NZVCA
NEW ZEALAND PRIVATE EQUITY &
VENTURE CAPITAL ASSOCIATION INC

NZVCA REGULATORY AND TAX RECOMMENDATIONS

MAY 2009

The New Zealand Private Equity and Venture Capital Association (NZVCA) has gone through an extensive consultation process to consider improvement in the New Zealand regulatory environment for venture capital and private equity investment.

This report highlights suggested changes which would make New Zealand a better place to do business and lighten regulatory load while maintaining sensible policy settings.

The NZVCA would be happy to discuss this report further. For more information contact Colin McKinnon (Executive Director, NZVCA) on +64 9 302 5218 or colin.mckinnon@nzvca.co.nz or Nick Wells (Partner, Chapman Tripp) on +64 9 357 9004 or nick.wells@chapmantripp.com.

The NZVCA would like to thank the following organisations for their contributions:

CHAPMAN TRIPP

iglobe

MinterEllisonRuddWatts LAWYERS

Glaister Ennor Barristers, Solicitors & Notary Public

Simpson Grierson

RUSSELL McVEAGH

DLA PHILLIPS FOX

LOWNDES JORDAN BARRISTERS & SOLICITORS

MAUI CAPITAL

ERNST & YOUNG Quality In Everything We Do

Contents

NZVCA’s Recommendations

The tables below summarise the NZVCA’s recommendations.

CRITICAL HIGH PRIORITY NECESSARY

CAPITAL GAINS ISSUES

KEY PROPOSALS	REDUCES COSTS	POLICY IMPACT	REDUCES RED TAPE
Specifically exempt gains made by private equity and venture capital funds from the sale of shares in New Zealand resident companies from tax.	✓	consistent with approach to similar investments, encourages investment in NZ companies	✓

MUTUAL RECOGNITION OF IMPUTATION AND FRANKING CREDITS

KEY PROPOSALS	REDUCES COSTS	POLICY IMPACT	REDUCES RED TAPE
As a first best, implement full mutual recognition of imputation and franking credits with Australia.	✓	consistent with efforts occurring to date	✓
If that is not possible consider crediting New Zealand companies for Australian franking credits received.	✓	is a policy change	

INTERNATIONAL TAX ISSUES

KEY PROPOSALS	REDUCES COSTS	POLICY IMPACT	REDUCES RED TAPE
Eliminate New Zealand tax on offshore income distributed to non-resident investors.	✓	is a policy change	✓
Extend thin capitalisation safe harbour thresholds.	✓	is a policy change	✓
Update and widen the double tax agreement network.	✓	consistent with efforts to date	✓
Remove tax on distributions of capital gains to non-resident corporate entities in a liquidation.	✓	consistent with approach to capital gains	✓
Increase certainty of tax treatment by overhauling the binding rulings process and by introducing non-binding rulings.	✓	neutral	✓

OVERSEAS INVESTMENT REGIME

KEY PROPOSALS	REDUCES COSTS	POLICY IMPACT	REDUCES RED TAPE
Raise the threshold for 'overseas person' status.	✓	neutral	✓
Allow more exemptions on a case by case basis.	✓	neutral	✓ (once exempt)
Refine the definition of 'sensitive land'.	✓	neutral	✓
Refine the offer-back procedure.	✓	neutral	✓
Clarify the definition of 'strategically important infrastructure on sensitive land'.	✓	neutral	✓

SECURITIES ISSUES FOR PRIVATE EQUITY AND VENTURE CAPITAL

KEY PROPOSALS	REDUCE COSTS	POLICY IMPACT	REDUCES RED TAPE
In the context of offers declared void by section 37 of the Securities Act as a result of the inadvertent inclusion of one or more members of the public, consideration being given to: • the offer only being void in relation to those investors who are members of the public, and/or • the Securities Commission being afforded the discretion to grant relief orders. At present, a court order is required.	✓	neutral	✓
Amend section 3(2)(iia) to allow an exempt person to "commit" to a subscription price of at least $500,000 for securities before the allotment of those securities. (This is designed to reflect that investors' interests in private equity and venture capital funds are typically drawn down at staged intervals once the fund has identified viable investment opportunities in circumstances where: • the investor has committed themselves to provide a prescribed capital amount, and • the securities are allotted following receipt of the commitment only.	✓	neutral	✓
Revisit: • the requirement to provide five year historical financial information. Two or three years of financial information is, in our view, adequate. If longer term information is required, disclosure could be by way of commentary only, and • the requirement for stand-alone reporting (in respect of recently acquired businesses (by the issuer)) or at least the 20% total tangible assets disclosure threshold.	✓	neutral	✓
Consider abolishing the disclosure obligation to provide material contracts.	✓	neutral	✓
Greater clarification on the definition of "close business associate" (under section 3(2)) to include senior management employees.	✓	neutral	✓

Adoption of a rule exempting offers that are below a certain value (in particular a rule similar to the Australian 20:12 Rule). This rule allows for offers to 20 people in a 12 month period in respect of offers for AUS$2 million or less in aggregate.	✓	pragmatic	✓
Abolish issuer liability for vendor shareholders where an IPO exit occurs.	✓	pragmatic	✓
Class exemption for funds from the requirement to provide a prospective statement of cash flows under clause 10(1)(c) of Schedule 1 of the Securities Regulations.	✓	neutral	✓
Reconsideration of the proposed extension of liability under sections 38B and 58 to those persons who fall within a section 3(2) exemption (as provided for under the new Securities Disclosure and Financial Advisers Amendment Bill).	✓	neutral	✓

LIMITED PARTNERSHIPS

KEY PROPOSALS	REDUCES COSTS	POLICY IMPACT	REDUCES RED TAPE
Exempt interests in limited partnerships from the statutory supervisor requirements of the Securities Act 1978.	✓	neutral	✓
Repeal or amend the anti-streaming rule in section HG 2(2) of the Income Tax Act 2007.	✓	corrects an unintended effect	✓
Clarify "intention" of limited partnership for tax purposes.	✓	neutral	✓
Clarify that non-resident partners would not be taxed in New Zealand on their proportionate share of foreign sourced income derived by a limited partnership.	✓	corrects an unintended effect	✓
Clarify filing requirements where there is a non-resident general partner.	✓	corrects an unintended effect	✓
Confirm a special partnership registering as a limited partnership succeeds to the rights and liabilities of the special partnership.		neutral	

Capital Gains Issues

OVERVIEW AND RECOMMENDATION

The income tax treatment of gains made from sale of investments by private equity funds is uncertain, except for the offshore funds that can use a tax treaty exemption. While Government and tax policy makers seem to have no enthusiasm for capital gains taxes, including on gains from sale of equities, this uncertainty is undesirable. It exposes fund managers to tax risk, can lead to the adoption of complex structures, and in a worst case could lead to protracted and messy litigation, with the potential to cause significant disruption to this important market.

In the current tax environment, where:

- there is, and is likely to remain, a relatively small gap between the rate of tax on corporate income and the rate of tax faced by investors (thus ensuring that it is not possible to avoid tax simply by accumulating income in a company), and

- gains that are identical or closely analogous to gains made by New Zealand private equity funds on sales of shares are clearly exempt from tax (e.g. gains made by PIEs on share sales; gains made by foreign funds with favourable treaties),

we recommend that an explicit exemption be given also to gains made by private equity funds from the sale of shares in New Zealand resident companies. The PIE and qualifying foreign equity investor definitions in the tax legislation demonstrate that it is possible to appropriately ring-fence such exemptions, and could be used as a base for developing an exemption in this case also.

This change would bring the taxation of gains by New Zealand-based private equity funds into line with the tax treatment of:

- New Zealand-based portfolio equity investment, i.e. PIEs

- Australian and US-based private equity funds, which are effectively exempt from New Zealand tax on capital gains, and face much lower rates of tax in their home jurisdictions than the New Zealand corporate rate of 30%, and

- other "DIY" type investment options such as direct investment into equities or into residential rental accommodation.

The effect would be to remove a disincentive to New Zealanders investing in the New Zealand productive economy at a time when we should be encouraging people to invest into New Zealand companies.

TAXATION OF GAINS ON SALE IN NEW ZEALAND - GENERAL

New Zealand's tax policy makers are not currently in favour of any general capital gains tax. Their view is that such taxes are complex, are inevitably subject to significant exceptions, and raise little revenue. Failure to consider a capital gains tax with appropriate exceptions leads to a degree of uncertainty and market distortion. This is particularly clear in relation to tax on sale of shares where the tax system provides a high degree of alignment between the rate of tax on corporate income and the rate of tax on personal income. Taxes on gains from the sale of assets therefore are only justifiable where the gains are in fact from sale of assets held for sale in the ordinary course of business.

The difficulty with private equity gains, as in other areas, is distinguishing between the cases where assets are held on capital account and where they are held on revenue account. As a practical matter, this dividing line is so difficult that over time, in most areas where it matters, it has been resolved either:

- by legislation making all gains of a particular type taxable (e.g. the financial arrangement rules) or tax-free (e.g. the PIE rules), and

- by practice, whereby again all gains are treated as either taxable (e.g. unit trusts before the PIE rules, gains made by banking and insurance companies) or exempt (e.g. gains from the sale of shares by individuals, which are very rarely audited).

There are some areas (notably land transactions) where the tax status of the gain is not resolved by any such explicit or implicit mechanisms, and these are inevitably areas where both taxpayers and tax authorities spend considerable time and money on planning, audit, legislative tinkering and dispute activity.

While participants in the private equity market would generally characterize their position as subject to an understanding that gains and losses are on capital account, and regard this position as having been morally strengthened by the international and PIE reforms, there is currently no certainty that this treatment will continue to be adopted by the Inland Revenue.

GAINS ANALOGOUS TO PRIVATE EQUITY GAINS

An approximate picture of when New Zealand imposes tax on gains from sale of property is provided in the attached table. The table shows that with the exception of:

- financial institutions and traders, and

- financial arrangements (debt and derivatives),

gains on sale in many categories are not subject to tax.

Categories of gains of particular relevance to this submission are gains from the sale of shares:

- by PIEs in New Zealand and Australian listed companies. These gains have been excluded from taxable income, at least in part on the basis that the income from these companies is fully taxed on a more or less current basis, either as earned (New Zealand companies) or when distributed (Australian companies)

- by any New Zealand resident in companies that are portfolio FIF interests subject to the FDR regime. These gains are exempt from tax, on the basis that a 5% deemed rate of return is imposed

- by residents of Australia, the US and the UK in any New Zealand company (provided the gain is not connected with a New Zealand branch). These gains are exempt from tax under the relevant tax treaties, even for many categories of investor not subject to tax in their own jurisdiction

- (not shown on the table) by qualifying foreign equity investors (QFEIs) in unlisted New Zealand companies held for 12 months or more (Income Tax Act 2007 section CW 12), subject to certain restrictions. A QFEI is generally a non-resident investor that is tax exempt or, if a collective vehicle, has no investor holding 10% or more of the entity who is either taxable or resident in a country with which New Zealand has no tax treaty, and

- (not shown on the table) by non-residents in companies which were acquired under a co-investment agreement with VIF and which are physically 50% or more located in New Zealand.

Given the existence of these exemptions, and the current practical position, giving an exemption for private equity funds generally from taxation on gain from sale of shares in New Zealand companies is not:

- a major departure in principle from the current law, or

- likely to result in any significant fiscal cost.

The PIE and QFEI definitions demonstrate that workable definitions in this area are achievable. For example, in this case the exemption could apply to funds which:

- are companies, unit trusts or partnerships

- have no investors which hold more than 20% of the fund, other than New Zealand Government (e.g. NZSF or ACC), foreign or tax exempt investors, and

- hold shares in New Zealand companies engaged in active business (similar to the definitions in section CW 12(2) and (3)).

NZ TAX ON GAIN ON SALE OF ASSETS – PRACTICAL OUTCOMES								
ASSET TYPE*	**INDIVIDUAL**	**SME**	**NZ PRIVATE EQUITY FUND**	**PIE**	**NON RESIDENT CORPORATE**	**AUSTRALIAN PRIVATE EQUITY FUND**	**TRADER**	**FINANCIAL INSTITUTION**
NZ SHARES – PORTFOLIO			N/A			N/A		
NZ SHARES – DIRECT			?			Protected by DTA, if not land rich	Taxed unless shareholding a structural asset	Taxed unless shareholding a structural asset
FOREIGN SHARES – PORTFOLIO (FIF)**					Outside NZ tax net	Outside NZ tax net		
FOREIGN SHARES - DIRECT NON CFC**				Not taxed if investee a foreign PIE	"	"		
FOREIGN SHARES DIRECT (GREY LIST CFC)			?		"	"		
FOREIGN SHARES DIRECT (NON GREY LIST CFC)			?		"	"		
FINANCIAL INSTRUMENT								
INVESTEE'S BUSINESS ASSETS AND GOODWILL			?	Taxed if receipt an ordinary incident of business				
REAL ESTATE	***	***	***	***	***	***		

* Assumes assets not held for the dominant purpose of resale (in which case gain would be taxable except for PIEs).
** Assumes shares are FIF interests e.g. not Australian listed etc. Foreign shares which are not FIF interests are treated the same as NZ shares, other than for a PIE.
*** The sale will be taxable if it falls within the criteria in sections CB 6 – CB 23B. Land sold 10 years after acquisition which has not been developed or subdivided and not subject to a zoning change should not be taxed unless the vendor is a developer, builder or trader.

Mutual Recognition of Imputation and Franking Credits

NZVCA supports the New Zealand Government's position in exploring the full mutual recognition of imputation and franking credits with Australia and considers a full mutual recognition policy would enhance the move towards a Single Economic Market with Australia. In particular, mutual recognition should reduce the impact tax has on New Zealand and Australian investors when making decisions on where to invest (which is currently biased to home country investment to maximise useable tax credits and avoiding potential double taxation) and how to invest (eg. Australian companies using debt leverage to reduce tax paid in New Zealand).

NZVCA considers a full mutual recognition policy will provide benefits to New Zealand, and its investors, including:

- a further move towards a Single Economic Market with a closer harmonisation of the New Zealand and Australian tax systems. Such an approach should reduce tax distortions impacting commercial decisions of corporates such as, domicile, risk and rewards of functions and assets, debt funding locations and the streaming of profits to a preferred jurisdiction. It should boost product and service market competition; lower compliance costs for business (particularly the SME market); and it also continues the development of a Single Economic Market

- widens the number of potential trans-Tasman investment opportunities and free flow of capital and income by removing (potential) double taxation and bias towards home country investment; lowers compliance costs and associated costs for tax planning on a trans-Tasman basis (where alternative complex structures may be used to reduce the impact of double taxation); and lowering the cost of equity for trans-Tasman investment

- a potential tax revenue advantage for New Zealand whereby incentives to lower New Zealand tax paid are reduced thereby increasing New Zealand tax paid. For example, Australian companies are currently encouraged to debt fund New Zealand operations to the extent possible given thin capitalisation constraints and focus on maximising tax deductions in New Zealand as a means of reducing New Zealand tax paid, and

- successful New Zealand businesses, and individuals, could remain with their tax base in New Zealand rather than relocating to Australia once their balance of earnings requires a change of jurisdiction due to the financial impact of double taxation.

NZVCA acknowledges that there are differences between the current New Zealand imputation and Australian franking credit regimes that will need to be reconciled under a full mutual recognition regime (eg. different rules around shareholder continuity for the carry forward of credits, streaming of credits amongst shareholders, and refundability of credits currently). However, we strongly encourage these differences and others be addressed in the context of the broader objective of moving towards a Single Economic Market.

Should the Australian Government not support a full mutual recognition policy, (or not be as pro-active as their New Zealand counterparts) NZVCA considers the New Zealand Government should urgently consider a policy whereby a full tax credit is available in New Zealand for Australian franking credits. This policy may give rise to an initial cost to the New Zealand Government however, NZVCA consider longer term benefits to New Zealand will outweigh any initial cost. In particular:

- for New Zealand businesses to grow additional capital is required to pursue these opportunities. For the ultimate New Zealand investors providing this capital, and for the businesses themselves, the benefits noted above in respect of a full mutual recognition policy are equally applicable

- it will encourage New Zealand business to grow and expand into the Australian market when similar growth opportunities are not available in the New Zealand market (eg. due to size of market). Without continued growth opportunities, New Zealand businesses may be sold to (offshore) investors before realising their full potential and value. Retaining these outbound businesses in New Zealand will provide ongoing economic benefits to New Zealand

- although the incentives for Australian investors to reduce New Zealand tax paid will remain (eg. by debt funding New Zealand operations to reduce non-creditable New Zealand tax paid together with transfer pricing), NZVCA believes a move by the New Zealand Government will encourage the Australian Government in ultimately moving to mutual recognition. A first move by New Zealand should encourage Australian corporates with New Zealand operations to look to the Australian Government for similar recognition thereby quickly resulting in ultimate mutual recognition, and

- as with mutual recognition, successful New Zealand businesses, and individuals, could remain with their tax base in New Zealand rather than relocating to Australia once their balance of earnings required a change of jurisdiction due to the financial impact of double taxation.

As with a full mutual recognition policy, NZVCA acknowledges such a policy will require further evaluation and NZVCA would welcome the opportunity to assist officials in this regard.

International Tax Issues

OVERVIEW AND RECOMMENDATION

New Zealand is a capital importing nation and increasing the levels of appropriately targeted foreign investment is essential for raising New Zealand's skill base, improving job markets, lifting productivity and providing opportunities for New Zealand entrepreneurs[3]. Further, it is important that barriers to international growth/expansion from New Zealand (i.e. the use of New Zealand as a platform for international growth) are minimised. In light of this, it is crucial that the New Zealand tax system does not act as a barrier to the flow of capital into, or out of, the New Zealand financial system.

Foreign direct investment and foreign portfolio investment are essential to increasing GDP per capita[4], and private equity and venture capital funds are significant sources of foreign capital. The New Zealand Government has in effect recognised the need to encourage foreign capital investment through enacting the current venture capital provisions contained in sections CW 12 and CW 13 of the Income Tax Act 2007. While the scope of these provisions recognises that taxing non-residents on New Zealand sourced capital gains is a barrier to capital investment, the restrictive nature of these provisions means that they have limited practical value in attracting investment.

Tax can act as a barrier to the flow of capital in two key ways: firstly, tax can be an additional cost which reduces the potential return to investors and, secondly, uncertainty in the application of tax law will increase risk. Both of these barriers act as disincentives to investment and the flow of capital.

We submit that certain aspects of New Zealand's international tax regime contain the above barriers. The following five key proposals have been identified to meet the principles and policy objectives set out above and thereby enhance New Zealand's competitiveness in attracting international investment. In our view, these proposals would increase the effectiveness of the international tax rules and reduce perceived disincentives for both inbound and outbound investment.

Reform Recommendations in brief

ELIMINATE NEW ZEALAND TAX ON OFFSHORE INCOME DISTRIBUTED TO NON-RESIDENT INVESTORS

New Zealand's international tax regime is designed to impose a 15% New Zealand tax cost on income derived by a New Zealand company from outside New Zealand, which is subsequently distributed to non-resident shareholders. This tax cost compares unfavourably with other comparable countries (especially Australia) where no tax is imposed on offshore income distributed to non-resident shareholders. The additional tax cost imposed in New Zealand means that, all other things equal, there is a disincentive to establish a regional holding company in, or to hold any offshore investments from, New Zealand.

The impact is that the New Zealand tax system increases the tax cost for non-resident investors, thereby acting as a barrier to attracting mobile capital to New Zealand's equity markets and private companies. Non-resident investors could potentially suffer tax on the same business operations at three levels, i.e. at the level of the non-resident investment, in New Zealand and potentially in their

3 Paraphrase of Tax Review 2001, Final Report, October 2001, Chapter 8, paragraphs 8.6 and 8.23.
4 Paraphrase of Tax Review 2001, Final Report, October 2001, Chapter 8, paragraph 8.22.

home jurisdiction, on what is in essence transitional income for New Zealand purposes. New Zealand companies with offshore operations are therefore at a disadvantage when competing for offshore capital.

To address this issue, we believe that there should be a nil New Zealand tax cost on income derived by a New Zealand company from outside New Zealand, which is subsequently distributed to non-resident shareholders. This could be achieved by lowering the rate of non-resident withholding tax applicable to dividends to zero percent, either in domestic legislation or in New Zealand's tax treaty network.

EXTENSION OF THIN CAPITALISATION SAFE HARBOUR THRESHOLDS

New Zealand's international tax regime contains thin capitalisation rules intended to limit the amount of tax relief available for interest paid when the New Zealand group:

- is controlled by a single non-resident, and/or
- has investments in controlled foreign companies.

The NZVCA accepts that the thin capitalisation regime is a necessary part of New Zealand's international tax regime to control both inbound and outbound investment (particularly in light of the proposed changes to the controlled foreign company regime). However, we believe that the safe harbour thresholds currently contained in the rules are arbitrary and should be amended to allow taxpayers to claim tax relief based on the actual borrowing position of the respective group.

Specifically, the safe harbour thresholds in the current thin capitalisation rules are based on assets recorded in the taxpayer's balance sheet for financial reporting purposes. Financial reporting rules do not generally allow taxpayers to recognise the market value of certain assets, e.g. internally generated goodwill. This means that, while a taxpayer may be able to comfortably support a certain level of debt based on cash flows, and may be able to obtain third party funding on this basis, tax relief for interest costs might be restricted. This is inequitable and significantly more restrictive than the safe harbour thresholds applied in other countries.

In particular, the Australian thin capitalisation rules contain both a safe harbour and an arm's length test for thin capitalisation purposes (i.e. in certain circumstances there is no restriction on tax relief provided the level of debt is justifiable on an arm's length basis), and the UK's thin capitalisation rules are currently contained in the transfer pricing rules (which require arm's length pricing and, in agreement with HMRC, include both interest cover and debt:equity ratios determining on an arm's length basis). This means that New Zealand resident groups that are subject to the thin capitalisation regime are at a comparative disadvantage, in that the cost of funding will be increased if tax relief is not allowed, compared to taxpayers in other territories.

Accordingly, we believe that the safe harbour rules contained in the thin capitalisation rules should be expanded so that taxpayers are entitled to full tax relief for interest provided they satisfy the existing safe harbour rules and if not, the debt can be justified on an arm's length basis. Such a test could be supported by guidance issued by the IRD, including comments in relation to key ratios (e.g. cash-flow or interest cover ratios) that would be used to assess the arm's length nature of a taxpayer's debt levels.

UPDATE AND WIDEN THE DTA NETWORK

New Zealand currently has double tax agreements (DTAs) with only 35 countries, which is considerably less than other countries such as Australia (47 countries) and the UK (110 countries). Further, New Zealand's existing DTAs tend to be with New Zealand's traditional trading partners, and not with key emerging trading partners (such as Hong Kong, Vietnam, or in South America (with the exception of Chile)).

A number of New Zealand treaties are out of date (e.g. the New Zealand/Japan treaty came into force in 1 April 1963) and are not consistent with the current OECD model treaty and the global trends in DTAs. In particular, New Zealand's DTAs generally have high withholding tax rates by international comparison (particularly with regard to dividends, where it is now common place to have a nil rate of withholding tax provided certain criteria are met), which create an additional cost and this is a disincentive for non-residents to invest in New Zealand.

We believe that negotiation of new DTAs, and renegotiation of existing DTAs, must be a key area of focus for the Government going forward. It is crucial that New Zealand's DTAs network is wide ranging and up-to-date so that New Zealand businesses are not disadvantaged by an uncompetitive DTA or by no DTA at all.

REMOVAL OF CAPITAL GAINS TAX ON DISTRIBUTIONS TO NON-RESIDENT CORPORATE ENTITIES ON A LIQUIDATION

New Zealand does not generally tax capital gains, except in limited circumstances (such as certain land transactions and financial arrangements). However, this general approach does not extend to certain non-resident shareholders. Specifically, New Zealand non-resident withholding tax is required to be deducted at a rate of 15% on distributions made to related non-resident corporate shareholders pursuant to a liquidation, if the distribution is paid out of capital gains. The impact is that there is effectively a 15% New Zealand tax cost on capital gains distributed to certain non-resident shareholders.

The policy rationale for this rule is that it prevents the erosion of the New Zealand tax base, and that there should be no additional cost to the non-resident as most will be able to claim a credit for the New Zealand tax paid in their home territory. This may not always be the position as the non-resident may not be tax paying in its local jurisdiction.

We believe that this rule is contrary to the stated policy of no capital gains tax in New Zealand and acts as a disincentive for non-residents to invest in New Zealand businesses where there is a possibility or prospect of capital gains being derived. Accordingly, we submit that this rule should be removed and/or withholding tax on dividends reduced to nil.

CERTAINTY OF TAX TREATMENT

As noted above, uncertainty in relation to the application of tax law increases risk and therefore acts as a barrier to investment. Accordingly, it is crucial that, to the extent possible, investors have certainty as to the tax status of their investments.

The binding rulings process was established to provide this certainty. The NZVCA supports the binding ruling process as rulings are becoming an increasingly important component of most modern tax systems and they play a key role in fostering confidence and trust. However the process for obtaining a binding ruling in New Zealand has become extremely cumbersome, time intensive and costly. Binding ruling applications commonly take over 12 months to be processed, and the IRD has refused to rule on key specific issues (such as tax avoidance). Further, there are recent examples of the IRD appearing to argue that certain rulings are not binding for what appear to be relatively minor technical reasons. These factors undermine the binding ruling process and the value of rulings in general, and this is evidenced by the apparent drop off in binding ruling applications.

We believe that an overhaul of the binding ruling process must be undertaken as a matter of urgency. The objective of this review must be to streamline the binding ruling process so that applications are processed quickly and that taxpayers can have confidence in the rulings they receive.

Further, we believe that the IRD should be prepared to issue non-binding rulings on specific transactions and arrangements. Taxpayers accept and understand that non-binding rulings are, by definition, not binding on the IRD. However, taxpayers believe that in certain circumstances there is value in obtaining IRD's considered, although not binding, opinion on a particular issue. We submit that taxpayers should be able to apply to the IRD to receive non-binding rulings.

In addition, there have been recent examples of officials' side stepping the generic tax policy process (GTPP) to introduce certain tax changes. An example of this is the previous Government's announcement that rules would be introduced in relation to the tax treatment of stapled stock. Announcements of this nature outside the GTPP undermine the certainty that investors have in the New Zealand tax system and increase the perceived investment risk that attaches to New Zealand. In addition, a clear statement from the IRD as to the use of grandfathering positions would provide taxpayers with certainty as to their historic tax position and adhere to the GTTP. We believe that all proposed tax policy changes should be subject to the GTPP, although consideration could be given to a fast track process within the GTPP to deal with matters of urgency.

Overseas Investment Regime

In the current business environment it is crucial that capital is able to flow quickly and freely. The Overseas Investment Act 2005 (the Overseas Investment Act) is intended to provide protection to sensitive land and assets with cultural, historical or strategic significance, while also ensuring a liberal foreign investment regime and reduced compliance costs.[3]

The Overseas Investment Office (OIO) has the role of monitoring "the flow of overseas investment needed to support New Zealand's sustainable economic growth"[4] but serious flaws in the Overseas Investment Act frustrate this objective and result in its application to unintended transactions. This 'red tape' creates significant additional costs and delays, an unnecessary increase in frustration and a corresponding loss of international competitiveness.

These factors combine to create unnecessary barriers to investment and reduce New Zealand's attractiveness as an investment destination for the already scarce foreign capital which is required to assist in New Zealand's ongoing development.

The following 5 key proposals have been developed to streamline and improve the Overseas Investment Act providing a low-cost way to enhance our international competitiveness and reducing the existing barriers to investment. In our view, they do not impact the intentions of the Overseas Investment Act, but they greatly increase its effectiveness and reduce existing 'red tape' and compliance costs.

KEY PROPOSALS	REDUCES COSTS	POLICY IMPACT	REDUCES RED TAPE
Raise the threshold for 'overseas person' status	√	neutral	√
Allow more exemptions on a case by case basis	√	neutral	√ (once exempt)
Refine the definition of 'sensitive land'	√	neutral	√
Refine the offer-back procedure	√	neutral	√
Clarify the definition of 'strategically important infrastructure on sensitive land'	√	neutral	√

Reformrecommendations in brief

RAISE THE THRESHOLD FOR 'OVERSEAS PERSON' STATUS TO A MORE MEANINGFUL LEVEL THAN THE CURRENT 25 PER CENT FOREIGN OWNERSHIP OR CONTROL

The threshold for determining an 'overseas person' under the Overseas Investment Act is set at 25 per cent foreign ownership or control, which is often too low, can have unintended consequences and unnecessarily increases the number of entities which are subject to the Overseas Investment Act. This threshold should be increased to a more significant level of ownership or control.

3 Terms of Reference, announced by Dr Michael Cullen, 10 November 2003.
4 The Ministerial Directive to the Overseas Investment Office, 15 November 2007.

ALLOW MORE EXEMPTIONS ON A CASE BY CASE BASIS

Use of exemptions under the Overseas Investment Act should be more routinely considered.

Exemptions under Regulation 34 of the Overseas Investment Regulations 2005 (the Regulations), where an entity is considered to be sufficiently "in New Zealand hands", should be utilised more to enable specific overseas persons (or classes of them) who meet the particular criteria to be exempt from the Overseas Investment Act.

It would also be helpful to provide the OIO with the discretion to exempt parties from the Overseas Investment Act without needing to resort to formal amendment of the Regulations. A more consultative regime could be introduced where a short form application (based on the current consent application) could be made broadly setting out why an entity should be exempt from the application of the Overseas Investment Act. Based on these applications and any necessary consultation, broad exemptions could be granted for the ongoing activities of the exempt entity (this exemption could be made subject to conditions where necessary).

A class exemption would be beneficial for limited partnerships which include a number of overseas investors as limited partners (passive investors) where that limited partnership is under the management and control of general partners who are New Zealanders for the purposes of the Overseas Investment Act.

REFINE THE DEFINITION OF 'SENSITIVE LAND' TO CAPTURE ONLY LAND WHICH IS OF SIGNIFICANT NATIONAL INTEREST

To date, the OIO has not published a list of "reserves and public parks … for which the adjoining land is sensitive" required by s 37 of the Overseas Investment Act, and instead the OIO has relied on a broad definition of the land that will fall under this section. The application of this broad definition of 'sensitive land' has often been interpreted to include land of low or trivial national interest and has unexpectedly captured commercial or industrial sites which could not have been intended to be protected by the Overseas Investment Act.

Publishing this list and restricting its application to specific parks and reserves, or those meeting defined criteria, would narrow the scope of the Overseas Investment Act to cover only land which is truly sensitive and worthy of protection. At the very least, pending the completion of the list, the minimum area for adjacent parks and reserves which was in place before the Overseas Investment Act's introduction should be reinstated.

REFINE THE OFFER-BACK PROCEDURE

The current offer-back procedure for 'special land' has several flaws which should be addressed.

The burden of making the offer-back falls on the existing owner of the land, rather than the proposed overseas investor which makes sale to an overseas person of any land including 'special land' an unattractive prospect for the vendor.

Additionally, the OIO is prevented from processing the overseas purchaser's application for the remainder of the land until the fate of the 'special land' has been decided and no time limits are imposed on the Crown's decision to accept or reject the 'special land' offer.

The definition of 'special land' should be amended to exclude its application to properties with a river boundary (as opposed to property with a river running through it) because all that can be offered to the Crown is a common law riparian ownership. The extra procedural compliance imposed on these properties causes undue delay to otherwise straightforward applications.

CLARIFY WHAT CONSTITUTES 'STRATEGICALLY IMPORTANT INFRASTRUCTURE ON SENSITIVE LAND'

Regulation 28(h) was recently introduced requiring the OIO to consider "whether the overseas investment will, or is likely to, assist New Zealand to maintain New Zealand control of strategically important infrastructure on sensitive land".

There is lack of clarity over which assets this Regulation was intended to protect. Providing a clear definition regarding what constitutes "strategically important infrastructure on sensitive land" would boost confidence in New Zealand's overseas investment regime.

Securities Issues for Private Equity and Venture Capital

INTRODUCTION

It is important that Private Equity and Venture Capital funds, and the companies in which they invest, are able to work in the capital market framework effectively and efficiently without undue regulatory burdens or costs. Existing regulatory structures affect:

- fund establishment and the ability to raise capital
- investee companies and their ability to raise capital
- the participation and incentivising of key/senior employees in investee companies, and
- investor exit via the public market (IPO).

We have proposed below certain changes to existing securities laws which, in our view, would materially enhance the capital markets experience of private equity and venture capital participants and their investee companies (and therefore the effectiveness of the capital markets) without derogating from the underlying intentions of the Securities Act 1978.

Before addressing the suggested changes, we would also like to take the opportunity to recognise the continued hard work and co-operative attitude of the New Zealand Companies Office (in contrast to the experience of other comparable overseas agencies). The willingness of the Companies Office to work with issuers (funds/investee companies) and their advisers to assist in addressing issues and meeting tight deadlines is a valuable aspect of capital markets efficiency.

Reform recommendations in brief

In the context of offers declared void by section 37 of the Securities Act as a result of the inadvertent inclusion of one or more members of the public, consideration being given to:

- **the offer only being void in relation to those investors who are members of the public, and/or**
- **the Securities Commission being afforded the discretion to grant relief orders.**

Currently exempt offers made that inadvertently include one or more members of the public result in that whole offer being automatically void, including the offers otherwise lawfully made to "exempt" persons under the Securities Act (i.e. under section 3(2)).

In many cases, there is no need to void the entire offer and doing so unfairly prejudices the issuer and potentially other investors. However, we appreciate that this conclusion may not apply where the investment voided is fundamental to the other investors (for instance where the capital subscribed for underpinned the acquisition of an investment asset).

The concern with the existing regime arises in the context of ambiguity around the meaning of "close business associate" (addressed below) and "habitual investor" – both referred to in sections 3(2) of the Securities Act. The way that the current law works, if the conclusion is mistakenly reached that say one of 50 participants in a particular investment is a habitual investor (when, in fact that investor is not a habitual investor), the entire allotment is void, and the issuer must apply to court for a mandatory or discretionary relief order (sections 37AC to 37AL).

The cost of any court application is significant, and we believe that alternative processes should be included in the Securities Act to permit:

- the allotment to be void as regards only the investor to whom the mistake was made, or
- the Securities Commission being afforded the discretion generally to grant relief orders (this might, for instance, only apply where the requirements for a mandatory relief offer have been satisfied).

Should this proposition be generally agreeable to the Task Force, some further work would be required to define the circumstances when the above two propositions would apply. Symmetry with the relief orders regime applicable to section 37A of the Act is also relevant here.

SECTION 3(2)(IIA) TO BE AMENDED TO ALLOW AN EXEMPT PERSON TO "COMMIT" TO A SUBSCRIPTION PRICE OF AT LEAST $500,000 FOR SECURITIES BEFORE THE ALLOTMENT OF THOSE SECURITIES

Section 3(2)(iia) currently provides for an exemption where a person is required to pay a minimum subscription price of at least $500,000 for the securities before the allotment of those securities.

Almost invariably a participant investing in a private equity or venture capital fund is required to commit their investment amount from the outset, although calls for payment on the investment may be made subsequently and in stages once the fund has identified the viable investment opportunities. It is also possible that the full investment amount committed by an investor is never actually called upon by the Fund.

In such scenarios, the investor cannot be said to have paid their $500,000 (or more) before the allotment of the securities (and in some possible cases, even at all) and so does not fall within the exemption provided for by section 3(2)(iia). This obviously reduces the availability of the exemption and excludes persons who would ordinarily satisfy the financial requirements of the exemption but do not technically comply due to the timing of investment payments.

At a policy level, there does not seem any basis for drawing this distinction. It is our proposal that the exemption is amended to allow for a person to be required to commit to pay the subscription price of at least $500,000. Alternatively, an exemption could be given to this effect through a class exemption. One way of effecting the suggested change could be to amend section 2D(2), which deals with payments for securities at different times, to provide for the principle expressed above.

REVISIT THE DISCLOSURE OBLIGATION TO PROVIDE FIVE YEAR HISTORICAL FINANCIALS

The schedules to the Securities Regulations require historical financial information (in summary form) to be presented for the five consecutive accounting periods preceding the most recent statement of position set out in a prospectus. Also required is five year historical financial information for any business or subsidiary which was acquired in the two years preceding the date of the prospectus, where the acquisition value was more than 20% of the total tangible assets (TTA) shown in the statement of position.

These requirements, particularly the second, puts issuers to considerable expense, without commensurate benefit accruing to investors. This is particularly acute in the Private Equity/Venture Capital area (we are discussing exits here principally), where bolt-on acquisitions are a core aspect of the investment strategy applicable to the funds.

Often where intending issuers have acquired businesses/subsidiaries, the financial reports of the acquired vehicle are non-existent or prepared on a different basis to the acquiring group. Another concern can arise from pre-float restructuring which can be purely internal restructuring to better position a group for a future public ownership model. That restructuring can trigger the requirement for five year standalone reporting. Similarly the 20% TTA threshold can be very low in the context of businesses with principally intangible/brand assets.

While we have always found the Commission to be very accommodating, with sensible exemptions given, nonetheless time taken and cost of obtaining the exemption, together with the preparation of the inevitable "compromise" financial reports, can be high.

Based on the above comments our proposals are as follows:

- that only two, or failing which three, years financial information be disclosed

- the requirement for stand-alone reporting, or at least the 20% TTA threshold, needs to be revisited, and

- if specific disclosure requirements are required in connection with financial information beyond say two or three years, that provision is made for a disclosure by issuers of historical commentary on material changes only. This information could be limited to word commentary on the development of the group without the need to provide detailed accounting information.

These views should be considered against the background of the overriding requirement on issuers to disclose all material matters (and the need to prepare PFI for IPOs, which inherently takes into account historical performance). We believe the issue of disclosure of financial performance of operating units of an issuer, to the extent relevant to investment decisions, is effectively captured or could be captured in a way that does not require specific accounting information to be presented for the duration.

ABOLISH THE DISCLOSURE OBLIGATION TO PROVIDE MATERIAL CONTRACTS

Schedules to the Securities Regulations require the disclosure of material contracts. Such disclosure can have an important impact in relation to the release of sensitive information and the risk this poses to a company's competitive edge. The time period set down by the rule provides for contracts in the last two years to be disclosed.

Given the overriding requirement on issuers to disclose all material matters, we believe the disclosure of material items arising from existing material contracts, to the extent relevant to investment decisions, is effectively captured or could be captured in a way that does not require specific details of all material contracts to be provided. It is also very unlikely that retail investors review the material contracts that are disclosed.

Should the view be retained that disclosure of material contracts is required:

- better processes need to be made available for the redaction of sensitive business information. The current requirement for an exemption is too difficult and time consuming. Securities Commission approval only would be a preferable option, and

- the prescription of a two year period should be revisited. It is an arbitrary line but one which has some international precedent. Material contracts may be in existence but fall outside of the time period. We are aware of international precedent that better defines what has to be disclosed.

It is therefore our proposal that the requirement to disclose material contracts be abolished.

CHANGES TO MAKE IT EASIER TO ISSUE SHARES TO MIDDLE/SENIOR MANAGEMENT AND KEY EMPLOYEES – EMPLOYEE INCENTIVISATION SCHEMES

It is important for investee companies that senior or other key employees are able to participate in the company at an equity level. This can dramatically assist to incentivise senior management, especially where the investee company is a start up or in a growth/acquisition phase and facing rapid growth.

Scenarios exist where key employees believe in the company and its potential, and are wanting to forego remuneration in return for equity options. The other common scenario is where the company wants to provide extra incentives to existing key employees by way of share schemes to ensure that those employees remain with the company.

Currently there are problems with the ease with which senior/middle-to-senior management employees can be issued with securities. These problems often arise as a result of the type of employee and/or length of service, which means that the employees do not necessarily easily fall within the existing exemptions.

In particular, and most relevant to this issue, certain employees who may well be equipped to determine the merits of an offer cannot always automatically be considered to be a "close business associate" due to the relatively short time that employee may have been with the company. Often they do not fall within the "eligible person" categorisation. Despite this, these employees regularly have sufficient understanding and information to decided on the merits of the offer. In addition, there may be no real downside to the employee in accepting the offer as they may have very limited downside in the offering (i.e. very little actual payments required).

Our proposals are two fold:

- greater clarification is needed to the definition of "close business associate" under section 3(2) to confirm that a "close business associate" could include senior management employees. We appreciate that there is potential for abuse should any amendment contain only reference to "senior management employees" and would be happy to engage with the Task Force or Commission with a view to identifying some controls, and

- there is real value in considering the adoption of a rule which exempts offers that are below a certain value, for instance, a rule similar to the Australian 20:12 Rule. This rule allows offers to 20 people in a 12 month period in respect of offers for AUS$2 million or less in aggregate.

We recognise that the introduction of a 20:12 rule may be considered controversial, and that the Securities Commission has previously indicated that it opposes such a rule. However, the introduction of the rule would effectively deal with the problems faced with the issue of securities to employees, and would also encourage smaller entrepreneurial elements of the market.

Should the introduction of a "full" 20:12 rule be rejected, alternative proposals could include providing powers to the Securities Commission to apply provisions similar to a 20:12 rule to approved investee companies (where the Commission approves those investee companies who have the requisite level of fund investment).

ABOLISH ISSUER LIABILITY FOR VENDOR SHAREHOLDERS WHERE AN IPO EXIT OCCURS

Currently any selling shareholder, even those who are merely "piggybacking" an IPO, will face issuer liability exposure. It is our observation that it is general market practice to avoid such exposure by putting structures in place so that no issuer liability arises (i.e. the structures result in the vendor shareholders not selling directly into the IPO, and so not meeting the "issuer" definition). The structuring process is often done at extra cost and expense and achieves no commensurate benefit or add value to any of the parties concerned.

Our proposal is to abolish vendor issuer liability altogether and recognise instead that issuer liability rests with the issuing company. Adequate additional protection would remain by the continued existence of promoter liability, particularly as those vendor shareholders who are actively involved with the IPO process are likely to be caught as promoters.

CLASS EXEMPTION FOR FUNDS FROM THE REQUIREMENT TO PROVIDE PROSPECTIVE STATEMENT OF CASH FLOWS UNDER CLAUSE 10(1)(C) OF SCHEDULE 1 OF THE SECURITIES REGULATIONS

On the establishment of a fund an exemption is often sought and obtained from the obligation to provide prospective statement of cash flows under clause 10(1)(c) of Schedule 1 of the Securities Regulations.

Historically, the Securities Commission has granted exemptions for the following reasons (and we quote from the statement of reasons to the relevant exemption notices):

- "the issuers are investment companies, and their business is more akin to that of a managed fund investing in market instruments than a traditional company. The issuers have not yet determined the precise make-up of their investment portfolio. For this reason, the provision of prospective financial information by the issuers would be highly speculative and may be of little relevance to potential investors

- the condition that the prospectus contains a statement of the issuers' reasons for not providing the prospective statement of cash flows, and an acknowledgement that the investment is high risk, requires that potential investors are informed that certain information is not included and why, and that their attention is drawn to the nature of the investment, and

- the directors of the issuers must still give a general description of their plans under clause 10(1)(a) of Schedule 1 of the Regulations."

Where such an exemption is provided the conditions attaching to the exemption tend to be very similar from one fund to the next. Notwithstanding the relative ease with which the exemption can be obtained, there is still the time and cost associated with obtaining the exemption. By providing for a class exemption these compliance costs will be reduced.

We recognise that any such exemption would need to be drafted appropriately so that it was not open to abuse by non-fund issuers. This could be achieved through the definition of the "issuer" entitled to use the exemption. We are happy to engage with the Task Force or Commission with a view to identifying the appropriate exemption language.

QUALIFIED SUPPORT FOR NEW SECURITIES DISCLOSURE AND FINANCIAL ADVISERS AMENDMENT BILL ALLOWING FOR OFFERS TO ELIGIBLE PERSONS TO BE MADE CONTEMPORANEOUSLY WITH OTHER EXCEPTED OFFERS

Whilst the new provisions in the Bill are welcomed, the rules on the prohibition of advertisements and criminal liability for misstatements in sections 38B and 58 will apply to bundled offers made to both eligible persons and persons who fall within one of the section 3(2) exemptions. Currently, where offers are made just to those persons who fall within a section 3(2) exemption no liability under sections 38(B) and 58 arises.

As a result of the extension of liability, we are of the view that funds may continue to be cautious and may restrict offers to habitual investors, rather than risk exposure to liability under sections 38(B) and 58 for the offer as a whole. This would defeat the intended purpose of bundling the exemptions.

Given the nature of the persons to whom offers are made, and the fact that currently no such liability arises in respect of offers to persons exempt under section 3(2), there appears to be no clear policy reasons why liability in these areas has been extended to bundled offers. We therefore propose that the extension of liability provided for under the Bill is reconsidered and removed in respect of offers made to those persons who fall within a section 3(2) exemption.

Limited Partnerships

The Limited Partnership Act 2008 is an example of industry and Parliament working successfully to implement an internationally competitive regime and improve access to capital for New Zealand businesses. However, to ensure that the regime achieves its objectives and encourages foreign investors to engage with New Zealand business, the New Zealand Venture Capital Association believes that several aspects of the regime need to be considered and amended.

Without these changes the objectives of the limited partnership regime will be seriously frustrated as uncertainty, unintended tax consequences, and increased costs reduce the international competitiveness and utility of the regime for international venture capital investors.

The following recommended changes to the Limited Partnership Act 2008, the Income Tax Act 2007, the Companies Act 1993, and the Securities Act 1978 are required to address issues which are currently barriers to the use of New Zealand limited partnerships and to foreign venture capital investment into New Zealand.

Reform recommendations in brief

AN INTEREST IN A LIMITED PARTNERSHIP SHOULD BE AN EQUITY SECURITY FOR THE PURPOSES OF THE SECURITIES ACT OR EXEMPT FROM THE STATUTORY SUPERVISOR REQUIREMENTS

While in many respects under the Limited Partnership Act 2008 a limited partnership is treated as a company and the general partner will have obligations of a director, an interest in a limited partnership is currently a participatory security for the purposes of the Securities Act. As a result, when a limited partnership raises money from the public a statutory supervisor must also be appointed, and a deed of participation entered into. This adds cost and complexity for little gain or protection and as a result limited partnerships have not been used in situations where there is a raising from the public, or structures where limited partnership interests are stapled to shares are considered.

Like the Capital Market Development taskforce, we think this is an unnecessary requirement that limits the flexibility around what may otherwise be an attractive fund raising vehicle for New Zealand business.

We believe that there should either be an exemption under the statutory supervisor requirements under the Securities Act in respect of limited partnerships or, alternatively that limited partnership interests should be treated as equity securities for the purposes of the Securities Act.

THE ANTI-STREAMING RULE IN SECTION HG 2(2) OF THE INCOME TAX ACT 2007 SHOULD BE REPEALED OR AMENDED

Section HG 2(2) of the Income Tax Act 2007 contains an anti-streaming rule which prevents income and expenditure (etc) from different sources or of different natures being allocated to different partners for tax purposes. Rather this must be allocated to each partner in accordance with their partnership share in the partnership income.

The anti-streaming rule undermines the key strength of partnerships which is their flexibility as an investment vehicle and clarity. The anti-streaming rule may give rise to tax allocations that do not reflect the actual business arrangements, which is governed by the Partnership Agreement. The anti-streaming rule also reduces the utility of a limited partnership as a fund raising vehicle for New Zealand business because the rule limits the ability for investors to participate in different investments, even where those investment decisions are not motivated at all by tax considerations. At best, all that the anti-streaming rule does is increase compliance costs for businesses by forcing them to set up different partnership vehicles for each underlying investment. This obviously increases the cost of fund raising. The rule is simply too widely expressed.

It may be that what was intended by the definition of "partnership share" (which is a term used in the anti-streaming rule) was that partners could have different interests in the underlying assets of the partnership and that tax law would respect that. On that analysis the anti-streaming rule affects those with a partnership share in the same underlying asset, but would not affect the allocation of those partnership shares in the first place. However, the commentary behind the Limited Partnership Bill suggests that the anti-streaming rule has a wider impact and the anti-streaming rule applies by reference to the partner's "partnership share in the partnership's income" – not the partner's partnership share in the underlying assets, and it applies to gains, income, losses and credits. As a consequence, this rule does not work, is too widely focused and to maintain the flexibility of a partnership as an investment vehicle we believe that the anti-streaming rule needs to be reconsidered.

We believe that the anti-streaming rule is unnecessary as anti-avoidance provisions in the Income Tax Act 2007 already provide protection against base maintenance concerns. Our recommendation is that the anti-streaming rule be either repealed (as it is unnecessary), or amended and replaced with a more focused provision that prevents streaming when to do so is a tax avoidance arrangement, which has a tax avoidance purpose or effect. If the anti-streaming rule was never intended to have as wide an impact as it appears to, then legislative clarification is needed as to its meaning.

CLARIFICATION IS NEEDED AS TO HOW THE INTENTION OF THE PARTNERSHIP IS DETERMINED FOR TAX PURPOSES

Section HG 2(1)(a) provides that a partner will have the intention of the partnership and the partnership will not have that intention. This test is difficult to apply in practice because it is difficult to separate the intention of the partnership from the intention of the partners. It is unclear whether unanimity of purpose is required by the partners before it will be the intention of the partnership and if not, which partners' purpose will be treated as paramount when determining the intention of the partnership.

This can cause confusion for example when seeking to determine if a partnership has an investment which it has acquired for the purpose of disposal (which will lead to particular tax consequence).

We recommend that official guidance be given as to how to determine the intention of the partnership (we suggest a binding Public Ruling).

THE INCOME TAX ACT 2007 SHOULD CLEARLY PROVIDE THAT NEW ZEALAND TAX DOES NOT ARISE ON A NON-RESIDENT PARTNER'S SHARE OF FOREIGN SOURCED INCOME DERIVED BY A PARTNERSHIP

The 2006 Discussion Document "General and Limited Partnerships – Proposed Tax Changes" stated at paragraph 7.15 that

"non-resident partners would not be taxed in New Zealand on their proportionate share of foreign sourced income derived by the partnership"

Although the intended consequence, that position is not clearly expressed in the Income Tax Act 2007.

Section YD 4(17B) of the Income Tax Act 2007 provides that income has a source in New Zealand if, treating all of the partners of a New Zealand partnership as resident in New Zealand, the income is treated as having a source in New Zealand under another provision of section YD 4. Section YD 4(2) of the Income Tax Act 2007 provides that income from a business "carried on in New Zealand" has a source in New Zealand. A New Zealand partnership could potentially be viewed as carrying on business in New Zealand even if it invests in foreign assets, particularly if its general partner is based in New Zealand (although that position is certainly arguable). If that position were taken, it could mean that income from foreign sourced investments (such as dividend income) could have a New Zealand source and could be subject to tax as it passes through the partnership to a non-resident partner. This is clearly contradictory to the intended operation of the legislation and undermines the tax transparency of a partnership as is outlined in section HG 2 of the Income Tax Act 2007. This lack of clarity creates a potential disincentive for foreign investors.

We recommend that the Income Tax Act 2007 is clarified so it is clear that as was intended foreign sourced income of a partnership passed through to non-resident partners will not be subject to New Zealand tax.

CLARIFY THE FILING POSITION OF A NEW ZEALAND LIMITED PARTNERSHIP WHEN THERE IS A NON-RESIDENT GENERAL PARTNER

The Limited Partnership Act 2008 does not require the general or limited partners to file accounts, other than for public issuers (which are addressed under the Financial Reporting Act). The Limited Partnership Act leaves this to be agreed in the Limited Partnership Agreement so confidentiality between the parties can be maintained.

However, a number of issues arise when the general partner is a non-resident entity. Section 19 of the Financial Reporting Act 1993 requires "overseas companies and certain other companies to register financial statements". An overseas company is a company incorporated outside New Zealand that carries on a business in New Zealand within the meaning of section 332 of the Companies Act 1993. Section 332(a)(ii) of the Companies Act 1993 includes in the definition of "carrying on business" an overseas company that administers, manages or deals with property in New Zealand as an agent, or personal representative or trustee. This is likely to apply to a general partner in a limited partnership where the limited partnership carries on business in New Zealand as well as New Zealand resident companies or former resident companies that have migrated elsewhere but were resident at the time the shareholding was obtained.

The filing implications of non-resident general partner meeting the definition of an overseas company under the Financial Reporting Act are as follows.

Firstly, the non-resident general partner carrying on business in New Zealand will have to file financial statements with the Registrar of Companies:

- section 19 of the Financial Reporting Act includes within its scope "any company, other than an issuer, that is an overseas company" (section 19(1)(a)). As a consequence, an overseas company must file audited company and group financial statements with the Registrar (section 19(3)(a))

- sections 8(2) and 9(2) of the Financial Reporting Act state that company and group financial statements in relation to an overseas company include, in addition to the financial statements and group financial statements of the overseas company, financial statements and group financial statements for its New Zealand business, prepared as if that business were conducted by a company formed and registered in New Zealand

- however, sections 8(3) and 9(3) grant an exemption from the requirement for financial statements and group financial statements of the New Zealand business if the Registrar notifies the overseas company that financial statements and group financial statements of the overseas company alone are sufficient to comply with sections 8(2) and 9(2), and

- therefore, a non-resident general partner will be required to file audited company financial statements with the New Zealand Registrar, together with audited financial statements for its New Zealand business unless notified otherwise by the Registrar. In addition, if the general partner is deemed to control the limited partnership, group financial statements for the overseas company (and its New Zealand business), which consolidate the limited partnership and its subsidiaries and associates, will need to be audited and filed.

Secondly, certain associates and subsidiaries of the limited partnership will be required to file financial statements with the Registrar:

- section 19 of the Financial Reporting Act also includes within its scope any company, other than an issuer, that is a subsidiary of a company incorporated outside New Zealand (section 19(1)(c)) and any company, other than an issuer, that is large and in which shares carrying 25% or more of the voting power are held by (i) a company incorporated outside New Zealand, (ii) a subsidiary of a company incorporated outside New Zealand or (iii) a person not ordinarily resident in New Zealand. This means that an associate and a subsidiary of a limited partnership that is controlled by a non-resident general partner will need to file separate financial statements

- section 19(2) of the Financial Reporting Act provides that a subsidiary of a company incorporated in New Zealand need not file audited financial statements if it is included in the group financial statements of its New Zealand parent and a copy of the parent's company and group financial statements are audited and filed. This means that an indirect subsidiary of the limited partnership controlled by a non-resident general partner need not file separate financial statements if the direct subsidiary of the limited partnership has already done so and group financial statements including all entities have been filed, and

- therefore, if a non-resident general partner is deemed to control the limited partnership, subsidiaries and associates of the limited partnership will also be required to file audited financial statements. The exception to this relates to indirect subsidiaries of the limited partnership, which are not required to file audited financial statements if the direct New Zealand subsidiary does so.

This means there are unintended high compliance costs for limited partnerships, particularly those with non-resident general partners, and those that invest in subsidiary companies. Those costs, and the impact of the filing requirements on the principles of confidentiality inherent in the Limited Partnership regime, do not seem to be justified. The position should be reviewed.

CLARIFY THAT A SPECIAL PARTNERSHIP WHICH REGISTERS AS A LIMITED PARTNERSHIP SUCCEEDS TO THE RIGHTS AND LIABILITIES OF THE FORMER SPECIAL PARTNERSHIP

The Limited Partnership Act 2008 repeals the special partnership provisions of the Partnership Act 1908 and it is clearly intended that existing special partnerships re-register as limited partnerships prior to expiry of their current term. As the new limited partnership has separate legal personality (unlike a special partnership), the new Act should contain a clear statement that the new limited partnership succeeds to the rights and liabilities of the former special partnership. Appropriate wording would be similar to that used in section 225 of the Companies Act 1993 to describe the effect of an amalgamation of two companies, in particular statements that:

- the limited partnership succeeds to all the property, rights, powers, and privileges of the special partnership
- the limited partnership succeeds to all the liabilities and obligations of the special partnership
- proceedings pending by, or against, the special partnership may be continued by, or against, the limited partnership, and
- a conviction, ruling, order, or judgment in favour of, or against, the special partnership may be enforced by, or against, the limited partnership.