



August 2008

Banking & Finance Update

Changes to the associated persons, continuity and dividend tax rules

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill (**Bill**) currently before Parliament proposes changes to the “associated persons”, company shareholder continuity and dividends rules in the Income Tax Act 2007. It will be some time before these changes become law, and the proposals in the Bill may change before enactment, however it is important to understand the potential impact these changes may have on your business as they will be implemented early next year. In particular, the shareholder continuity concessionary rule which is targeted at Australian banks with significant New Zealand operations.

Changes to the associated persons rules affecting lenders and borrowers

The Bill proposes changes to the “associated persons” rules. Those rules are relevant to businesses using the approved issuer levy (**AIL**) regime because it cannot be used for payments of interest between associated persons. People who are “approved issuers” under the AIL regime are able to pay interest to non-resident lenders without deducting the 15% non-resident withholding tax (**NRWT**) (or 10% NRWT if a tax treaty applies). Instead the approved issuer pays a 2% levy.

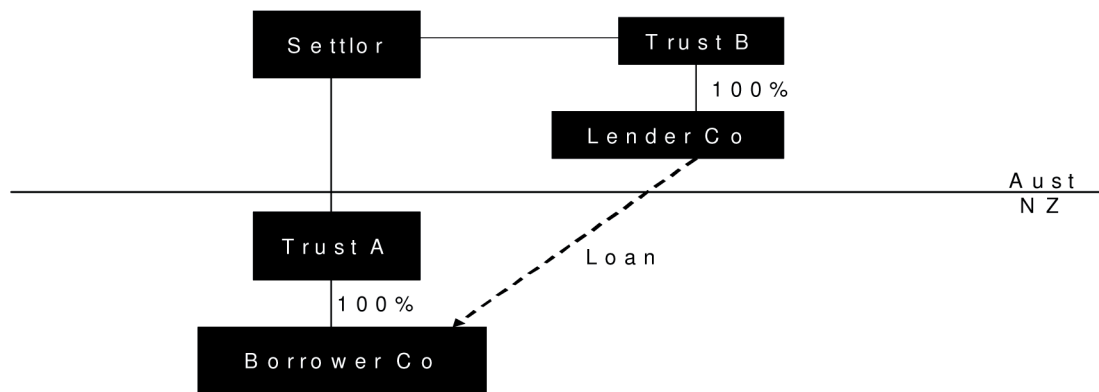
The proposed changes widen the definition of associated persons and therefore tighten the eligibility to use the AIL regime. Under current law:

- two companies will be associated for the purposes of the AIL regime if there is a shareholder or group of shareholders that own 50% or more of each company (in general terms, measured on the basis of voting interests, economic interests or control of the company); and
- a company and a person (non-company) will be associated if the person owns 25% or more of the company.

There are also tests associating relatives with each other, and partnerships with partners, and people associated with partners.

These existing tests will be retained but the tests associating two companies, and a company and a person (non-company), will be subject to an aggregation rule. The aggregation rule combines the ownership interests of associated people for the purpose of measuring association. For example, in the diagram below as Trust A is associated with Trust B (under a

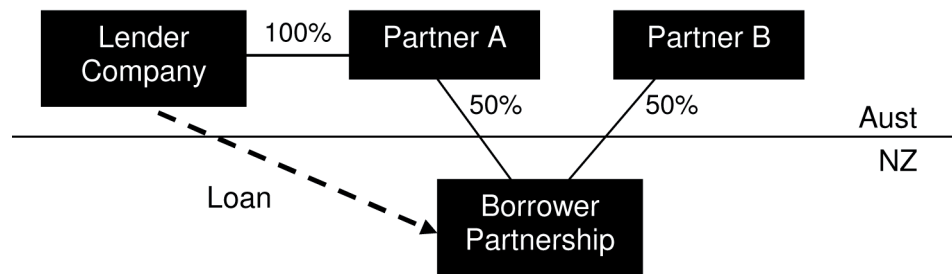
new proposal that associates trusts settled by the same settlor), then Trust A will be treated as holding the ownership interests of Trust B in Lender Co, and Trust B will be holding the interests of Trust A in Borrower Co, therefore making it not possible to use the AIL regime.



Additional association tests will also apply under the proposed new rules. The new tests will associate:

- A person and a trustee for a relative of that person
- A trustee and a beneficiary
- Trustees of trusts with a common settlor
- A trustee and settlor
- A settlor and beneficiary
- A trustee and a person with power of appointment and removal of a trustee
- Two persons who are each independently associated with the same third person

This last test is known as the “tripartite” test and is another significant change to the associated persons rules. For example, in the diagram below Lender Company and the Borrower Partnership will be associated because the Borrower Partnership is associated with Partner A, who is also associated with the Lender Company, therefore making it not possible to use the AIL regime.



The changes to the “associated persons” rules as they relate to the AIL regime will apply, if passed, from the 2009-2010 income year.

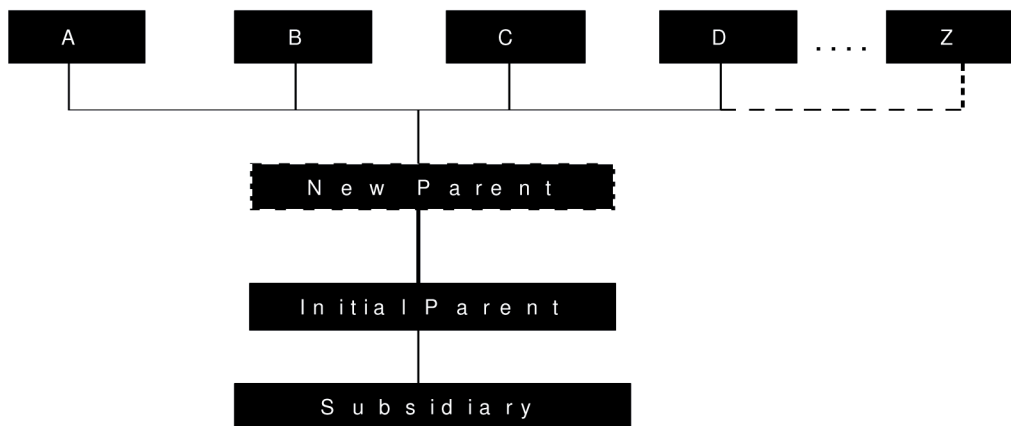
Proposed concessionary rule affecting tax losses and imputation credits

Under current rules, a company cannot carry forward its accumulated tax losses and/or imputation credits when there has been a significant change in the ultimate ownership of the company. These rules are known as the “continuity rules” and provide that a company loses its accumulated imputation credits when there has been a change of more than 34% of the company’s shareholding since the credits arose, and loses its accumulated tax losses when there is a change of more than 51% of its shareholding since the losses arose. In general terms, shareholding is measured on the basis of voting interests or economic interests in the company.

Continuity of shareholding is measured by tracing ownership interests through a group of companies to their ultimate shareholders. To save widely held or listed companies the rigmarole of tracing their ownership back to every small investor, there is a concessionary rule that allows shareholders with a less than 10% ownership interest in a company to be ignored, and their interest is deemed to be held by the company itself.

The Bill proposes an addition to the continuity rules in circumstances where that concessionary rule is used by listed and widely held companies. This proposed change ensures continuity is maintained by a company when a group of companies is restructured but the fundamental ownership of the group is unchanged.

The restructuring that is captured by this change is when a new parent company is inserted into a group of companies above an initial parent company where there is a subsidiary that has accumulated losses/imputation credits. As long as certain criteria are met, the continuity rules will not be breached, even though there may technically be a breach caused by the change in ownership which results from the concessionary ownership rule deeming the new parent company to hold the interests of all of the less than 10% shareholders previously deemed to be held by the initial parent. The key criteria is that the ultimate shareholder interests and proportions must be the same in the new parent as they were in the initial parent - i.e. the ultimate economic ownership of the subsidiary company with the losses/imputation credits has not changed.



Commentary to the Bill states that the reason for this change is that some Australian banks with significant New Zealand operations are considering restructuring to separate their banking operations from other business operations. The proposed restructuring is a response to Australian regulatory standards and results in the Australian bank replacing its initial parent company with a new company as the listed banking group parent company. Although this is given by Officials as the reason for the change to the continuity rules, this of course does not preclude it being applied to other groups of companies that restructure in this way.

This proposed concessionary change will apply retrospectively from 1 April 2008.

Proposal to widen the definition of "Dividends"

The concept of a dividend for tax purposes is based on a "transfer of value" from a company that is caused by a shareholding in the company. The dividend rules state that it will be an indication that a transfer is caused by a shareholding if the terms of the transfer are more favourable than they would have been if no shareholding had been involved. Under the current legislation a transfer of value caused by a shareholding is only a dividend if it is made to a shareholder or an associate of the shareholder and the company makes the transfer because of that shareholding.

The proposed changes to the dividend rules provide that a transfer of value by a company to *any* person is potentially a dividend if it is made because of any shareholding in the company. The person receiving the dividend does not have to be a shareholder or associated with a shareholder as the current rules require. The focus of the proposed definition will be on the reason for the company making the transfer of value, not on the relationship between the company and the recipient. This change widens the already very broad concept of what is a dividend for tax purposes.

The proposed change will apply from the 2009-2010 income year.

contacts

Auckland

Joanne Dunne - Partner - Tax

T +64 9 353 9990

M 021 610 874

E joanne.dunne@minterellison.co.nz

Tom Fail - Partner - Banking & Finance

T +64 9 353 9913

M 021 966 835

E tom.fail@minterellison.co.nz

Kate Lane - Partner - Banking & Finance

T +64 9 353 9992

M 021 610 860

E kate.lane@minterellison.co.nz

Michael Langdon - Partner - Banking & Finance

T +64 9 353 9981

M 021 435 055

E michael.langdon@minterellison.co.nz

Andrew Ryan - Partner - Tax

T +64 9 353 9950

M 021 606 190

E andrew.ryan@minterellison.co.nz

Kate Jenkison - Senior Associate - Banking & Finance

T +64 9 353 9914

M 021 791 301

E kate.jenkison@minterellison.co.nz

Amanda Somers - Senior Associate - Tax

T +64 9 353 9994

M 021 440 842

E amanda.somers@minterellison.co.nz

Wellington

Chris O'Brien - Partner - Banking & Finance

T +64 4 498 5133

M 021 888 739

E chris.obrien@minterellison.co.nz

David Patterson - Partner - Tax

T +64 4 498 5128

M 021 610 203

E david.patterson@minterellison.co.nz

John Peterson - Partner - Tax

T +64 4 498 5028

M 021 895 559

E john.peterson@minterellison.co.nz

Vivian Cheng - Senior Associate - Tax

T +64 4 498 5079

M 021 610 863

E vivian.cheng@minterellison.co.nz

Karen Haynes - Senior Associate - Banking & Finance

T +64 4 498 5106

M 021 221 7513

E karen.haynes@minterellison.co.nz

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