NZVCA REGULATORY AND TAX RECOMMENDATIONS

OCTOBER 2013

NZVCA REGULATORY AND TAX ISSUES

In 2009, the New Zealand Private Equity and Venture Capital Association (*NZVCA*) conducted an extensive consultation process to consider improvement in the New Zealand regulatory environment for venture capital and private equity investment.

This report updates that 2009 report and highlights those suggested changes which the NZVCA still believes 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 at *colin.mckinnon@nzvca.co.nz*, or Nick Wells (Partner, Chapman Tripp) on +64 9 357 9004 or at nick.wells@chapmantripp.com.

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

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1. SUMMARY OF THE NZVCA'S RECOMMENDATIONS

	Quick wins

KiwiSaver

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
1	Refer to submissions dated 24 December 2012, regarding the Review of KiwiSaver Default Provider Arrangements.		Consistent with desire to improve NZ's capital markets the and availability of capital towards private investments	

Mutual Recognition of Imputation and Franking Credits

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
1	In the first instance, implement full mutual recognition of imputation and franking credits with Australia	√	Consistent with efforts occurring to date	√
2	If that is not possible, consider crediting New Zealand companies for Australian Franking credits	√	Is a policy change	

International Tax Issues

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
1	Eliminate New Zealand tax on offshore income distributed to non-resident investors	√	is a policy change	√
2	Update and widen the double tax agreement network	√	consistent with efforts to date	√
3	Remove capital gains tax on capital gains distributed to non-resident corporate shareholders	√	consistent with approach to capital gains	√
4	Increase certainty of tax treatment by introducing non-binding rulings	√	neutral	√

Overseas Investment Regime

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
1	Raise the threshold for 'overseas person' status	√	neutral	√
2	Allow more exemptions on a case by case basis	√	neutral	√ (once exempt)
3	Refine the definition of 'sensitive land'	√	neutral	√
4	Refine the offer-back procedure	√	neutral	√
5	Clarify the definition of 'strategically important infrastructure on sensitive land'	√	neutral	√

Limited Partnerships

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
1	Exempt interests in limited partnerships from the statutory supervisor requirements of the Securities Act 1978	√	neutral	√
2	Exempt interests in limited partnerships from the managed investment scheme requirements of the Financial Markets Conduct Act 2013	√	neutral	√
3	Repeal or amend the anti-streaming rule in section HG 2(2) of the Income Tax Act 2007	√	corrects an unintended effect	√
4	Clarify "purpose" and "intention" of limited partnership for tax purposes	√	neutral	√
5	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	√
6	Clarify filing requirements where there is a non-resident general partner	√	corrects an unintended effect	√
7	Reconsider the Limited Partnership Act amendments in the Financial Reporting Bill 2012	√	neutral	√
8	Confirm a special partnership registering as a limited partnership succeeds to the rights and liabilities of the special partnership		neutral	

Capital Gains issues

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
1	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	
2	Correct a legislative error in section CW 12(4) of the Income Tax Act 2007 by reinstating the definition of 'qualifying foreign equity investors'	√	neutral	√

Other topical issues

	Key proposals	Reduces Costs	Policy Impact	Reduces Red Tape
	The NZVCA is currently in dialogue with the Financial Markets Authority in relation to the application of the Anti-Money Laundering and Countering Financing of Terrorism Act.			

2. KIWISAVER

The KiwiSaver scheme is a good start for voluntary work place savings in New Zealand. However, due to some design elements of the KiwiSaver scheme it has yet to contribute to the pool of capital available to private businesses.

On 24 December 2012, NZVCA made submissions to the Ministry of Business, Innovation and Employment on the Review of KiwiSaver Default Provider Arrangements Discussion Document. NZVCA reiterates those submissions here.

3. 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 (e.g. 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:

1 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;

2 widening 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; lowering 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;

3 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

4 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 (e.g. 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 proactive 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 considers that the 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 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 (e.g. 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 (e.g. 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.

4. 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.[1] 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,[2] 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 potentially taxing non-residents on New Zealand sourced capital gains is a barrier to capital investment, the very narrow 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: first, 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

[1] Paraphrase of Tax Review 2001, Final Report, October 2001, Chapter 8, paragraphs 8.6 and 8.23.

[2] Paraphrase of Tax Review 2001, Final Report, October 2001, Chapter 8, paragraph 8.22.

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 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. This has already been effected in relation to portfolio investment into New Zealand funds by offshore investors through the introduction of the foreign investment zero-rate PIE rules, so it is anomalous that non-portfolio investment into New Zealand companies by offshore investors is not treated in the same way.

Update and Widen the DTA network.

New Zealand currently has double tax agreements (*DTAs*) with only 37 countries, which is considerably less than other countries such as Australia (44 countries) and the UK (124 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 Vietnam, or 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 creates an additional cost and disincentivises non-residents from investing in New Zealand. We acknowledge the Government has introduced nil (when certain conditions are met) or reduced withholding tax rates on dividends in some of its more recent treaty negotiations with countries such as the United States and Australia. We support the continued negotiation of other treaties on similar lines.

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 comprehensive 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 liquidation distributions made to related non-resident corporate shareholders, 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, whereas New Zealand resident shareholders would receive such distributions tax-free.

There is no policy rationale for this rule and it is clearly contrary to the stated policy of no capital gains tax in New Zealand. It acts as a disincentive for non-residents to invest in New Zealand businesses. 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 binding rulings process is both lengthy and costly, and so is not a practical option in many circumstances. Therefore, we believe that the IRD should be prepared to issue "fast-track" 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 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 taxpayer's with certainty as to their historic tax position and adhere to the GTPP. 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.

Thin Capitalisation Proposals

We note that there are currently parliamentary proposals (announced as part of the 2013 Budget) to amend the thin capitalisation rules. The NZVCA will submit separately on this issue.

5. 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] In this vein, the Court of Appeal has recently confirmed that "overseas persons have a right to acquire [sensitive] assets if they meet the statutory criteria".[4]

The Overseas Investment Office (*OIO*) has the role of administering New Zealand's overseas investment regime 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.

We recognise and are encouraged by the Government's efforts (through its latest Ministerial Directive in December 2010) to clarify the policies surrounding the Overseas Investment Act as a means to encourage investment through increased regulator efficiency and the avoidance of unnecessary administrative issues, but these directives do not change the statutory landscape.

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	√

[3] Terms of Reference, announced by Dr Michael Cullen, 10 November 2003.

[4] *Tiroa E and Te Hape B Trusts & Ors v Chief Executive of Land Information & Ors,* Court of Appeal, Wellington, 7 August 2012, CA 88/2012, paragraph 1 as approved by the Supreme Court in *Tiroa E and Te Hape B Trusts v Chief Executive of Land Information & Ors* [2012] NZSC 85.

REFORM RECOMMENDATIONS 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 (including for bona fide New Zealand investors) and unnecessarily increases the number of entities which are subject to the Overseas Investment Act.

The 25 per cent threshold has been flowed through into the recent amendments to the Overseas Investment Regulations 2005, implementing the 2011 Protocol on Investment to the New Zealand Australia Closer Economic Relations Trade Agreement (*CER Amendments*). In particular, while certain Australian investors are entitled to the benefit of higher significant business investment thresholds, investors are disqualified from that benefit where they are 25 per cent or more under foreign ownership or control.

This threshold should be increased to require a more significant level of overseas ownership or control. The New Zealand market is small and is not dominated by large listed companies (where a 25 per cent control/ownership threshold is more appropriate). Instead, New Zealand should be looking to Canada's approach to foreign investment – generally, majority non-Canadian ownership or control is required for foreign investment restrictions to apply.

In addition, the CER Amendments should be revised to enable New Zealand registered or incorporated entities which otherwise meet the Australian ownership and control criteria to make use of the higher investment threshold for Australian investors. As drafted the requirement that Australian investors must be registered in Australia puts New Zealand registered entities that are 25 per cent or more owned or controlled by Australians at a significant disadvantage.

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. Under the current regime, those limited partnerships are tainted as "overseas persons", despite the passive nature of the limited partner's participation, and management and control being in New Zealand hands.

An indication by the OIO of an increased willingness to consider exemptions of this nature would make investors more willing to apply for them.

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. We support the Government's guidance in the latest Ministerial Directive as to the areas of land likely to meet the criteria for inclusion on that list. We also appreciate the Government's direction that "land should only be added to the list if it is held for a purpose relating to protecting or providing public access to natural and physical resources or historic heritage."[5]

However, we query whether those directions have been effective in practice. It appears however, that the OIO continues to rely 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.

We accept that the Ministerial Directive refers to what land should and should not be caught under this classification. However, without a list enshrined in the Overseas Investment Act, investors are required to undergo the costly consent process even when proposing to purchase land that may automatically be accepted based on the OIO's application of the Ministerial Directive. We query whether this is acceptable given the Government's emphasis on increasing regulator efficiency.

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, consideration could be given to whether Part 1 of Schedule 1 of the Overseas Investment Act should be revised to increase the minimum land area threshold for sensitive land, and to implement minimum areas for adjacent parks and reserves where there are none (e.g. foreshore and lakebed).

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.

[5] The Ministerial Directive to the Overseas Investment Office, 8 December 2010.

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) requires 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.

6. LIMITED PARTNERSHIP ACT ISSUES

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. There has been significant uptake of limited partnerships in a wide range of circumstances, and to ensure that the regime fully achieves its objectives and encourages foreign investors to engage with New Zealand business, the NZVCA 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. We also note the potential impacts the Financial Markets Conduct Act 2013 (FMCA) and the Financial Reporting Bill could have on the regime.

Most recently the NZVCA has been working with the Ministry of Business, Innovation and Employment (*MBIE*) in relation to changes to the limited partnership regime under the Companies and Limited Partnerships Amendment Bill (*Amendment Bill*). In part, this engagement has been conducted in an effort to ensure the changes proposed by the Amendment Bill do not unintentionally stifle the utility of limited partnerships through additional and unnecessary red tape.

The NZVCA has had partial success with this engagement. In particular, the requirement for companies and limited partnerships to have a registered agent has been removed. Instead, this registered agent concept has been replaced by a requirement that every New Zealand company and limited partnership must have at least one director or general partner with a "connection to New Zealand". For limited partnerships with a company as a general partner (whether that company is a New Zealand company or an overseas company registered as such in New Zealand) that company must have at least one New Zealand director.

The NZVCA has worked closely with MBIE to determine what this means in relation to general partners and the NZVCA has had some success in broadening the scope of MBIE's proposed legislative drafting. The drafting is more prescriptive than we would have liked (adopting an entity by entity approach to who may be a general partner – effectively limiting those who may be a general partner) however we will wait to see how the regime beds down before making any further submissions or recommendations.

REFORM RECOMMENDATIONS IN BRIEF

An interest in a limited partnership should be an equity security for the purposes of the Securities Act 1978 (and Financial Markets Conduct Act 2013) 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 1978.

As a result, when a limited partnership raises money from the public a statutory supervisor must also be appointed and a deed of participation be entered into. This adds cost and complexity for little gain or protection and as a result limited partnerships are unlikely to be used in situations where there is a raising from the public, or in structures where limited partnership interests are stapled to shares are considered. Under the Financial Markets Conduct Act 2013 (*FMCA*) the cost and complexity of limited partnerships participating in public fundraising has not improved, as an interest in a limited partnership will be a "managed investment scheme" subject to even more stringent registration, governance and reporting requirements.

We think both the current and the proposed treatment of limited partnerships impose unnecessary requirements that limit the flexibility around what may otherwise be an attractive fund raising vehicle for New Zealand business.

New Zealand's limited partnership model was adopted following an extensive cross jurisdictional review (comparable regimes in nine international jurisdictions were considered). The result was a regime that was intended to be flexible and internationally recognisable and to facilitate the development of venture capital in New Zealand (Limited Partnerships Act s 3). The Act requires mechanics dealing with governance to be built in on an entity by entity basis.

We believe that there should either be an exemption under the statutory supervisor requirements under the Securities Act 1978 (with a similar exemption under the FMCA) in respect of limited partnerships or, alternatively that limited partnership interests should be treated as equity securities for the purposes of the Securities Act 1978 and the FMCA.

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 (*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 Rule undermines the key strength of partnerships which is their flexibility as an investment vehicle and clarity. The Rule may give rise to tax allocations that do not reflect the actual business arrangements, which is governed by the Partnership Agreement. The 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 Rule does is increase structuring and 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 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 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 Rule has a wider impact and the 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, 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 Rule needs to be reconsidered.

We believe that the Rule is unnecessary as anti-avoidance provisions in the Income Tax Act 2007 already provide protection against base maintenance concerns. Further, it can be side-stepped in practice, albeit via compliance-intensive means. Our recommendation is that the 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 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 purpose or intention of the partnership is determined for tax purposes

Section HG 2(1)(a) provides that a partner will have the purpose or intention of the partnership and the partnership will not have that purpose or intention. This test is difficult to apply in practice because it is difficult to separate the purpose/intention of the partnership from the purpose/intention of the partners. It is unclear whether unanimity of purpose/intention is required by the partners before it will be the purpose/intention of the partnership and if not, which partners' purpose/intention will be treated as paramount when determining the purpose/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/intention 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 publicly 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, under the Financial Reporting Act 1993 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[6] carrying on business in New Zealand has 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, that general partner, as 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,

[6] Note that under the Companies and Limited Partnerships Amendment Bill a New Zealand limited partnership may have an overseas company as a general partner provided that company has at least one New Zealand director.

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).

- 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 are 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 a (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.

- 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. This situation will be rectified, to an extent, by the Financial Reporting Bill (as reported by the Select Committee) which refines these reporting requirements by restricting the requirement to file financial statements to large (total assets of $60 million or total revenue of $30 million in each of the two previous accounting periods) overseas body corporates, subsidiaries and associates.

The NZVCA appreciates that this proposed regime will somewhat limit the confusion surrounding filing requirements of non-resident general partners, and addresses some of the compliance costs imposed on smaller limited partnerships by the current financial reporting regime (going forward, in general only "large" limited partnerships or those that otherwise opt in to compliance with financial reporting obligations will need to prepare and audit financial statements).

The Financial Reporting Bill provides limited partnerships the ability to opt in to financial reporting obligations or out of auditing requirements (depending on their size) by resolution within 6 months of the relevant balance date. In our view, this ability to opt in / out is consistent with the flexible nature of limited partnerships; however, the need for annual resolutions adds an unnecessary layer of administration. Instead, a single and on-going agreement to opt in / out by the relevant (statutory) majority - for example, in the limited partnership agreement - should be sufficient until such time as that majority agrees otherwise.

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:

(a) the limited partnership succeeds to all the property, rights, powers, and privileges of the special partnership;

(b) the limited partnership succeeds to all the liabilities and obligations of the special partnership;

(c) proceedings pending by, or against, the special partnership may be continued by, or against, the limited partnership; and

(d) a conviction, ruling, order, or judgment in favour of, or against, the special partnership may be enforced by, or against, the limited partnership.

7. CAPITAL GAINS ISSUES

In 2009, the New Zealand Private Equity and Venture Capital Association included recommendations on capital gains issues. The NZVCA reiterates those submissions here (refer appendix 1).

8. OTHER TOPICAL ISSUES FOR PRIVATE EQUITY AND VENTURE CAPITAL

Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (*AMLA*)
The AMLA came into force on 30 June 2013.

The NZVCA is interested in the application of AMLA to the industry, particularly with regard to the obligations it may impose on limited partnerships.

While advising those members to comply with AMLA, the NZVCA is discussing the application of that Act with the Financial Markets Authority (*FMA*).

In particular, the NZVCA queries the FMA's blanket view that all private equity funds are caught within the scope of AMLA. Instead, we believe this requires a case by case, fund by fund analysis and that, on a black letter interpretation of AMLA and an examination of individual fund structures, some may validly be excluded.

Securities issues for Private Equity and Venture Capital
We note the considerable work that is being carried out by Parliament under the review of New Zealand securities laws and particularly the introduction of the Financial Markets Conduct Act 2013 (*FMCA*). As the NZVCA has already been actively involved in reviewing and making submissions on the FMCA, we make no further comment here on it here.

ABOUT THE NZVCA

The New Zealand Private Equity and Venture Capital Association Incorporated (NZVCA) is a not-for-profit industry body committed to developing a world-best venture capital and private equity environment for the benefit of investors and entrepreneurs in New Zealand. Its core objectives include the promotion of the industry, and the asset class on both a domestic and international basis. NZVCA members cover the whole spectrum of investment in New Zealand private enterprise, including angel investment, seed and early-stage venture capital through to development capital and private equity (including management buyouts and buy-ins).

CONTACT DETAILS:

The NZVCA would be happy to discuss the issues raised in this paper. To engage further, please contact Colin McKinnon, Executive Director, on 09 302 5218 or email colin.mckinnon@nzvca.co.nz

APPENDIX 1

CAPITAL GAINS ISSUES

In 2009, the New Zealand Private Equity and Venture Capital Association included recommendations on capital gains issues. The NZVCA view has not changed and reiterates those submissions here.

Overview and recommendation

The income tax treatment of gains made from sale of investments by private equity and venture capital funds is uncertain, except for the offshore funds that enjoy a tax treaty exemption. In an environment where 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 explicitly exempt from tax (e.g. gains made by PIEs on certain 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 explicitly into line with the tax treatment of:

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

- Australian, US and other treaty country-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 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); or

- 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 characterise 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 (We note that in 2008, a legislative error meant that the definition of a QFEI disappeared from the Act. It needs to be reinstated); and

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

Given the existence of these exemptions, and the practical position that most private equity investments would be classified as on capital account under current rules, giving an explicit 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 limited 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**	****	****	****		"	"	****	****
Foreign shares direct (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 or resident in Australia under section EX 35 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 section 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.

**** Depends on calculation method used e.g. will be taxed if taxpayer elects to use the attributable FIF income method or the comparative value method.

Key: Taxed Not Taxed Depends