)(c)(ii), the $6,000 credit carry forward from the income year ending 31/3/1993 may be offset against the New Zealand tax of $4,500 payable on attributed foreign income from CFC2. This results in no New Zealand tax being payable in relation to the attributed foreign income derived from CFC2 and a foreign tax credit carry forward of $1,500 to the next income year.

(x) The credit allowed under s.245K is $267,300: ie $217,800 in relation to the attributed foreign income derived from CFC1 and $49,500 in relation to the attributed foreign income derived from CFC2. New Zealand tax payable is $1,092,300 - $267,300 = $825,000. The credits carried forward are $7,700 in relation to tax payable on attributed foreign income from any CFC resident in country Y in future years, and $1,500 in relation to tax payable on attributed foreign income from any CFC resident in country X in future years.

Rules applying to carry forward of foreign tax credits: s.245K(4) and (5)

Description

13.31 Sections 245K(4) and (5) contain rules that apply to the carry forward of tax credits. Section 245K(4) provides that where credits allowable in two or more income years are carried forward in accordance with s.245K, those credits are allowed in the same order that those credits were initially allowable. Section 245K(5) provides that where a company is entitled to a tax credit under s.245K, the credit may be carried forward only to the extent that if the credit had been a loss to which s.188 applied the carry forward of the loss would have been permitted under s.188. For the purposes of this rule the credit is deemed to be a loss incurred on the last day of the income year in respect of which the credit was initially allowable.

Application of s.188 for purposes of s.245K(5)

(a) Description

13.32 Section 245K(5) provides that a credit may be carried forward by a company only if in terms of s.188 it would be able to be carried forward if it were a loss. The circumstances in which a loss may be carried forward are set out in s.188(7). Applying s.188(7) to determine whether a company may carry forward a credit arising under s.245K, such a credit may be carried forward by a company only if:

(a) at all times from the beginning of the income year in which the tax giving rise to the credit was paid or was payable (referred to as the year of credit) to the end of the income year to which the credit is sought to be carried forward (referred to as the later income year), shares in the company seeking to carry forward the credit carrying between them -

  (i) the right to exercise not less than 40 percent of the voting power in the company; and

  (ii) the right to receive not less than 40 percent of the profits that may be distributed by the company; and

  (iii) the right to receive not less than 40 percent of any distribution of the paid up capital of the company; -

  were held directly, or through one or more interposed companies, by or on behalf of the same persons, excluding any company; or

(b) if the requirements of (a) are not met -

  (i) during the period commencing with the beginning of the year of credit and ending with the end of the later income year, the shares of the company were quoted in the official list of the New Zealand Stock Exchange; and

  (ii) the failure to meet the requirements of (a) was because the shares had been sold in the

ordinary course of trading on the share market; and

(iii) during the period commencing with the beginning of the year of credit and ending with the end of the later income year, not more than 10 percent of the shares in the company had been acquired by any one person, including any nominee of that person as defined in s.7, or by any two or more persons who are associated persons; or

(c) where the requirements of (a) and (b) are not met, the failure to meet those requirements was by reason only of the fact that the shares had been transferred in accordance with a matrimonial agreement.

(b) Continuity of ownership: s.188(7)(a)

13.33 Section 188(7)(a), modified to apply for the purposes of determining whether a s.245K foreign tax credit may be carried forward by a company, requires continuity of share ownership at all times during the period commencing with the beginning of the income year in which the tax giving rise to the credit was paid or was payable to the end of the income year to which it is sought to carry the credit forward. Thus, if a company seeks to carry forward a credit arising in the income year ending 31 March 1991 to the income year ending 31 March 1992, and to carry the balance forward to the income year ending 31 March 1993, the continuity requirements must be satisfied at all times from the beginning of the income year commencing on 1 April 1990 to the end of the income year ending on 31 March 1993.

13.34 The continuity of ownership test in s.188(7)(a) is applied in relation to shares held directly, or through one or more interposed companies, by persons other than companies. Section 188(7A) sets out rules for calculating shareholding through interposed companies. It provides that where shares in a company are held by persons other than companies through one or more interposed companies -

(a) the voting power attaching to those indirectly held shares is calculated by multiplying the percentage of the voting power held by the persons in the interposed company and the percentage of the voting power held by the interposed company (directly or through any chain of interposed companies) in the company claiming the s.245K credit carry forward; and

(b) the percentage of the rights to distributions of profits or of paid up capital attaching to the indirectly held shares in the company claiming the credit carry forward is calculated as the percentage of the profits or paid up capital that the persons would receive if the company claiming the credit carry forward distributed its profits and paid up capital, and the interposed company (or companies if there is a chain of interposed companies) in turn distributed those profits or that capital.

13.35 The effect of applying s.188(7)(a) by looking through interposed companies to shareholders other than companies is to prevent persons from avoiding the continuity of ownership requirements by interposing a company between the shareholders and the company claiming the s.245K credit carry forward, and then changing the ownership of the interposed company while the holding of the interposed company in the company claiming the carry forward remains constant.

13.36 Section 188(8)(b) provides that shares held by or on behalf of the trustee of the estate of a deceased shareholder, or by or on behalf of the persons entitled to those shares as beneficiaries under the will or intestacy of a deceased shareholder, are deemed to be held by the deceased shareholder. This means that shares held before the shareholder dies are not treated as having changed hands after the person dies. The death of a shareholder therefore does not prevent the continuity requirements in s.188 from being satisfied where the shares are held by the trustee of the deceased's estate or by or on behalf of the beneficiaries under the will or intestacy of the deceased shareholder.

13.37 Section 188(8)(c) contains an anti-avoidance rule that applies where shares in a company claiming a s.245K credit carry-forward have been subject to an arrangement, or have had any rights attaching to them extinguished or altered, for the purpose of enabling the company to meet the requirements of s.188(7)(a). In these circumstances, the company is deemed not to have met the requirements of s.188(7)(a).

(c) Shares quoted on stock exchange

13.38 Where the requirements of s.188(7)(a) are not met, s.188(7)(b), modified to apply in relation to the carry forward of a s.245K credit, allows a s.245K credit carry forward where the shares are quoted in the official list of the New Zealand stock exchange during the period commencing with the beginning of the income year in which the tax giving rise to the credit was paid or was payable and ending with the end of the income year to which the credit is sought to be carried forward.

13.39 For a credit carry forward to be allowed under this provision, the failure to satisfy s.188(7)(a) must only arise because shares in the company have been sold in the ordinary course of trading in the sharemarket. Further, a credit carry forward is permitted only if during the period commencing with

the beginning of the income year in which the tax giving rise to the credit was paid or was payable and ending with the end of the income year to which the credit is sought to be carried forward, not more than 10 percent of the shares in the company had been acquired by any one person, including any nominee of the person, or by any two or more associated persons.

13.40 The definition of "nominee" contained in s.7(1) applies for the purposes of this rule. In terms of that definition a nominee of a person is any other person who may be required to exercise that other person's voting power in accordance with the direction of the person, or who holds shares or debentures on behalf of the person. Any relative of a person is treated as a nominee. The term "relative" is defined in s.2. That definition is discussed in paragraph 4.14 of this bulletin. The term "associated persons" is defined in s.8.

(d) Matrimonial agreement

13.41 A company may carry forward a s.245K credit by virtue of s.188(7)(c) if the requirements of ss.188(7)(a) and (b) are not met, and the only reason for the failure to meet those requirements is that the shares had been transferred in accordance with a matrimonial agreement. Section 2 provides that a matrimonial agreement in relation to two persons is an agreement made by those persons under s.21 of the Matrimonial Property Act 1976 or by an order of the Court made in relation to the persons under s.25 of the Matrimonial Property Act 1976.

Credit deemed to be a loss incurred on last day of income year

13.42 For the purposes of s.245K(5), it is provided that a foreign tax credit which a company seeks to carry forward is deemed to be a loss incurred on the last day of the income year in respect of which the credit was initially allowable. The reason for this provision is that the requirements for carrying forward losses set out in s.188(7) must be satisfied on the basis of income years of the company. However, foreign tax credits arise under s.245K in relation to accounting periods of CFCs. Therefore, s.245K(5) makes it clear that the s.188(7) requirements are applied on the basis of the income year of the company claiming the credit carry forward, rather than on the basis of the accounting period of the CFC in relation to which the credit arose.

Effect of s.245K(4) in relation to s.245K(5)

13.43 Section 245K(4) provides that where credits initially allowable in two or more income years are carried forward under s.245K, those credits shall be allowed in the same order as they were initially allowable. This rule allows s.188(7) to be applied to determine whether a company may carry foreign tax credits forward. Under s.188(7), as modified by s.245K(5) to apply to foreign tax credit carry-forwards by companies, the continuity of ownership and the stock exchange listing requirements must be satisfied at all times during the period commencing with the beginning of the income year in which the tax giving rise to the credit was paid or was payable and ending with the end of the income year to which the credit is sought to be carried forward. Where credits from several income years are carried forward it is necessary to identify each credit individually to determine whether the s.188(7) requirements have been satisfied in relation to that credit. The ordering rule in s.245K(4) allows this identification to be made.

Foreign tax credits in relation to taxable distributions from non-qualifying trusts: s.245K(6)

13.44 Section 245K(6) limits the availability of a foreign tax credit where a taxable distribution derived by a CFC from a non-qualifying trust is attributed to a resident under s.245G(5). Section 245K(6) is discussed in paragraphs 8.33 to 8.35 of the appendix to Taxpayer Information Bulletin No.5. Section 245G(5) is discussed in paragraphs 8.59 and 8.60 of that appendix.

Determinations, and notices of determination, of credit carry forward: s.245K(7) and (8)

13.45 Section 245K(7) provides that where a person has furnished a return in respect of an income year and -

(a) the return shows that the person has an allowable credit that cannot be deducted from or offset against tax payable on attributed foreign income; or

(b) the Commissioner ascertains that the person has a credit;

the Commissioner is required to make a determination of whether or not and to what extent the credit may be carried forward to a later income year.

13.46 Section 245K(8) provides that as soon as is convenient after a determination of a credit available for carry forward has been made the Commissioner is required to give notice of the determination to the person. The notice may be included in a notice of assessment made under s.29(1) or in a notice of determination made under s.29(2). The omission to give notice does not invalidate the assessment or the determination of the excess credit available for carry forward.

Credit for tax payable under other CFC regimes: s.245K(9)

13.47 Section 245K(9) provides that where and to the extent to which any foreign company has paid income tax in respect of the income derived by a CFC by virtue of any legislation of any country or territory which has a similar intent and application as the provisions of Part IVA of the Income Tax Act, that income tax is deemed to have been paid by the CFC and not by the foreign company.

13.48 This provision allows a foreign tax credit against New Zealand tax on attributed foreign income derived in relation to a CFC where the tax is paid by a foreign company other than the CFC, and where that tax is paid by virtue of legislation that is similar in intent and application to the legislation contained in Part IVA. The credit is thus available where, pursuant to the controlled foreign companies legislation of another country or territory, a foreign company pays tax on income derived by a CFC.

13.49 By way of example, assume that a resident holds shares in a United Kingdom resident company that constitute 100 percent of the paid-up and nominal capital of that company and that the United Kingdom company holds 100 percent of a company resident in the Cayman Islands. If the Cayman Islands company derives income of the type that is subject to tax under ss.747 to 756 of the Income and Corporation Taxes Act 1988 (UK), tax on that income may be payable in the United Kingdom. Tax will also be payable on that income in New Zealand because the New Zealand resident will have an income interest in the Cayman Islands CFC. Section 245K(9) will deem the Cayman Islands CFC to have paid the tax paid by the United Kingdom company. The credit given for that tax against New Zealand tax payable on attributed foreign income derived in respect of the Cayman Islands CFC will be determined under the other provisions of s.245K.

Refunds or repayment of income tax to CFC: s.245K(10)

13.50 Section 245K(10) applies where a credit has been allowed against New Zealand income tax payable by a person under s.245K and that credit has not taken into account any refund or repayment of income tax received by the CFC, whether before or after the credit was allowed. In these circumstances, if the amount of the credit was in excess of the amount that would have been allowed if only the amount of the income tax not refunded or repaid to the CFC was taken into account in calculating the credit, the amount of the excess:

(a) is applied to reduce the balance of the credits carried forward pursuant to s.245K(3) in respect of that CFC; and

(b) any further excess is deemed to be income tax due and payable to the Commissioner on the thirtieth day after the date of the notice of determination of the credit or the date of the receipt of the refund or repayment, whichever is the later.

- Example 54

Facts: (i) A New Zealand resident company, NZco, holds an income interest of 100 percent in a controlled foreign company, CFC, for the accounting period of CFC ending on 30 June 1992. CFC pays income tax to country X of $100,000 for the accounting period ending 30 June 1992. CFC's branch equivalent income in relation to NZco for that period is $250,000.

(ii) The attributed foreign income of NZco in relation to CFC for the income year ending 31 March 1993 is $250,000. Assuming a tax rate of 33 percent, New Zealand tax of $82,500 is payable on this amount. NZco is allowed a foreign tax credit of $82,500 against the New Zealand tax under s.245K, and the $17,500 balance of the foreign tax credit is carried forward to the next income year. A determination of the credit is made by the Commissioner on 1 June 1993 and a notice is given on that date.

(iii) On 1 October 1993 CFC receives a refund from country X of $30,000 of the tax paid to that country in the accounting period ending 30 June 1992.

Result: (i) The credit allowed against the attributed foreign income derived by NZco in the income year ending 31 March 1993 did not take into account the refund subsequently granted to CFC. Further, the amount of the credit is in excess of the amount that would have been allowed if only the foreign tax not refunded had been taken into account in calculating the credit. If that tax only had been taken into account, the credit would have been $70,000 as opposed to $100,000.

(ii) Applying s.245K(10), the excess credit arising because of the refund is $30,000. This is applied first to reduce the balance of the credits carried forward from $17,500 to zero. The remaining $12,500 excess is income tax due and payable to the Commissioner. This tax is due and payable on the thirtieth day after the later of the date of the notice of determination of the credit or receipt of the refund. The notice of determination was given on 1 June 1993 and the refund

was received on 1 October 1993. The $12,500 therefore becomes tax payable on 31 October 1993.

Group of companies foreign tax credits: s.245L

Entitlement to group foreign tax credits

13.51 Section 245L(1) applies where in any income year a company has a credit in respect of an income interest in a CFC (including a credit carried forward to that income year under s.245K(3)) that cannot be utilised in accordance with s.245K(3). In these circumstances, the credit may be allowable against income tax payable on attributed foreign income derived by any other company in respect of an income interest in a CFC resident in the same country or territory as the CFC in respect of which the credit arose where for that income year the companies are members of the same group of companies. The credit is allowed to be grouped only if the requirements of s.245L(2) are satisfied.

Requirements to satisfy for grouping of credits: s.245L(2)

13.52 Section 245L(2) provides that any credit that is allowable to one company (referred to as the "first company") against income tax payable on attributed foreign income derived from a CFC is only allowed against income tax payable by another company (referred to as the "second company") in respect of attributed foreign income derived by the other company from a CFC resident in the same country or territory where the first and second companies constitute a specified group, as defined in s.191(4), for the income year in which it is sought to consolidate the credit. Section 191(4) provides that a group of companies is a specified group for an income year where -

(a) the same persons held at the end of the income year the whole of the paid-up capital in the same proportions in every company included in the group; or

(b) where one or more of the companies in the group did not have paid-up capital at the end of the income year, the same persons held at the end of the income year the whole of the allotted shares in the same proportions in every company included in the specified group, and also held at the end of that income year all the paid-up capital in those same proportions in the companies in the group that had paid-up capital at the end of the income year.

Shares bearing a fixed rate of dividend only are ignored in determining whether the same persons held the whole of the paid-up capital or allotted shares in every company in the group at the end of an income year.

13.53 Five further requirements must be satisfied before a foreign tax credit may be consolidated:

(a) The first company (ie the company with the excess foreign tax credit) must elect irrevocably for the income year for which the credit is claimed to offset the credit against tax payable on attributed foreign income derived by the second company. The election must be made in writing to the Commissioner within the time within which the first company is required to furnish a return of income for the income year, or within such further time that the Commissioner may allow.

(b) The first company and the second company must have been members of the same group of companies for the income year in which the credit was initially available. The definition of a group of companies is set out in s.191(3). Broadly, that subsection provides that two companies constitute a group of companies for an income year if at the end of the income year the same persons hold not less than two thirds of the paid-up capital, or of the nominal value of the allotted shares, or of the voting power in each of those companies, or an entitlement to a distribution of two thirds of the profits of the companies. The effect of this requirement is that a credit cannot be consolidated where in the income year when the credit was initially allowable the two companies did not constitute a group of companies, even though in the income year in which the consolidation is claimed the companies constitute a specified group of companies. This ensures that companies with excess foreign tax credits cannot be acquired by other companies for the purpose of utilising those credits.

(c) Where in accordance with the proviso to s.191(4) the Commissioner disregards shares held at the end of the income year which bear only a fixed rate of dividend, the first company (ie the company with the excess foreign tax credit) must have disclosed to its shareholders that an election has been made.

(d) Consolidation of credits is not allowed where s.191(7C) would apply if the credit were a loss subject to s.191. The effect of s.191(7C) is that a credit cannot be consolidated where shares of the first company or the second company have been subject to any arrangement, or have had rights attaching to them extinguished or altered, for the purpose of including either company in a group of companies or specified group of companies in the income year in which the credit is allowed.

(e) The credit allowed to the second company must not exceed the amount that the first company could have carried forward pursuant to s.245K(3) to the income year immediately succeeding the income year in which the credit was initially allowable. Thus, a credit cannot be consolidated under s.245L if the first company cannot carry a credit forward from the income year in which the credit was initially allowable because the requirements of s.188(7), modified to apply to foreign tax credits, are not satisfied.

13.54 To the extent that a credit has been allowed to the second company under s.245L it is not allowed to the first company and it may not be carried forward by the first company.

Application of s.245K(4)

13.55 The ordering rule in s.245K(4) is relevant in applying s.245L because it is necessary under s.245L(2)(b) to determine whether the first company and the second company were members of the same group of companies in the income year in which the credit was initially allowable. Where credits have been allowed or carried forward by the first company in respect of several years, and the first and second companies were not members of a group of companies for all of those years, it will be necessary to apply s.245K(4) to determine whether the credits come from income years when the two companies constituted a group of companies or from income years in which the companies did not constitute such a group.

13.56 Where the first and second companies did not constitute a group of companies in respect of some income years when credits were initially allowable, while in respect of other income years when credits were initially allowable the companies did constitute a group, the ordering rule in s.245K(4) may be modified in that credits from the later income years when the companies constituted a group of companies may be used under s.245L before credits arising in earlier income years when the companies were not a group can be utilised under s.245K.

PART 14: ATTRIBUTED FOREIGN LOSSES

Overview

14.1 Sections 245M and 245N prescribe rules applying to the treatment of attributed foreign losses. Section 245M(1) provides that an attributed foreign loss incurred by a person in any income year in relation to an income interest in a CFC may be deducted from attributed foreign income derived by the person in that income year from any other CFC resident in the same country or territory as the CFC in relation to which the attributed foreign loss was incurred. Any excess loss may be carried forward to the next succeeding income year and offset against attributed foreign income derived in that income year in relation to the CFC in respect of which the attributed foreign loss was incurred or in relation to any other CFC resident in the same country or territory as that CFC.

14.2 Section 245N provides rules for the consolidation of attributed foreign losses. Section 245N(1) allows attributed foreign losses incurred by one company to be set off against attributed foreign income derived by another company where the CFCs in respect of which the loss and the income were derived are resident in the same country or territory in the accounting period in which the loss giving rise to the attributed foreign loss was incurred.

Application of ss.245M and 245N to attributed foreign losses

14.3 Sections 245M and 245N apply to attributed foreign losses. The attributed foreign loss of a person in relation to an accounting period of a CFC is calculated in accordance with s.245G(2) by multiplying the income interest of the person in the CFC for the accounting period by the branch equivalent income or loss of the CFC for that period. Attributed foreign losses which might be incurred by a person on application of s.245G(2) are limited by:

(a) s.245H which reduces the aggregate income interests held by residents in a CFC to 100 percent where the aggregate income interests are greater than 100 percent;

(b) the rules contained in s.245G(4) which limit the attributed foreign loss of a person to the economic or financial loss suffered by the person in relation to the income interest in the CFC; and

(c) the rules in s.245E which limit opportunities for temporarily manipulating control and income interests in a CFC around measurement days in order to increase attribution of losses from a CFC.

14.4 The rules governing the treatment of attributed foreign losses in ss.245M and 245N apply only after the rules limiting the amount of an attributed foreign loss contained in ss.245E, 245G and 245H have been applied.

Deduction and carry forward of attributed foreign loss: s.245M(1)

Deduction from attributed foreign income

14.5 Section 245M(1)(a) provides that any person who, in any income year, incurs an attributed foreign loss in relation to an income interest in a CFC may claim that the attributed foreign loss be deducted from attributed foreign income derived by the person in that income year from any other CFC resident in the same country or territory as the CFC in respect of which the attributed foreign loss was incurred. The CFC in relation to which the attributed foreign income was derived must be resident in the same country or territory as the CFC in relation to which the attributed foreign loss was derived for the accounting period in which the loss giving rise to the attributed foreign loss was incurred. The residence of CFCs is determined under s.245Q.

14.6 Where the accounting periods of the CFCs differ, the CFC from which attributed foreign income is derived must be resident in the same country or territory as the CFC in relation to which attributed foreign loss is incurred for the accounting period in which the attributed foreign income is derived. For example, assume that the accounting period of CFC1 ends on 31 December 1992, the accounting period of CFC2 ends on 30 June 1992, and an attributed foreign loss is incurred in respect of CFC1 while attributed foreign income is derived in respect of CFC2. If CFC1 is resident in country X for the accounting period ending 31 December 1992, the attributed foreign loss incurred in relation to CFC1 may be deducted from the attributed foreign income derived in relation to CFC2 if CFC2 is resident in country X for the accounting period ending 30 June 1992. For the attributed foreign loss to be deducted from attributed foreign income in the income year ending 31 March 1993 it is not necessary that CFC2 be resident in country X for the period between 1 July 1992 and 31 December 1992.

Carry forward of excess attributed foreign loss

14.7 Section 245M(1) provides that to the extent that an attributed foreign loss cannot be deducted or set off in accordance with s.245M(1)(a), it is carried forward to the income year immediately succeeding the income year in which the loss was incurred. In that succeeding income year the attributed foreign loss carried forward is deducted from or set off against attributed foreign income derived in that year from -

(a) the CFC in relation to which the attributed foreign loss was originally incurred if that CFC remains resident in the same country or territory as that in which it was resident in the accounting period when the branch equivalent loss giving rise to the attributed foreign loss was incurred; or

(b) any other CFC resident in the same country or territory as that in which the CFC in relation to which the attributed foreign loss was incurred was resident in the accounting period when the branch equivalent loss giving rise to the attributed foreign loss was incurred.

14.8 The excess attributed foreign loss may be carried forward under s.245M(1)(b) whether or not in the income year to which the loss is carried forward the person who incurred the loss has retained an income interest in the CFC in respect of which the loss was incurred. Also, an excess attributed foreign loss may be carried forward by the person who incurred the loss although the CFC in relation to which the loss was incurred has been wound up or has changed its residence. However, such loss may be carried forward only in terms of the country by country limitation contained in s.245M(1).

14.9 Any balance of attributed foreign loss remaining after applying s.245M(1)(b) to the initial income year to which the loss is carried forward is carried forward to succeeding income years and is deducted and set off against attributed foreign income derived in those succeeding income years in accordance with s.245M(1)(b).

- Example 55

Facts: (i) For the accounting periods of two controlled foreign companies, CFC1 and CFC2, ending on 31 December 1991 and 1992 a New Zealand resident, A, holds an income interest of 60 percent in CFC1 and 50 percent in CFC2. CFC1 and CFC2 are resident in country X for their accounting periods ending 31 December 1991. For the accounting periods ending 31 December 1992, CFC1 is resident in country Y and CFC2 is resident in country X. A returns income to the year ending 31 March.

(ii) The branch equivalent income and loss of CFC1 and CFC2 (with the loss figure being indicated in brackets) for the accounting periods ending 31 December 1991 and 1992 are:

	CFC1 $	CFC2 $
accounting period ending 31/12/91	(1,000,000)	400,000
accounting period ending 31/12/92	100,000	450,000

Result:

Income year ending 31 March 1992

(i) A has an attributed foreign loss in respect of the income interest in CFC1 of $1,000,000 x 60% = $600,000. A has attributed foreign income in respect of the income interest in CFC2 of $400,000 x 50% = $200,000. CFC2 was resident in the same country as CFC1 for the accounting period ending 31 December 1991. Therefore, the attributed foreign loss may be deducted from the attributed foreign income under s.245M(1)(a) leaving an attributed foreign loss balance of $400,000. The attributed foreign loss completely sets off the attributed foreign income so that no attributed foreign income is included in assessable income.

(ii) The $400,000 attributed foreign loss balance may be carried forward to the income year ending 31 March 1993 (it is assumed that the carry forward requirements of s.245M(4) are satisfied).

Income Year ending 31 March 1993

(iii) A has attributed foreign income in respect of the income interest in CFC1 of $100,000 x 60% = $60,000. A has attributed foreign income in respect of the income interest in CFC2 of $450,000 x 50% = $225,000.

(iv) CFC1 was not resident in country X for the accounting period ending 31 December 1992. Therefore, the attributed foreign loss carry forward of $400,000 cannot be set off against the $60,000 attributed foreign income derived in relation to CFC1 in the income year ending 31 March 1993. The $60,000 is included in assessable income.

(v) CFC2 remains resident in country X, the country in which CFC1 was resident when the loss was incurred. Therefore, the carried forward attributed foreign loss of $400,000 may set off the attributed foreign income of $225,000 derived in relation to CFC2. No attributed foreign income is included in assesssable income in relation to the interest in CFC2 and the balance of the attributed foreign loss carry forward is reduced to $175,000.

Attributed foreign losses and foreign tax credits

14.10 Section 245M(1) allows attributed foreign losses to be deducted from or set off against attributed foreign income. Attributed foreign losses are deducted from or set off against attributed foreign income before foreign tax credits are calculated. Where attributed foreign losses completely offset attributed foreign income any foreign tax credit arising in relation to the attributed foreign income thus offset will be available to offset tax payable on other attributed foreign income, or for carry forward, in accordance with s.245K.

- Example 56

Facts: A New Zealand resident, A, holds an income interest of 100 percent in two controlled foreign companies, CFC1 and CFC2. Both controlled foreign companies are resident in country X at all relevant times. For the income year ending 31 March 1992, A incurs attributed foreign loss of $150 in relation to the income interest in CFC1 and derives attributed foreign income of $100 in respect of the income interest in CFC2. CFC2 pays foreign income tax of $15 in relation to the income it derives in its accounting period ending 31 December 1991. This tax is available for crediting under s.245K.

Result: (i) By s.245M(1)(a), the $150 attributed foreign loss incurred by A in relation to CFC1 may be set off against the $100 attributed foreign income derived in relation to CFC2. The $50 balance of the attributed foreign loss may be available for carry forward under s.245M(1)(b).

(ii) There is no New Zealand tax payable on the $100 attributed foreign income derived by A in relation to CFC2. Therefore, the $15 foreign tax credit is available for carry forward to the next income year in terms of s.245K(3)(c) if the terms of s.245K in relation to the carry forward of foreign tax credits are satisfied.

Limitation on use of attributed foreign losses: s.245M(2)

14.11 Section 245M(2) provides that an attributed foreign loss incurred by a person cannot be deducted from or set off against any assessable income of the person except pursuant to s.245M. The effect of this rule is:

(a) to prevent attributed foreign losses from being deducted from or set off against attributed foreign income except as provided in s.245M; and

(b) to prevent attributed foreign losses from being deducted from assessable income derived from other sources. That is, attributed foreign income may not be deducted from assessable income derived from New Zealand or from income derived from outside New Zealand that is not attributed foreign income.

Rules applying to carry forward of attributed foreign losses: ss.245M(3) and (4)

14.12 Section 245M(3) provides that where attributed foreign losses incurred in two or more income years are carried forward in accordance with s.245M, the losses must be deducted or set off in the same order in which they were incurred. Section 245M(4) provides that where a company incurs an attributed foreign loss, that loss may be carried forward only if the carry forward of the loss would have been permitted by s.188 if the attributed foreign loss was a loss to which s.188 applied. For the purposes of s.245M(4) the attributed foreign loss is deemed to be a loss incurred on the last day of the income year in respect of which the loss was attributed.

14.13 By virtue of s.245K(5), s.188 is also applied to determine whether a company may carry foreign tax credits forward. The discussion of the requirements set out in s.188(7) in relation to the carry forward of foreign tax credits (at paragraphs 13.32 to 13.41) is relevant in relation to the rule that attributed foreign losses may be carried forward by a company only if the requirements of s.188 are met.

14.14 For the purposes of s.245M(4), the attributed foreign loss that the company seeks to carry forward is deemed to have been incurred on the last day of the income year in respect of which the loss was attributed. Attributed foreign losses are calculated on the basis of the accounting period of a CFC. Section 188(7) is applied on the basis of the income year of the taxpayer. Therefore, the effect of deeming the attributed foreign loss to have been incurred on the last day of the income year of the company which incurred the loss is to allow s.188(7) to be applied to determine whether the loss is available for carry forward.

Determinations of attributed foreign loss: ss.245M(5) and (6)

14.15 Section 245M(5) requires the Commissioner to make a determination of the attributed foreign loss of a person, or of the attributed foreign loss of a person that may be carried forward, where the person has furnished a return in respect of an income year and the return shows that the person has an attributed foreign loss that cannot be deducted from attributed foreign income under s.245M, or where the Commissioner ascertains that the person has an attributed foreign loss. Section 19(5) provides that ss.22 to 28 and Part III of the Income Tax Act apply to a determination of loss made under s.245M(5) as if such determination were an assessment. This has the effect of applying the provisions governing assessments and objections to determinations of attributed foreign loss under s.245M(5).

14.16 Section 245M(6) provides that as soon as convenient after a determination of an attributed foreign loss or of an attributed foreign loss carried forward is made, the Commissioner is required to give notice of the determination to the person in respect of whom the determination was made. Such notice may be included in a notice of assessment or determination of loss made under ss.29(1) or (2). The omission to give such notice does not invalidate any assessment, or any determination of attributed foreign loss or attributed foreign loss carried forward.

Group of companies attributed foreign losses: s.245N

Entitlement to group attributed foreign losses

14.17 Section 245N(1) applies where in any income year a company (referred to as the first company) has an attributed foreign loss in relation to an income interest in a CFC, or has carried forward such a loss under s.245M(1), and that loss may not be deducted from attributed foreign income under s.245M(1). In these circumstances, the loss may be deducted from attributed foreign income derived in that income year by any other company (referred to as the second company) in respect of any CFC resident in the same country or territory as that in which the CFC in respect of which the attributed foreign loss was incurred was resident when the loss giving rise to the attributed foreign loss was incurred. The requirements to satisfy before a loss may be consolidated under s.245N are set out in s.245N(2).

Requirements to satisfy in order to group losses

14.18 The requirements to satisfy in order to consolidate an attributed foreign loss set out in s.245N(2) are the same as those applying with respect to the grouping of foreign tax credits as set out in s.245L(2). The comments made in relation to s.245L(2) are relevant in the context of s.245N(2) and this section provides only a brief description of s.245N(2).

14.19 Section 245N(2) provides that an attributed foreign loss incurred by the first company may only be deducted from attributed foreign income derived by the second company where in the income year in which the deduction is claimed the first and second companies are members of a specified group as defined in s.191(4). Five further requirements are listed:

(a) The first company must have elected irrevocably by notice in writing to the Commissioner to deduct the attributed foreign loss from the attributed foreign income derived by the second company. The election must be made within the time for furnishing a return for the income year in relation to which the election is made, or within such further time as the Commissioner may allow.

(b) The first company and second company must have been members of the same group of companies for the income year in which the attributed foreign loss was incurred.

(c) Where in accordance with the proviso to s.191(4) shares carrying only a fixed rate of dividend have been disregarded, the first company must have disclosed to its shareholders that an election has been made.

(d) Consolidation of attributed foreign losses is not permitted where s.191(7C) would apply if the attributed foreign loss were a loss. The effect of s.191(7C) is that attributed foreign losses cannot be grouped where shares of the first or second company have been subject to an arrangement, or have had any rights attaching to them extinguished or altered, for the purpose of including either company in a group of companies or specified group in the income year in relation to which the claim to deduct the attributed foreign loss is made.

(e) The loss deducted by the second company must not exceed the amount that the first company could have carried forward pursuant to s.245M to the income year immediately succeeding the income year in which the attributed foreign loss was incurred.

14.20 To the extent that an attributed foreign loss has been deducted by the second company, it may not be deducted or carried forward by the first company.

Dual resident companies

14.21 Section 245N(3) provides that where the first company (ie the company which incurred the attributed foreign loss) is a dual resident company as defined in s.191(1), no attributed foreign loss may be deducted by the second company under s.245N.

14.22 Section 191(1)(f) defines a dual resident company in relation to an income year as a company that -

(i) in that income year or any part of that income year is resident in New Zealand; and

(ii) in that income year or in that part or any other part of that income year is also, by the law of another territory resident in that other territory or registered, incorporated, or domiciled in, or a national of, that other territory, if by reason of that residence, incorporation, domicile or nationality the company is liable to tax in that other territory on its income or profits, or would be so liable if it derived income or profits.

PART 15: CHANGES OF RESIDENCE OF CONTROLLED FOREIGN COMPANIES

Company becoming, or ceasing to be, a foreign company

15.1 Section 245O applies where a company becomes a foreign company, or where a company that is a foreign company ceases to be a foreign company. The objective of s.245O is to enable branch equivalent income or loss of a CFC to be calculated where, during an accounting period, a resident company becomes a CFC or where a CFC ceases to be a foreign company and becomes solely a New Zealand resident company. This ensures that only amounts derived or incurred when the company was a CFC, and not those derived or incurred when the company was resident in New Zealand, are taken into account in calculating the attributed foreign income or attributed foreign loss of any person holding an income interest in the company. Income derived by the company while it is resident in New Zealand and is not a foreign company will be assessable to the company in terms of the Income Tax Act.

15.2 Section 245O(1) provides that where after 1 April 1988 a company that is not a foreign company becomes a foreign company, an accounting period of the foreign company is deemed to commence on the day on which it became a foreign company. The former accounting period is deemed to end on the day preceding the day on which the company became a foreign company. The question of whether the company is a CFC, and, if so, the calculation of income interests in the company, is determined on the basis of the short accounting period. The branch equivalent income or loss of the company in relation to the short accounting period is calculated in accordance with s.245O(3).

15.3 By way of example, if a resident company with an accounting year ending 31 March became a foreign company on 1 July 1991, s.245O(1) would deem it to have a short accounting period from 1 July 1991 to 31 March 1992. If at any time during that period the control interests of five or fewer residents in the

company in any category of interest was 50 percent or more the company would be a CFC. If five or fewer residents did not hold control interests of 50 percent or more in any category during that period the company would not be a CFC even if five or fewer residents held control interests of 50 percent or more in the company before 1 July 1991. If the company was a CFC, the income interests of residents in the company would be calculated on the basis of the period from 1 July 1991 to 31 March 1992. Any interests held before this period would be ignored. If the company was a CFC in relation to the 1 July 1991 to 31 March 1992 accounting period, the branch equivalent income or loss of the company would be calculated in relation to that period on the basis of one of the two optional methods set out in s.245O(3). Attributed foreign income or attributed foreign loss would therefore be calculated on the basis of the short accounting period from 1 July 1991 to 31 March 1992.

15.4 Section 245O(2) applies where a foreign company ceases to be a foreign company and becomes or continues to be resident in New Zealand. In these circumstances, an accounting period of the company is deemed to commence on the day on which the company ceased to be a foreign company. Consequently, an accounting period of the company is deemed to end on the day before the day on which the company ceased to be a foreign company. The question of whether the foreign company was a CFC is determined in relation to the period preceding the day on which the company ceased to be a foreign company.

15.5 Section 245O(3) applies where a foreign company ceases to be a foreign company and becomes or "continues to be resident" in New Zealand. In terms of the "foreign company" definition in s.245A(1), in addition to non-resident companies, a company resident in New Zealand is a foreign company where it is not subject to tax on all or part of its income by virtue of a double taxation agreement where the company is treated as not being resident in New Zealand for the purposes of the agreement. Therefore, where a company resident in New Zealand for the purposes of the Income Tax Act but resident in another jurisdiction for the purposes of a double taxation agreement ceases to be resident in the other jurisdiction for the purposes of the agreement, it will cease to be a foreign company while continuing to be resident in New Zealand.

Calculation of branch equivalent income or loss

15.6 Section 245O(3) provides two alternative methods for calculating branch equivalent income or loss of a CFC where, pursuant to s.245O(1) or (2), a person is required to calculate the branch equivalent income or loss of a CFC on the basis of an accounting period that is shorter than the otherwise applicable accounting period of the CFC. Under the first method, the branch equivalent income or loss for the shorter accounting period is calculated in accordance with the following formula:

$$a \times \frac{b}{c}$$

where -

a is the branch equivalent income or loss of the CFC for the otherwise applicable accounting period, determined without regard to ss.245O(1) or (2);

b is the number of days in the shorter accounting period; and

c is the number of days in the otherwise applicable accounting period.

15.7 The "otherwise applicable" accounting period referred to in the formula is the accounting period that the company would have had if not for the application of ss.245O(1) or (2). For example, if the accounting year of a resident company ends on 31 December, and the company becomes a foreign company on 1 October 1991, the otherwise applicable accounting period of the company for the purposes of applying the formula is 1 January 1991 to 31 December 1991. The accounting period of the foreign company determined under s.245O(1) (ie item b in the formula) is 1 October 1991 to 31 December 1991.

15.8 The second method that may be used to calculate branch equivalent income or loss of the CFC for the short accounting period is to calculate the branch equivalent income or loss of the company actually derived or incurred during that short period.

Relationship to s.245Q

15.9 Section 245Q contains rules for determining the residence of a CFC for an accounting period. The effect of those rules is to treat a CFC as being resident in one country or territory for an accounting period, although in fact it may be resident in more than one country or territory. This is the case whether the CFC is resident in more than one country or territory concurrently or whether the residence of the CFC changes during the accounting period. Section 245O assumes that the residence of a CFC can change during an accounting period. However, this is not inconsistent with s.245Q. Section 245Q is concerned with determining which of a number of foreign countries or territories a CFC is resident in. Section 245O is concerned with the different question of whether a company becomes or ceases to be a for-

eign company in terms of the "foreign company" definition. If in terms of s.245O a company is a foreign company for part of an accounting period, s.245Q may then be applied to determine the foreign country or territory that the company is resident in for that period.

PART 16: CONTROLLED FOREIGN COMPANIES RESIDENT IN FIFTEENTH SCHEDULE COUNTRIES

Overview of s.245P

16.1 Section 245P provides an exception from the requirement to calculate attributed foreign income or loss in relation to an income interest in a CFC. It applies where the CFC is resident in a country or territory specified in the Fifteenth Schedule to the Income Tax Act. The reason for the exception is to reduce compliance costs by not requiring the calculation of attributed foreign income or loss in circumstances where a significant amount of revenue would not be generated if the calculation of attributed foreign income or loss were required. This is the case where the effective tax rate of a foreign jurisdiction is close to that of New Zealand. In these circumstances, the application of the foreign tax credit mechanism in s.245K would result in little revenue being collected on attributed foreign income.

16.2 In some cases the effective tax rate of a foreign jurisdiction is generally close to that of New Zealand but tax preferences may be offered by that jurisdiction in certain circumstances which reduce the effective tax rate. In this case the jurisdiction may be listed in the Fifteenth Schedule, so that the exemption in s.245P generally applies. However, the tax preferences may be listed in the Sixteenth Schedule so that calculation of attributed foreign income or loss is required if a CFC utilises a listed preference. In the case where a listed preference is utilised compliance costs would not be excessive in relation to the revenue generated. Therefore, it is appropriate to require the calculation of attributed foreign income or loss. However, if a listed preference is not utilised the compliance costs incurred in calculating attributed foreign income or loss would be excessive in relation to the revenue generated. Therefore, in these cases the calculation of attributed foreign income or loss is not required.

Exception to calculation of attributed foreign income or loss: s.245P(1)

16.3 Section 245P(1) provides that no person shall have any attributed foreign income or attributed foreign loss in relation to an accounting period of a CFC where the CFC is resident in a country or territory listed in the Fifteenth Schedule to the Income Tax Act at all times in that accounting period. This exception applies only if, for the purposes of calculating income liable to income tax in the country or territory in which the CFC is resident, the CFC did not apply any of the preferences specified in Part A of the Sixteenth Schedule.

16.4 The residence of a CFC for the purposes of s.245P(1) is determined in accordance with s.245Q. The countries or territories listed in the Fifteenth Schedule as at 1 April 1990 are:

Australia, excluding the Territory of Norfolk Island;
Canada;
Federal Republic of Germany;
French Republic, including the European and Overseas Departments but excluding the Overseas Territories;
Japan;
United Kingdom of Great Britain and Northern Ireland;
United States of America, excluding its possessions and territories.

16.5 Only one preference is listed in Part A of the Sixteenth Schedule as at 1 April 1990. That preference is described as:

> "Any exemption from income tax for income derived from business activities carried on outside the country."

This preference encompasses any exemption from income tax granted by the taxation law of a country or territory listed in the Fifteenth Schedule for income derived from business activities carried on outside the country. Thus, it includes the exemption granted by France for income derived from business activities carried on outside France. It also includes an exemption granted by one of the listed countries for income derived from foreign business activities where the exemption is granted through a double taxation agreement entered into between the listed country and another country or territory.

16.6 The exception contained in s.245P(1) applies only to the calculation of attributed foreign income or attributed foreign loss. The CFC regime applies in relation to a company resident in a country or territory listed in the Fifteenth Schedule for other purposes. Therefore, residents hold control and income interests in companies resident in the Fifteenth Schedule, and where the control interests of five or fewer residents in such a company at any time during an accounting period is 50 percent or more in any category the company will be a CFC. Consequently,

where a CFC resident in a country or territory listed in the Fifteenth Schedule holds control or income interests in another foreign company, residents who hold control or income interests in the CFC will have indirect control or income interests in the foreign company. If the foreign company is itself a CFC, residents will be required to calculate attributed foreign income or loss in relation to that company if it is not resident in a country or territory listed in the Fifteenth Schedule.

16.7 By way of example, assume that a resident holds control interests in CFC1 of 100 percent in each category throughout CFC1's accounting period, and that CFC1 holds direct control interests in CFC2 in each category of 100 percent throughout CFC2's accounting period. Assume further that CFC1 is resident in the United Kingdom and CFC2 is resident in Luxembourg. Pursuant to s.245P(1), the resident is not required to calculate attributed foreign income or attributed foreign loss in relation to CFC1. However, the resident has an income interest of 100 percent in CFC2 through the holding in CFC1. CFC2 is not resident in a country or territory listed in the Fifteenth Schedule. Therefore, the resident is required to calculate attributed foreign income or loss in relation to CFC2.

Income must be subject to tax

16.8 Paragraph (a) of the proviso to s.245P(1) provides that, notwithstanding s.245Q, a CFC is not resident in a country or territory specified in the Fifteenth Schedule unless the CFC is liable to income tax in that country or territory by reason of domicile, residence, place of incorporation or place of management in that country or territory. The effect of the rules in s.245Q may be to treat a company as being resident in a country or territory listed in the Fifteenth Schedule in circumstances where that country or territory itself does not regard the company as being resident there or does not regard the company as being liable to income tax on worldwide income. For example, a company incorporated in the Bahamas and managed in the United States may be resident in the United States under s.245Q(4). However, for United States income tax purposes the company may not be liable to tax on income derived from outside the United States because in terms of United States tax law companies are taxable on worldwide income only if they are incorporated there. As the company would not be liable to United States tax on its worldwide income it would not be appropriate to apply the s.245P(1) exception.

Attribution of foreign investment fund income or loss

16.9 Paragraph (b) of the proviso to s.245P(1) provides that nothing in s.245P(1) prevents foreign investment fund income or foreign investment fund loss from being attributed to a person pursuant to s.245G(6). Section 245G(6) provides that where a CFC derives foreign investment fund income or foreign investment fund loss, that income or loss is attributed to residents who hold an income interest in the CFC in proportion to their income interests in the CFC. The amount thus attributed is treated as foreign investment fund income or foreign investment fund loss. The effect of paragraph (b) of the proviso to s.245P(1) is to ensure that where a CFC resident in a country or territory listed in the Fifteenth Schedule derives foreign investment fund income or incurs a foreign investment fund loss, that income or loss is attributed to residents who hold an income interest of 10 percent or greater in the CFC.

Calculation of attributed foreign income or loss where preference is utilised: s.245P(2)

16.10 Section 245P(2) provides the method for calculating attributed foreign loss in relation to a CFC resident in a country or territory listed in the Fifteenth Schedule where the CFC applies a preference listed in Part A of the Sixteenth Schedule in calculating income tax in the country in which it is resident. Such income or loss is calculated by assuming that item "b" in s.245G(2) is the net income or loss of the CFC under the taxation law of the country in which the CFC is resident:

(a) excluding any allowance for carry forward of prior year tax losses; and

(b) adjusted to the figure that would have been arrived at if no benefit had been derived from the preference listed in Part A of the Sixteenth Schedule that the CFC applied for the purposes of income tax calculations in its country of residence; and

(c) converted to New Zealand currency at the average of the close of trading spot exchange rates for the 15th day of each complete month falling within the period.

16.11 Item "b" in s.245G(2) is the branch equivalent income or loss of the CFC for the accounting period. Persons holding an income interest in a CFC multiply this amount by that income interest to calculate attributed foreign income or attributed foreign loss. Therefore, the effect of s.245P(2) is that where that provision applies a person calculates attributed foreign income or loss by taking into account the income or loss of the company under the tax rules of the jurisdiction in which the CFC is resident, as adjusted to take into account the utilisation of the listed preference by the CFC. Section 245P(2) does not require persons calculating attributed foreign income or loss to calculate the branch equivalent

income or loss of the CFC in accordance with s.245J.

16.12 Losses carried forward from prior accounting periods of the CFC are not taken into account in calculating the income or loss of the CFC under s.245P(2). If attributed foreign income was calculated in relation to the CFC in a prior income year because the listed preference was utilised in that prior year, the losses carried forward by the CFC may have been attributed to the person calculating attributed foreign income or loss and carried forward by that person. Consequently, it would not be appropriate to allow the losses to be carried forward by the CFC. If attributed foreign income or loss was not calculated in relation to a prior year it would also not be appropriate to allow the CFC to carry losses forward because prior years' income derived by the CFC had not been taken into account for New Zealand tax purposes.

PART 17: RESIDENCE OF A COMPANY

Overview of s.245Q

17.1 Section 245Q contains two sets of rules in relation to the residence of companies. The first rule, set out in s.245Q(1), is relevant in determining whether a company is a foreign company. The remaining subsections of s.245Q contain a series of rules for determining the country or territory of residence of a foreign company for an accounting period. These rules are applied consecutively until the CFC is resident in one country or territory only. The residence of a foreign company is relevant under the CFC regime because:

(a) foreign tax credits arising in relation to an interest in one CFC may be offset against tax payable on attributed foreign income derived in relation to another CFC, or consolidated with tax payable on attributed foreign income derived by another company in relation to another CFC, where the CFCs are resident in the same country or territory for the relevant periods: s.245K, s.245L;

(b) attributed foreign losses incurred in relation to one CFC may be deducted from attributed foreign income derived in relation to another CFC, or they may be consolidated with attributed foreign income derived by another company in relation to another CFC, where the CFCs are resident in the same country or territory for the relevant periods: s.245M, s.245N;

(c) in applying the exception in s.245P it is necessary to establish that the CFC is resident in one of the countries or territories listed in the Fifteenth Schedule;

(d) in applying the transitional rules in s.245Y it is necessary to establish whether CFCs are resident in a country or territory listed in the Seventeenth Schedule of the Income Tax Act;

(e) in the following cases the residence of a CFC is relevant in calculating branch equivalent income or loss under s.245J:

(i) s.245J(3) requires the income or loss of a CFC to be calculated in the currency of the country in which the CFC is resident if the CFC does not prepare financial accounts;

(ii) s.245J(21), in calculating the branch equivalent income or loss of a CFC engaged in the business of insurance other than life insurance.

17.2 Section 245Q is also relevant in determining the residence of a foreign company for the purposes of the foreign investment fund regime contained in ss.245R to 245T. Section 245R(2)(c) provides that an interest in a foreign entity is not an interest in a foreign investment fund for an income year if the foreign entity would, pursuant to s.245Q, be resident in a country or territory listed in the Fifteenth Schedule if the foreign entity were subject to s.245Q.

Definition of non-resident company: s.245Q

17.3 Section 245Q(1) provides that a company is a "non-resident company" if it is not resident in New Zealand for the purposes of the Income Tax Act. A company is resident in New Zealand for the purposes of the Income Tax Act if it is resident in New Zealand in terms of s.241(6). Inland Revenue's interpretation of s.241(6) is set out in Public Information Bulletin No.180.

17.4 The definition of "non-resident company" is relevant for the purposes of the "foreign company" definition in s.245A(1). Non-resident companies are one category of company that are treated as foreign companies. The "foreign company" definition is discussed in paragraphs 3.44 to 3.59 of this bulletin.

Determining residence of foreign company: ss.245Q(2) to (5)

Resident in country where liable to income tax: s.245Q(2)

17.5 Section 245Q(2) provides that a foreign company is resident in a country or territory for any

accounting period if at any time during the accounting period it is liable to income tax in that country or territory by reason of domicile, residence, place of incorporation or place of management in that country or territory.

17.6 Under this rule it is not sufficient that the foreign company be domiciled, resident, incorporated or managed in a particular country or territory. Section 245Q(2) has the effect of making a foreign company resident in a country or territory only if by reason of domicile, residence, incorporation or place of management in the country or territory it is liable to income tax there. For example, a foreign company incorporated and managed in a country that taxes only income derived from sources in that country will not be resident there in terms of s.245Q(2) because its tax liability, if any, arises from the fact that it derives income from within that country and not from the fact that it is incorporated or managed there.

17.7 Double taxation agreements between foreign countries may be relevant in determining whether a company is liable to income tax by virtue of domicile, residence, place of incorporation or place of management. For example, a company may be resident in two countries in terms of the tax legislation of those countries, and it may be liable to tax in each country by virtue of that residence. However, by virtue of a double taxation agreement between those countries the company may be treated as being resident in only one country for the purposes of the agreement and, consequently, it may be liable to tax on a residence basis only in that country. In these circumstances, the company will be treated as being resident in the country in which it is resident for the purposes of the double taxation agreement.

17.8 A foreign company is resident in a country or territory for an accounting period by virtue of s.245Q(2) if "at any time" during that accounting period it is liable to income tax there by reason of domicile, residence, place of incorporation, or place of management. Section 245Q(2) may therefore apply where a foreign company is liable to income tax in a country or territory by reason of domicile, residence, place of incorporation or place of management for an entire accounting period or for part of an accounting period only.

Application of s.241(6): s.245Q(3)

17.9 Section 245Q(3) applies where for an accounting period a foreign company is resident in two or more countries or territories in terms of s.245Q(2) or where the company is not resident in any country or territory in terms of s.245Q(2). In these situations the company is resident for the accounting period in the country or territory in which it would be resident by virtue of s.241(6) if the country or territory were New Zealand.

17.10 A company may be resident in two countries or territories under s.245Q(2) where it changes residence during an accounting period. Alternatively, and less likely, it may be resident in two countries because it is concurrently liable to tax in more than one country or territory by reason of domicile, residence, place of incorporation or place of management. A company may not be resident in any country or territory under s.245Q(2) where, for example, it is liable to income tax on a source basis only or where it is not liable to income tax at all. If a company has a place of management in one country and is incorporated or is controlled by directors in another, and the company is liable to tax in the country where it has a place of management but is not liable to tax in the other country by reason of the factors listed in s.245Q(2), the company will be resident in the country in which it has its place of management by virtue of s.245Q(2). In this case s.245Q(3) will not apply because the company is resident in only one country by virtue of s.245Q(2).

17.11 Where s.245Q(3) applies, the company is resident in the country or territory that it would be resident in under s.241(6) if the country or territory were New Zealand. Applying s.241(6), a foreign company is resident in a country or territory if -

(a) it is incorporated in that country or territory; or

(b) it has its head office in that country or territory; or

(c) it has its centre of management in that country or territory; or

(d) control of the company by its directors, acting in their capacity as directors, is exercised in that country or territory, whether or not decision making by directors is confined to that country or territory.

17.12 These tests differ from those in s.245Q(2) in that residence is not determined on the basis of whether the company is liable to tax. Therefore, pursuant to s.245Q(3) a company may be resident in a country or territory by virtue of incorporation or place of management although it is not liable to tax there. For example, a company incorporated or managed in Hong Kong may not be resident there pursuant to s.245Q(2) because it is liable to tax there only because it derives income from Hong Kong, and not because it is incorporated or managed there. However, the company would be resident in Hong Kong pursuant to s.245Q(3) because it is incorporated there or has its centre of management there.

Centre of management: s.245Q(4)

17.13 Section 245Q(4) provides that if the application of ss.245Q(2) and (3) do not result in a company

being resident in only one country or territory for an accounting period, the company is resident in the country or territory in which its centre of management is located in that accounting period.

17.14 A company may not be resident in only one country or territory under ss.245Q(2) and (3) where, for example:

(a) The company is incorporated in country X and managed in country Y, but is not liable to tax in either country by virtue of incorporation or place of management so that s.245Q(2) does not apply. The company is resident in both country X and country Y pursuant to s.245Q(3) because it is incorporated in one and has its centre of management in the other.

(b) The company is incorporated in country X and has its centre of management there but is not liable to tax in that country by reason of domicile, residence, place of incorporation, or place of management. The company is controlled by its directors from country Y but is not liable to tax in country Y by reason of any of the factors listed in s.245Q(2). Therefore, the company is not resident in any country under s.245Q(2). The company is resident in both country X and country Y under s.245Q(3) because it has its centre of management and place of incorporation in country X and is controlled by directors from country Y.

(c) The company is incorporated in country X, has its centre of management in country Y and is controlled by its directors from country Z during the relevant accounting period. The company is not liable to tax in any of the three countries by reason of domicile, residence, place of incorporation or place of management. Consequently, the company's residence for the accounting period cannot be fixed under s.245Q(2). The residence of the company cannot be fixed under s.245Q(3) because it is incorporated in one country, has its centre of management in another and is controlled by its directors from a third country.

(d) The company changes its centre of management from country X to country Y during an accounting period, and is not resident in only one country under s.245Q(2) because it is liable to income tax in each country for a part of the accounting period by virtue of its centre of management there. The company is not resident for the accounting period in only one country under s.245Q(3) because it has its centre of management in both countries during different parts of the accounting period, and because after the company's centre of management has changed the company may be incorporated in one country and have its centre of management in another.

(e) The company is incorporated in country X and is controlled by its directors from country Y. The company does not have a centre of management. The company is not liable to tax in country X or country Y by virtue of domicile, residence, place of incorporation or place of management. Therefore, its residence cannot be fixed under s.245Q(2). The company's residence cannot be fixed under s.245Q(3) because it is incorporated in one country and is controlled by its directors from another.

17.15 In these types of case the residence of the company for the accounting period may be established under s.245Q(4) on the basis of the location of the company's centre of management:

(a) In the first example, the company would be resident in country Y for the accounting period pursuant to s.245Q(4) because its centre of management is in that country.

(b) In the second example, the company would be resident in country X for the accounting period pursuant to s.245Q(4) because its centre of management is in that country.

(c) In the third example, the company would be resident in country Y for the accounting period pursuant to s.245Q(4) because its centre of management is in that country.

(d) In the fourth example, the residence of the company for the accounting period cannot be established under s.245Q(4) because it does not have its centre of management in only one country for the accounting period. Therefore, the company's residence must be determined finally under s.245Q(5).

(e) In the fifth example, the residence of the company cannot be determined under s.245Q(4) because it does not have a centre of management. The company's residence is determined finally under s.245Q(5).

Commissioner determines residence: s.245Q(5)

17.16 Section 245Q(5) provides that if no single country or territory of residence of a company for an accounting period can be determined under ss.245Q(2) to (4), the company is resident for that accounting period in the country or territory that the Commissioner determines the company to be resident in.

17.17 Section 245Q(5) does not list the factors that the Commissioner must consider in finally deter-

mining the residence of a foreign company. Each case must be determined on its facts, and the factors to be taken into account may differ from case to case. Relevant factors may be:

(a) From where the company is controlled by its directors. If the centre of management of a company has changed during an accounting period, but there has been no change in the country from which the company is controlled by its directors, it may be possible to determine the residence of the company by reference to the country from which it is controlled by its directors. If the company does not have a centre of management, the country from which the company is controlled by its directors will be a strong indicator of which country the company is resident in.

(b) Where during an accounting period a company has changed the location of its centre of management, place of incorporation (through redomiciliation procedures permitted by some jurisdictions), place of control by directors or head office, it may be appropriate to consider the time during the accounting period that the company has its centre of management, place of incorporation, place of control by directors or head office in each country. If the centre of management, place of incorporation, place of control by directors or head office is located in one country for the majority of the accounting period that may influence the Commissioner in determining that the company is resident in that country.

(c) Where the company carries on business and where the assets of the company are located. These factors may be significant in cases where the company is carrying out manufacturing, assembly or packaging operations, for example. If these operations are located in one country, the location of the operations may be taken into account in determining the residence of the company. However, in other cases the location of the company's business or assets will be a less important factor. This would be the case, for example, where the company was a financing subsidiary, or an investment vehicle where investments were made in a range of markets.

(d) Where the company is incorporated. If, for example, the centre of management of a company changes during an accounting period the fact that the company is incorporated in one of the countries in which it has its centre of management during the period may be a factor indicating that the company should be treated as being resident in that country rather than in the other country.

(e) The location of general meetings of the company, if any. Shareholders exercise ultimate control of a company through general meetings. Consequently, if general meetings are held in a particular country that may be a factor taken into account in determining the residence of the company.

Residence of foreign companies and s.245P

17.18 Paragraph (a) of the proviso to s.245P(1) provides that, notwithstanding s.245Q, a CFC is not resident in a country or territory specified in the Fifteenth Schedule unless the CFC is liable to income tax in that country or territory by reason of domicile, residence, place of incorporation or place of management in that country or territory. If s.245Q treats a CFC as being resident in a country or territory listed in the Fifteenth Schedule, but it is not liable to income tax in that country or territory by reason of domicile, residence, place of incorporation or place of management, s.245Q is applied again until the company is treated as being resident in another country or territory.

17.19 By way of example, assume that a CFC has its centre of management in a country listed in the Fifteenth Schedule and is incorporated in another country. Assume further that the CFC is not liable to tax in either country by reason of domicile, residence, place of incorporation or place of management. In these circumstances, the residence of the CFC would ordinarily be determined under s.245Q(4) as being the country listed in the Fifteenth Schedule. However, as the CFC is not liable to tax in that country by reason of domicile, residence, place of incorporation or place of management paragraph (a) of the proviso to s.245P(1) applies and the CFC is not resident in the Fifteenth Schedule country. Consequently, the residence of the CFC is finally determined under s.245Q(5). In determining the country of residence, the Commissioner must have regard to the fact that pursuant to paragraph (a) of s.245P(1) the CFC cannot be resident in the Fifteenth Schedule country.

17.20 By way of further example, assume that during an accounting period the centre of management of a CFC changes from a non-Fifteenth Schedule country to a Fifteenth Schedule country and that the CFC is not liable to tax in either country by reason of any of the factors listed in s.245Q(2). In this case the residence of the CFC could not be determined under ss.245Q(2) to (4), and the CFC's residence would be determined by the Commissioner under s.245Q(5). Applying that provision, and taking into account the factors listed in paragraph 17.17 above, the Commissioner might ordinarily determine that the CFC is resident in the Fifteenth Schedule country. However, the effect of paragraph (a) of the

proviso to s.245P(1) is that the Commissioner cannot determine the CFC to be resident in the Fifteenth Schedule country because it is not liable to tax there by reason of domicile, residence, place of incorporation or place of management.

Residence of foreign companies during transitional period: s.245Y(3)

17.21 Section 245Y(3) provides that, nothwithstanding s.245Q, a non-resident company is deemed to be resident in a country or territory listed in the Seventeenth Schedule to the Income Tax Act for the purposes of s.245Y(1). This rule does not apply if any person resident in New Zealand with an income interest in the company can establish to the satisfaction of the Commissioner that the company is liable to tax in a country or territory not listed in the Seventeenth Schedule by reason of domicile, residence, place of incorporation or place of management. Section 245Y(1) provides that where before 1 April 1990 a person holds an income interest in a CFC that is resident in a country or territory not listed in the Seventeenth Schedule, the person is deemed to have acquired that interest on 1 April 1990 for the purposes of calculating attributed foreign income or loss in relation to the interest.

17.22 The effect of s.245Y(3) in relation to s.245Q is that two requirements must be satisfied in order to avoid attribution of income or loss from a CFC before 1 April 1990:

(a) in terms of s.245Q the CFC must be resident in a country or territory not listed in the Seventeenth Schedule; and

(b) it must be established that the CFC is liable to tax in a country or territory not listed in the Seventeenth Schedule by reason of domicile, residence, place of incorporation or place of management.

17.23 Section 245Y(3) effectively applies only if a CFC is resident outside a country or territory listed in the Seventeenth Schedule, and applies to treat the CFC as being resident in a country or territory listed in the Seventeenth Schedule in the circumstances specified. Therefore, if pursuant to s.245Q a CFC is treated as being resident in a country or territory listed in the Seventeenth Schedule before 1 April 1990, it is not necessary to establish that it is liable to tax in that country or territory by reason of domicile, residence, place of incorporation or place of management.

PART 18: ADMINISTRATIVE PROVISIONS

Default assessments: s.245V

Situations in which default assessment can be made: s.245V(1)

18.1 Section 245V(1) provides that the Commissioner may make an assessment of the amount of attributed foreign income, attributed foreign loss, foreign investment fund income or foreign investment fund loss derived or incurred by a person in three situations:

(a) where for any period any person has failed to disclose in accordance with s.245W a control interest or income interest in a CFC or in a foreign investment fund;

(b) where any person has failed to disclose any information requested by the Commissioner pursuant to s.17 of the Inland Revenue Department Act 1974 in relation to an interest in a CFC or foreign investment fund;

(c) where for any period any person is unable to obtain sufficient information to calculate the person's attributed foreign income or attributed foreign loss or foreign investment fund income or foreign investment fund loss in relation to an interest in a CFC or foreign investment fund.

Method of assessment: s.245V(2)

18.2 Section 245V(2) sets out five methods that the Commissioner may use in making an assessment of attributed foreign income or loss or foreign investment fund income or loss in the circumstances specified in s.245V(1). It is specifically provided that the listed methods do not limit the methods that the Commissioner may use in making an assessment for the purposes of s.245V(1). The listed methods are:

(a) Having regard to the accounts of the CFC or foreign investment fund prepared for the purposes of -

  (i) furnishing an income tax return in New Zealand or in any other country; or

  (ii) providing information to creditors, shareholders, or other persons having an economic relationship with the CFC or foreign investment fund; or

(b) Having regard to the branch equivalent income of the CFC for any prior period in relation to any person, and applying to that branch equivalent income an appropriate percentage rate of presumed increase, being a rate not less than 10 percent compounding annually; or

(c) Having regard to the accounts of the CFC or foreign investment fund referred to in (a) for any prior period, and applying to the income disclosed in those accounts a rate of presumed increase that the Commissioner considers appropriate, being a rate not less than 10 percent compounding annually; or

(d) Imputing an appropriate rate of return to the value of the interest at the beginning of the relevant period; or

(e) Treating any gain derived or loss incurred on disposal of the interest during the relevant period, or any increase or reduction in the market value of the interest over the relevant period, as attributed foreign income, attributed foreign loss, foreign investment fund income or foreign investment fund loss.

Disclosure of interests: s.245W

18.3 Section 245W(1) provides that where any person at any time has an income interest or control interest in a foreign company or an interest in a foreign investment fund, the person shall disclose to the Commissioner in the prescribed form and with the person's return of income for the year -

(a) the existence and nature of the interest; and

(b) such other information as may be required by the Commissioner in respect of the interest for the purposes of the administration of the Income Tax Act.

18.4 The proviso to s.245W(1) provides that a person is not required to disclose a control interest to the extent that it exists only by virtue of s.245C(3)(b) or (d). This exception does not apply where the Commissioner specifically requires a person to disclose interests held by a person by virtue of s.245C(3)(b) or (d). A control interest is held by a person by virtue of s.245C(3)(b) or (d) to the extent that it constitutes a direct or indirect control interest held by an associated person. Therefore, the effect of the proviso is that as a general rule persons are not required to disclose control interests held by their associates. However, this does not mean that such interests are not taken into account in determining whether a foreign company is a CFC. Direct and indirect interests held by associated persons are still aggregated in determining whether a foreign company is a CFC in terms of s.245C and in determining whether a person holds an income interest of 10 percent or greater in a CFC in terms of s.245F(1)(b).

18.5 Section 245W(2) provides that the Commissioner may exempt any person or class of persons from the requirements of s.245W(1) where, in the Commissioner's opinion, disclosure by that person or class of persons is not necessary for the administration of Part IVA of the Income Tax Act. Section 245W(3) provides that the Commissioner may at any time cancel any exemption granted to any person or class of persons under s.245W(2).

18.6 Where an exemption from disclosure has been granted under s.245W(2), the exemption does not affect the operation of Part IVA. For example, persons are still required to calculate control or income interests in a foreign company although disclosure of the interests is not required. This may be important because a person may have an interest in a CFC in respect of which disclosure is not required and that CFC may hold an interest in another foreign company in respect of which disclosure is required. The person will be required to calculate control or income interests in relation to the CFC in order to determine whether the foreign company is a CFC and, if so, to calculate the person's income interest in relation to that foreign company.

Offences and penalties

18.7 Several offences in relation to the disclosure obligations imposed under s.245W are created by ss.416(1)(ba), 416(1)(bb) and 416A:

(a) Section 416(1)(ba) provides that a person commits an offence if that person knowingly fails, or knowingly permits the failure, to disclose any information which the person is required to disclose under s.245W. Prior to the enactment of the Income Tax Amendment Act 1989, s.416(1)(ba) applied only to any corporate body that was required to make a disclosure under s.245W. Section 416(1)(ba) was amended by s.76 of the Income Tax Amendment Act 1989 with effect from 22 March 1989. Section 416(1)(ba) now applies to any "person" who is required to make a disclosure under s.245W.

(b) Section 416(1)(bb) provides that a person commits an offence if that person knowingly makes a false disclosure, or knowingly gives any false information, to the Commissioner in relation to the disclosure obligation imposed on the person under s.245W.

(c) Sections 416A(3)(a) and (b) apply where an officer or employee of a corporate body is required, by virtue of that office or employment, to make a disclosure under s.245W. Such an officer or employee commits an offence if he or she knowingly fails or permits the failure to disclose information that the corporate body is required to disclose under s.245W, or knowingly makes a false disclosure or gives any false information to the Commissioner in relation to the obligation to disclose imposed on the corporate body under s.245W.

(d) Section 416B(2B) provides that for the purposes of s.416(1)(ba), s.416(1)(bb) and s.416A(3) the term "person" includes any person who aids, abets, or incites any other person to commit the offences specified in those provisions. This effectively means that s.416(1)(ba), s.416(1)(bb) and s.416A(3) create offences of aiding, abetting or inciting persons to commit the offences specified in those provisions.

18.8 Section 416B(2A) sets out the penalties for the offences created by ss.416(1)(ba), 416(1)(bb) and 416A(3). It provides that the penalty for those offences is the same in each case: imprisonment for a term not exceeding two years or a fine not exceeding $50,000, or both. Any person who aids, abets or incites the commission of such an offence is liable to the same penalty by virtue of s.416(2B).

PART 19: TRANSITIONAL RULES

Overview

19.1 Section 245Y sets out transitional rules in relation to the application of the CFC and foreign investment fund regimes. As a general rule, the CFC and foreign investment fund regimes came into force on 1 April 1988: s.15 Income Tax Amendment Act (No 5) 1988. Section 245Y delays the application of the regimes in some circumstances, and provides transitional rules for the application of the regimes where they apply from 1 April 1988.

Interests in CFCs resident in Seventeenth Schedule country: s.245Y(1)

Description

19.2 Section 245Y(1) applies where a person holds an income interest in a CFC which, by virtue of s.245Q, is resident in a country or territory not listed in the Seventeenth Schedule to the Income Tax Act at all times during the period commencing with the later of the date of acquisition of the income interest or 1 April 1988 and ending with the earlier of the date of disposition of the interest or 31 March 1990. In these circumstances, for the purposes of calculating attributed foreign income or loss in relation to the income interest:

(a) the person is deemed to have acquired that interest on 1 April 1990 or, if the person disposed of the income interest before 1 April 1990, never to have held that interest; or

(b) where the income interest is in a CFC resident in a country or territory that by amendment to the Income Tax Act becomes specified in the Seventeenth Schedule before 1 April 1990, the person is deemed to have acquired the interest on the day on which the country or territory became specified or, if the interest is disposed of before the day on which the country or territory became specified, never to have held that interest.

19.3 Section 245Y(1) applies only for the purpose of calculating attributed foreign income or loss. It does not apply for the purposes of determining whether a company is a CFC, for the purpose of determining whether a person has an income interest of 10 percent or greater in a CFC for the purpose of attributing foreign investment fund income or loss under s.245G(6), or for any other purpose.

Seventeenth Schedule

19.4 Section 245Y(1) applies where, during the period falling between 1 April 1988 and 31 March 1990, a person at any time holds an income interest in a CFC resident in a country or territory not listed in the Seventeenth Schedule to the Income Tax Act. The Seventeenth Schedule is divided into two parts. Part A simply provides a list of 61 countries or territories. Part B lists 10 further countries and describes specific categories of company that are resident in those countries. The categories of company are described by reference to specific tax preferences available in the listed countries that are received by companies.

19.5 The objective of the Seventeenth Schedule is to provide a list of low tax jurisdictions in relation to which the CFC regime applies from 1 April 1988. The list is significant in relation to the CFC regime only for the period between 1 April 1988 and 31 March 1990. After that period the CFC regime applies in full to CFCs resident in all jurisdictions except those listed in the Fifteenth Schedule. The rationale for applying the CFC regime with respect to low tax jurisdictions from 1 April 1988, and to other jurisdictions from 1 April 1990, is that taxpayers were warned in the July 1987 Budget that CFC legislation would be enacted to deal with investments in tax havens. Thus, it was appropriate to apply the CFC regime to tax haven companies from 1 April 1988: *Report of the Consultative Committee on International Tax Reform Part 1*, March 1988, para 7.1. However, taxpayers were not warned of the wider application of the legislation until publication of the *Consultative Document on International Tax Reform* on 17 December 1987. Therefore, in recognition of the later notice of the broader application of the CFC regime, the application date of the regime to jurisdictions other than low tax jurisdictions was delayed until 1 April 1990. Residents with interests in CFCs resident in jurisdictions other than the listed low tax jurisdictions are therefore given a period of transitional

relief within which they can analyse the impact of the CFC regime on their investments and restructure where necesssary.

19.6 Part A of the Seventeenth Schedule contains a list of countries or territories which are considered to be tax havens. These are countries which are commonly used as part of international tax planning strategies to shelter income from domestic taxation. Part B of the Seventeenth Schedule is more limited in scope and applies only to certain companies resident in the listed countries. The countries listed in Part B are not generally low tax jurisdictions. However, some features of the taxation law of these countries may be used in order to have income taxed at a low rate. These countries may therefore be used as tax havens for limited purposes. The objective of Part B is to apply the CFC regime from 1 April 1988 in relation to a CFC resident in a country listed in that Part where the CFC is utilising the country as a tax haven, but not to apply the regime until 1 April 1990 where the country is used by a CFC for other purposes.

Application of s.245Y(1) only for purpose of calculating attributed foreign income or loss

19.7 Section 245Y(1) deems a person to have acquired an interest in a CFC on 1 April 1990, or to have disposed of an interest before that date, only for the purposes of calculating attributed foreign income or loss. It does not apply for the purposes of determining whether a foreign company is a CFC, for the purposes of determining whether the income interest of a person in a CFC is 10 percent or greater for the purposes of attributing foreign investment fund income or loss under s.245G(6), or for any other purpose.

19.8 Although for periods prior to 1 April 1990 s.245Y(1) does not require the calculation of attributed foreign income or loss in relation to an income interest in a CFC resident in a country or territory not listed in the Seventeenth Schedule, it is still necessary to determine whether foreign companies resident in such countries are CFCs for such periods for several reasons:

(a) A foreign company resident in a country not listed in the Seventeenth Schedule may hold an interest in a foreign company resident in a country listed in the Seventeenth Schedule. In order to determine whether the foreign company resident in the Seventeenth Schedule country is a CFC it will generally be necessary to first determine whether the foreign company resident in the country not listed in the Seventeenth Schedule is a CFC. This is because by virtue of s.245C control interests of residents in the foreign company resident in the listed country are calculated by taking into account their indirect control interests held through the CFC resident in the non-listed country.

(b) If in the situation described in (a) the foreign company resident in the listed country is a CFC, it will be necessary to calculate indirect income interests held by residents in that CFC through the foreign company resident in the non-listed country. For this purpose it is necessary to establish that the foreign company resident in the non-listed country is a CFC because indirect income interests can only be held through CFCs.

(c) It is specifically provided that s.245Y(1) does not apply in determining whether a person holds an income interest of 10 percent or greater in a CFC for the purpose of attributing foreign investment fund income or loss under s.245G(6). Section 245G(6) applies only where foreign investment fund income or loss is derived by a CFC. To apply s.245G(6) with respect to foreign investment fund income or loss derived by a foreign company resident in a country not listed in the Seventeenth Schedule it is therefore necessary first to establish that the foreign company is a CFC.

(d) Section 245Y(1) does not apply in calculating the branch equivalent income or loss of a CFC resident in a country not listed in the Seventeenth Schedule for the accounting period within which 1 April 1990 falls. For example, if the accounting period of a CFC ends on 31 August 1990 the branch equivalent income or loss of the CFC for the accounting period ending on 31 August 1990 is calculated on the basis of the income derived and losses incurred in the entire accounting period ending on that day, and not only for the portion of the period falling after 31 March 1990. The fact that a person is not required to attribute income or losses from a CFC which is not resident in a country listed in the Seventeenth Schedule before 1 April 1990 is recognised by reducing the person's income interest in the CFC, rather than by apportioning the income and loss of the CFC to portions of the accounting period falling before and after 1 April 1990. (Income interests are reduced in these circumstances because s.245Y(1) deems the interest to be acquired on 1 April 1990. Therefore, the formula in s.245D(5) reduces income interests for accounting periods of CFCs that straddle 1 April 1990 because taxpayers will have zero income interests for portions of those periods falling before 1 April 1990).

(e) Section 226(4) provides that where a CFC settles a trust any person who held a control interest of 10 percent or more at the time of settlement is a settlor of the trust. The new trust taxation regime applies from the beginning of the income

year commencing on 1 April 1988. The trust regime applies with respect to all countries and the transitional rules for that regime are not based on the list of countries contained in the Seventeenth Schedule. Consequently, where a foreign company which is resident in a country or territory not listed in the Seventeenth Schedule settles a trust before 1 April 1990 it is necessary to determine whether that company is a CFC for the purpose of applying s.226(4). Section 226(4) is discussed at paragraphs 6.100 to 6.119 of the appendix to Tax Information Bulletin No.5.

Deemed acquisition on, or disposal before, 1 April 1990

19.9 Where between 1 April 1988 and 31 March 1990 a person holds an income interest in a CFC resident in a country or territory not listed in the Seventeenth Schedule, s.245Y(1)(a) provides that for the purposes of calculating attributed foreign income or loss the person is deemed to have acquired that interest on 1 April 1990 or, where the interest was disposed of before 1 April 1990, never to have held that interest.

19.10 If pursuant to s.245Y(1)(a) a person is deemed to acquire an income interest in a CFC on 1 April 1990, and the accounting period of the CFC does not end on 31 March 1990, the income interest of the person in the CFC will vary in the accounting period of the CFC during which 1 April 1990 falls. Consequently, the income interest of the person for that accounting period will be calculated under s.245D(5). The effect of the formula in that provision will be to reduce the income interest of the person in the CFC for the accounting period because the person will be deemed not to have held an income interest in the CFC prior to 1 April 1990.

19.11 The fact that a person is deemed to acquire an income interest in a CFC on 1 April 1990 does not necessarily mean that the person will have an income interest in the CFC for the accounting period in which 1 April 1990 falls. If a person who calculates income interests on a measurement day basis in accordance with s.245A(2)(e) does not hold an income interest in the CFC on any measurement day after 1 April 1990 the person will not have an income interest for the accounting period in which 1 April 1990 falls.

19.12 For example, assume that a resident acquires an income interest of 100 percent in a CFC which is not resident in a country listed in the Seventeenth Schedule on 1 June 1986 and disposes of that income interest on 15 June 1990. Section 245Y(1) would deem the resident to have acquired the interest in the CFC on 1 April 1990. However, the resident would not hold an income interest in the CFC on the 30 June 1990 and 30 September 1990 measurement days. Therefore, the resident does not hold an income interest in the CFC from 1 April 1990 to 31 August 1990: s.245A(2)(e)(ii). In this example the resident would have held an income interest in the CFC before 1 April 1990. However, the effect of s.245Y(1) is that the resident would not have held an income interest before 1 April 1990 for the purposes of calculating attributed foreign income or loss in relation to that CFC.

Amendments to Seventeenth Schedule

19.13 Section 245Y(1)(b) applies where a person holds an income interest in a CFC which is resident in a country or territory that, pursuant to an amendment to the Income Tax Act, becomes a country or territory specified in the Seventeenth Schedule before 1 April 1990. In these circumstances, the person is deemed to have acquired that interest on the date on which the country or territory became specified in the Seventeenth Schedule or, if the person disposed of the interest before the date on which the country or territory became specified, the person is deemed never to have held that interest.

19.14 Two countries, Fiji and Western Samoa, were added to Part B of the Seventeenth Schedule by s.77 of the Income Tax Amendment Act 1989. Fiji was added to the Seventeenth Schedule in relation to companies obtaining relief under the tax free zone or tax free factory scheme. Western Samoa was added to the list in relation to companies engaged in offshore banking activities. The additions to the list came into effect on 1 April 1989. Therefore, where on and before 1 April 1989 a person holds an income interest in a CFC resident in Fiji that is obtaining relief under the tax free zone or tax free factory scheme, or in a CFC resident in Western Samoa that is engaged in offshore banking activities, the person is deemed to have acquired that interest on 1 April 1989 for the purposes of calculating attributed foreign income or loss. If the interest was disposed of before 1 April 1989 the person is deemed, for the purposes of calculating attributed foreign income or loss, never to have held that interest.

Comparison with application of CFC regime from 1 April 1988

19.15 The application of the CFC regime from 1 April 1988 is governed by s.245G(3). In terms of that provision, discussed in Part 9 of this bulletin, where an accounting period of a CFC commences before 1 April 1988 the branch equivalent income or loss of the CFC is calculated only in relation to the portion of the period falling on and after 1 April 1988. Therefore, the fact that the CFC regime did not apply before 1 April 1988 is recognised by apportioning income and losses derived by the CFC in the accounting period in which 1 April 1988 falls to the periods falling before and on and after 1 April 1988.

19.16 In contrast to s.245G(3), for the purposes of s.245Y(1) income and losses of a CFC are not apportioned between portions of the accounting period in which 1 April 1990 falls, or in which the day on which the Seventeenth Schedule was amended falls. Instead, the income interest of persons holding an income interest in the CFC on 1 April 1990 is averaged down for the accounting period in accordance with s.245D(5). This has a similar effect to apportionment in that it results in a reduced attribution of income and losses, reflecting the fact that attribution is not required for the entire accounting period.

Companies resident in countries listed in Part B of Seventeenth Schedule

19.17 Section 245Y(1A) provides that for the purposes of ss.245Y(1) and (7) a CFC or foreign entity is deemed not to be resident in a country or territory specified in the Seventeenth Schedule to the extent that the company or entity:

(a) is resident in a country or territory specified in Part B of the Seventeenth Schedule; and

(b) is not a company or entity of a kind specified in the second column of Part B of that Schedule.

19.18 The effect of this provision is that where a company resident in a country specified in Part B of the Seventeenth Schedule is not described in the second column of that Part of the Schedule because it is not utilising a tax preference described in that second column, residents holding an income interest in the company are not required to calculate attributed foreign income in relation to periods before 1 April 1990, or before the accounting period in which the CFC commences to utilise a listed tax preference. Where a CFC resident in a country listed in Part B of the Seventeenth Schedule does utilise a preference specified in that Part, residents with income interests in the CFC of 10 percent or more are required to calculate the branch equivalent income or loss of the CFC in accordance with s.245J. That is, in contrast to s.245P(2), there is no mechanism for calculating the income or loss of the CFC in accordance with foreign tax rules, adjusted to take account of the preference.

Election not to apply s.245Y(1)

19.19 Section 245Y(2) provides that any person who holds an income interest in a CFC to which s.245Y(1) would apply if not for the application of s.245Y(2) is entitled to elect that s.245Y(1) not apply to that interest. By paragraph (a) of the proviso to s.245Y(2), an election under s.245Y(2) must be made in relation to all income interests held by the person. Therefore, it is not possible to make election only in relation to income interests in CFCs that have made a loss while not electing in relation to income interests in CFCs that have made a profit.

19.20 Paragraph (b) of the proviso to s.245Y(2) provides that where an election has been made under s.245Y(2) in relation to an income interest in a CFC for an accounting period falling, in whole or part, during the period between 1 April 1988 and 31 March 1990, and the CFC has incurred a loss for that period, the income interest of the person in the CFC for any measurement day during the period is deemed to be the lesser of -

(i) the income interest that the person would have held on 17 December 1987 if that day were a measurement day; or

(ii) the income interest actually held by the person in the CFC on the measurement day.

Residence for purposes of s.245Y(1)

19.21 Section 245Y(3) provides that notwithstanding s.245Q a non-resident company is deemed to be resident in a country or territory for the purposes of s.245Y(1) unless any person resident in New Zealand with an income interest in the company can establish, to the satisfaction of the Commissioner, that the company is liable to income tax in a country or territory not so specified by reason of domicile, residence, place of incorporation or place of management in that country or territory. Section 245Y(3) is discussed in paragraphs 17.21 to 17.23 of this bulletin.

Income derived in 1988 income year

19.22 Section 245Y(4) provides that where attributed foreign income or foreign investment fund income would be derived by a taxpayer in the income year ending 31 March 1988, that income is deemed to have been derived in the income year ending with 31 March 1989.

19.23 The objective of this provision is to ensure that all attributed foreign income and foreign investment fund income is taxable at the lower rates of tax applying from the 1989 income year. This is consistent with one of the policies underlying the CFC regime of broadening the tax base in return for lower income tax rates. In the absence of s.245Y(4), taxpayers with a late balance date might derive attributed foreign income or foreign investment fund income in the 1988 income year. In the case of attributed foreign income, this could occur where the taxpayer furnished a return of income for a year ending with a balance date falling after 31 March 1988 and on or before 30 September 1988, and where the accounting period of a CFC in which the taxpayer held an income interest ended after 1 April 1988 and before the date to which the taxpayer furnished a return of income.

19.24 By way of example, assume that pursuant to s.15 a taxpayer furnishes a return of income for a year ending with a balance date of 31 July, and that for the period 1 April 1988 to 31 July 1988 the taxpayer holds an income interest of 100 percent in a CFC. Assume further that the accounting period of the CFC ends on 30 June. Pursuant to s.245G(1), the taxpayer would derive attributed foreign income in relation to the accounting period of the CFC ending on 30 June 1988 for the year ending 31 July 1988. By s.15, this income would be derived in the income year ending on the preceding 31 March: ie the 1988 income year. In these circumstances, the effect of s.245Y(4) is to deem the income to be derived in the 1989 income year.

Provisional tax

19.25 Section 245Y(8) provides that for the purposes of Part XII of the Income Tax Act, in calculating the provisional tax payable by any person in respect of the income year commencing on 1 April 1988 attributed foreign income or loss or foreign investment fund income or loss derived or incurred by the person in that income year are not taken into account.

PART 20: RELATIONSHIP OF CFC REGIME TO OTHER PROVISIONS

CFC regime and foreign investment fund regime

Distinction between interest in CFC and interest in foreign investment fund

20.1 Section 245R(2) provides that an interest in a foreign company will be an interest in a foreign investment fund if none of the exceptions in ss.245R(2)(c) to (h) apply. This rule applies to all foreign companies. Therefore, an interest in a CFC may be an interest in a foreign investment fund. To avoid application of both regimes in these circumstances, s.245R(2)(h) provides that an income interest of 10 percent or greater in a CFC is not an interest in a foreign investment fund. Thus, persons holding an income interest of 10 percent or greater in the company will be subject to the CFC regime while those holding an interest that is not an income interest of 10 percent or greater may hold an interest in a foreign investment fund.

Changes in regime to which interest in foreign company is subject

20.2 Where a person holds an interest in a foreign investment fund, that interest may become an income interest of 10 percent or greater in a CFC, for example because the person increases the interest held by the person in the foreign company or because the foreign investment fund becomes a CFC. Alternatively, an income interest of 10 percent or greater held by a person in a CFC may become an interest in a foreign investment fund, for example because the person disposes of a portion of his or her interest in the foreign company or because the foreign company ceases to be a CFC. The rules which apply in these circumstances are set out in ss.245R(13) and (15).

20.3 Section 245R(13) applies where a person holds an interest in a foreign investment fund and that interest becomes an income interest of 10 percent or greater in a CFC in relation to an accounting period of the CFC. In these circumstances, the person is deemed to have disposed of the interest in the foreign investment fund at its market value on the last day of the immediately preceding accounting period of the CFC.

- Example 57

Facts: (i) A New Zealand resident, A, holds an interest in a CFC for the accounting periods of the CFC ending 30 June 1990 and 1991. For the accounting period ending on 30 June 1990 A's interest in the CFC is 5 percent in each of the categories listed in ss.245C(4) and 245D(2). A furnishes a return of income for the year to 31 March.

(ii) A acquires further shares in the CFC on 30 October 1990. The effect of the acquisition is that the shares held by A in the CFC constitute an interest of 15 percent in each category of interest.

Result: (i) For the accounting period of the CFC ending 30 June 1990 the interest held by A in the CFC constitutes an interest in a foreign investment fund because it is not an income interest of 10 percent or greater and none of the exceptions in ss.245R(2)(a) to (g) apply.

(ii) The income interest of A in the CFC in relation to the accounting period ending on 30 June 1991 is calculated in accordance with the formula in s.245D(5) as follows:

period from 1 July 1990 to 29 October 1990

$$5\% \times \frac{121}{365} = 1.65\%$$

period from 30 October 1990 to 30 June 1991

$$15\% \times \frac{244}{365} = 10.03\%$$

income interest for accounting period

1.65% + 10.03% = 11.68%

(iii) The interest held by A in the CFC therefore becomes an income interest of 10 percent or greater for the accounting period ending 31 March 1991. Therefore, pursuant to s.245R(13) A is deemed to have disposed of the interest in the CFC which constituted an interest in a foreign investment fund on 30 June 1990 for its market value. This amount is taken into account (in accordance with the formula in s.245R(3)) in calculating the foreign investment fund income or loss of A in relation to the interest in the CFC for the income year ending 31 March 1991. The income and loss derived or incurred by the CFC in the accounting period ending 30 June 1991 is taken into account in calculating the attributed foreign income or loss of A in relation to the CFC for the income year ending 31 March 1992.

20.4 Section 245R(15) applies where a person holds an interest in a foreign investment fund and that interest ceases to be an income interest of 10 percent or greater in a CFC in relation to an accounting period of the foreign investment fund. Where s.245R(15) applies the person is deemed to have acquired the interest in the foreign investment fund on the day immediately succeeding the last day of the accounting period of the CFC for which the interest was an income interest of 10 percent of greater. The acquisition is deemed to have been for consideration equal to the market value of the interest on that day.

Attribution of foreign investment fund income or loss through CFC

20.5 Where a CFC holds an interest in a foreign investment fund the foreign investment fund income or loss derived in relation to the interest by the CFC is not taken into account in calculating the branch equivalent income or loss of the CFC: s.245J(25). Pursuant to s.245G(6) this foreign investment fund income or loss is attributed to residents holding an income interest of 10 percent or greater in the CFC separately from other income or loss of the CFC. The amounts thus attributed are treated as foreign investment fund income or loss. These provisions are discussed in paragraphs 9.33 to 9.43 of this bulletin.

CFC regime and trusts

Calculation of control interests where interests in foreign company held by trustees or by persons associated with trustees

20.6 Where trustees of a trust hold control interests in a foreign company those interests will be taken into account by persons associated with the trustees in determining whether the foreign company is a CFC: s.245C(3). The "associated persons" definition in s.245B sets out four situations in which an associated persons relationship may arise within the context of a trust:

(a) trustees and beneficiaries are associated under s.245B(g)(i);

(b) a trustee is associated with any person who may benefit from a trust if that potential beneficiary is associated with a settlor: s.245B(g)(ii);

(c) trustees of two separate trusts with a common settlor may be associated under s.245B(h);

(d) trustees of a trust may be associated with a settlor of that trust under s.245B(i).

These associated persons relationships do not arise in certain instances where the trust is settled by an employer for the benefit of employees. These exceptions are discussed in paragraphs 4.67 to 4.70 of this bulletin.

20.7 The definition of "trustee" in s.2 of the Income Tax Act provides that a reference to a trustee of a trust means the trustee only in the trustee's capacity as trustee of that trust. In the context of s.245C(3) this means that interests in a foreign company held by trustees of a trust other than in the capacity as trustees of that trust are not deemed to be held by persons associated with the trustees with respect to that trust. Also, trustees of a trust are deemed to hold interests in a foreign company held by persons associated with the trustees in relation to that trust only in the trustees' capacity as trustees of that trust.

Calculation of income interests where interests in foreign company held by trustees or by persons associated with trustees

20.8 Except for the limited purpose of determining whether a person holds an income interest of 10 percent or greater in a CFC, interests held by associated persons are not aggregated for the purpose of calculating income interests. The effect where income interests are held by trustees or by persons associated with trustees is:

(a) Income interests held by non-resident trustees of a trust in a foreign company are not aggregated with income interests held by resident beneficiaries in calculating the income interests of the beneficiaries in that company. However, income interests held by non-resident trustees are taken into account in determining whether resident beneficiaries hold an income interest of 10 percent or greater in a CFC. For example, if a resident beneficiary of a trust holds an income interest of 5 percent in a CFC, and non-resident

trustees of the trust hold an income interest of 6 percent in the CFC, the resident beneficiary is deemed to hold an income interest of 10 percent or greater in the CFC by virtue of s.245F(2). However, the beneficiary is required to calculate attributed foreign income or loss in relation to the income interest of 5 percent only.

(b) Where two trusts have at least one settlor in common and the trustees of one trust are resident while the trustees of the other trust are non-resident, income interests held by the non-resident trustees in a CFC are not aggregated with the income interests held by the resident trustees in that CFC. However, the income interests held by the non-resident trustees are taken into account in determining whether the resident trustees hold an income interest of 10 percent or greater in the CFC in their capacity as trustees.

(c) Income interests held by non-resident trustees of a trust in a CFC are not aggregated with income interests held by resident settlors of the trust. However, income interests held by the non-resident trustees of the trust are taken into account in determining whether the resident settlors hold income interests of 10 percent or greater in the CFC. Also, if a settlement was made on the trust after 17 December 1987 any resident settlor may be liable to tax on trustee income derived by the trustees as agent for the trustees: s.228(4). Where the trustee income includes attributed foreign income derived in relation to an income interest in a CFC, the settlor may be liable for tax on that income in terms of s.228(4).

(d) Resident trustees of a trust are not deemed to hold income interests held by non-resident beneficiaries or settlors of the trust in a CFC, or by non-resident trustees of another trust where the trust and that other trust have a settlor in common, in calculating the income interest of the trustees in the CFC. Such income interests held by non-residents will be deemed to be held by the resident trustees in determining whether the resident trustees hold an income interest in the CFC of 10 percent or greater. However, if there is no resident settlor of the trust, the trust is not a superannuation fund or no settlor of the trust has died resident in New Zealand the trustee income of the trust will not include income derived from outside New Zealand: s.228(3). Consequently, in these circumstances the resident trustees would not be liable for tax on attributed foreign income because that income is derived from outside New Zealand.

Attributed foreign income included in trustee income

20.9 By virtue of s.228(3), where trustees of a trust hold an income interest of 10 percent or greater in a CFC, attributed foreign income and losses derived or incurred during an income year in relation to that income interest are taken into account in calculating trustee income for that year if:

(a) any settlor of the trust is resident in New Zealand at any time during that year;

(b) the trust is a superannuation fund at any time during that year;

(c) any trustee of the trust was resident in New Zealand at any time during that year and the trust is a testamentary trust or an inter vivos trust where any settlor of the trust died resident in New Zealand.

20.10 Attributed foreign income or losses are taken into account in calculating trustee income in these circumstances whether or not the trustee is resident in New Zealand. For example, if a resident settles shares in a foreign company on a trust with non-resident trustees, and those shares constitute an income interest of 10 percent or greater in a CFC, attributed foreign income and losses in relation to the interest are taken into account in calculating trustee income for any income year in which any settlor of the trust is at any time resident in New Zealand. However, if the shares in the foreign company are settled by a non-resident on resident trustees, attributed foreign income or losses are not taken into account in calculating trustee income for any income year in which a settlor of the trust is not at any time resident in New Zealand because the requirements in s.228(3) for taxing foreign source trustee income are not satisfied.

20.11 A trustee who is resident outside New Zealand at all times during an income year is not liable to tax on trustee income derived from outside New Zealand in an income year in the circumstances set out in s.228(6). Section 228(6) is discussed in paragraphs 10.74 to 10.84 of the appendix to Taxpayer Information Bulletin No.5.

20.12 Section 228(3) provides that in the circumstances specified in that provision a non-resident trustee is liable to tax on trustee income derived from outside New Zealand as if the trustee were an individual resident in New Zealand. The effect of making a non-resident trustee liable as if the trustee were resident in New Zealand is discussed in paragraph 10.43 of the appendix to Taxpayer Information Bulletin No.5. Where the non-resident trustees are required to take attributed foreign income or

losses into account in calculating trustee income the effect of treating the non-resident trustees as if they were resident is that:

(a) s.245F(1), which provides that any person who is resident outside New Zealand at all times during an income year is not required to calculate attributed foreign income or loss in respect of an income interest in a CFC, does not apply; and

(b) the trustees are permitted to elect to maintain a branch equivalent tax account (BETA) in accordance with s.394ZZS (s.394ZZS applies rather than s.394ZZN because s.228(1) provides that trustees are liable for tax on trustee income as if they are individuals). The non-resident trustee is permitted to maintain a BETA because the trustee is liable to tax in respect of trustee income derived from outside New Zealand on the same basis as if the trustee were resident in New Zealand. Therefore, all provisions which affect the liability to tax of a person resident in New Zealand apply in calculating the liability of the non-resident trustee. A BETA is relevant in calculating the liability of a person resident in New Zealand to tax on dividends derived from a foreign company. Consequently, the non-resident trustee is permitted to maintain a BETA.

20.13 One of the cases in which income derived from outside New Zealand during an income year is included in trustee income is where a settlor of a trust is resident in New Zealand at any time during the income year. The term "settlor" is defined in s.226. That definition is discussed in Part 6 of the appendix to Taxpayer Information Bulletin No.5. One situation in which a person is treated as a settlor of a trust is where a settlement is made on the trust by a CFC and at the time of settlement the person held a control interest of 10 percent or more in the CFC: s.226(4). Therefore, if a CFC settles a trust the trustee income of the trust is calculated by taking into account any income derived from outside New Zealand (including attributed foreign income) in any income year in which any person who held a control interest of 10 percent or more in the CFC at the time of settlement is resident in New Zealand. In these circumstances, the trustee income is not included in branch equivalent income or loss of the CFC but is assessed directly to the trustee or to any resident settlor as agent of the trustee (this point is discussed in paragraphs 6.116 to 6.118 of the appendix to Taxpayer Information Bulletin No.5).

Liability of settlor for tax on trustee income

20.14 Section 228(4) provides that where a settlement has been made on the terms of a trust after 17 December 1987, any settlor of the trust who is resident in New Zealand at any time during an income year is liable to tax on trustee income derived in that income year as agent of the trustee. Exceptions to this rule are set out in s.228(5). Sections 228(4) and (5) are discussed in paragraphs 10.46 to 10.73 of the appendix to Taxpayer Information Bulletin No.5.

20.15 Where a non-resident trustee is required to take attributed foreign income or loss into account in calculating trustee income a resident settlor of the trust may be liable to tax on that income as agent of the trustee by virtue of s.228(4). Section 228(4) may also apply where a CFC settles a trust. In these circumstances any person who held a control interest of 10 percent or more in the CFC at the time of settlement is treated as a settlor of the trust: s.226(4). Thus, any person who by virtue of s.226(4) is a settlor of a trust settled by a CFC may be liable to tax on trustee income derived by the trustees of that trust as agent for the trustees. In this case, although the CFC is also a settlor of the trust, the trustee income is not included in the branch equivalent income or loss of the CFC. Instead the trustee is liable to tax on the trustee income and any resident settlor is liable to tax on the trustee income as agent of the trustee in terms of s.228(4).

Distributions from CFCs

20.16 Where a distribution is made by a CFC to a resident shareholder the distribution may be included in the assessable income of the shareholder as a dividend if the shareholder is a natural person, or the distribution may be subject to the dividend withholding payment regime contained in Part XIIB of the Income Tax Act if the shareholder is a company. If the amount distributed has already been subject to tax in the shareholder's hands under the CFC regime, double taxation of the income would occur. To prevent double taxation from occuring in these circumstances Part XIIC of the Income Tax Act allows persons resident in New Zealand to a maintain branch equivalent tax account (BETA).

20.17 The operation of BETAs and the relationship of the BETA provisions with the dividend withholding payment and imputation regimes is discussed in the appendix to Taxpayer Information Bulletin No.1. Broadly, a BETA allows double taxation to be avoided through a tax credit mechanism. Tax paid on attributed foreign income (such tax being calculated in accordance with the formulae in ss.394ZZP(1) or 394ZZU(1)) is credited to the BETA. The amount thus credited may then be offset against tax payable on a dividend derived from the CFC or against a dividend withholding payment liability arising in relation to the dividend under Part XIIB. The tax credit mechanism is not precise. Tax paid on attributed foreign income is not matched against tax payable on that income when it is distributed. However, in a broad sense the tax credit mechanism operates to reduce the incidence of double taxation.

Distribution of dividend derived by CFC

20.18 The effect of the proviso to s.245J(9) and the BETA legislation in Part XIIC is that, generally, income derived by a CFC is subject to New Zealand tax only once as it is distributed through a chain of CFCs and distributed ultimately to a New Zealand resident. The proviso to s.245J(9) provides that dividends derived by a CFC are not included in the branch equivalent income or loss of a CFC in relation to a person where the dividend is derived from shares in another CFC, and the person holds an income interest of 10 percent or greater in that other CFC. This ensures that income assessed to a person under Part IVA in relation to an interest in a CFC is not assessed to the person again under Part IVA when the income is distributed to another CFC in which the person holds an income interest. The BETA legislation in Part XIIC then ensures that the income is not taxed a second time when it is later distributed to the person from that other CFC.

20.19 By way of example, assume that a resident, A, holds an income interest of 10 percent or greater in two CFCs, CFC1 and CFC2, and that CFC1 holds shares in CFC2. In these circumstances, assuming that the conditions in the proviso to s.245J(9) and in Part XIIC are satisfied, the treatment of income derived by CFC2 and later distributed to CFC1 and from CFC1 to A will be as follows:

(a) A will have attributed foreign income in relation to the income interest in CFC2. Tax payable on that attributed foreign income will be credited to the BETA maintained by A.

(b) When the income derived by CFC2 is distributed to CFC1 as a dividend the proviso to s.245J(9) will apply so that the income is not included in the branch equivalent income or loss of CFC1 in relation to A.

(c) When the dividend derived by CFC1 from CFC2 is distributed by CFC1 to A as a dividend it will be included in A's assessable income if A is a natural person or it will be subject to the dividend withholding payment regime contained in Part XIIB. The income tax or dividend withholding payment liability of A in relation to the dividend may be offset to the extent of any credit in the BETA: s.394ZZV; s.394ZZQ.

20.20 Dividends derived by a CFC are included in the branch equivalent income or loss of the CFC in relation to a person where the proviso to s.245J(9) does not apply. In these circumstances , the dividend will be taken into account in calculating the attributed foreign income or loss of residents holding an income interest of 10 percent or greater in the CFC, and the tax paid on that income will give rise to a credit in the BETA. This credit may be used to offset an income tax or dividend withholding payment liability which arises when the dividend derived by the CFC is distributed as a dividend to any resident holding an income interest of 10 percent or greater in the CFC.

CFC regime and company residence rules

20.21 The CFC regime applies with respect to interests in foreign companies which are CFCs. The term "foreign company" is defined in s.245A(1). That definition is discussed in paragraphs 3.44 to 3.59 of this bulletin. Broadly, a company is a foreign company if it is not resident in New Zealand in terms of s.241 or, if the company is resident in New Zealand, it is treated as not being resident for the purposes of a double taxation agreement and it is not liable for tax on all or part of its income pursuant to such agreement. The question of whether a company is resident in New Zealand is therefore central to the determination of whether the CFC regime applies to interests in a company.

20.22 The residence rules for companies set out in s.241(6) are discussed in Public Information Bulletin No. 180. The relationship between the CFC regime and the rules of company residence is discussed at paragraphs 4.73 to 4.76 of that PIB.