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**Tax Avoidance and the Financial
Structures of Non-Resident
Controlled Companies
in New Zealand**

**Andrew MC Smith
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ABSTRACT

For many years the New Zealand tax regime for non-resident investors has been unfavourable due to high effective tax rates imposed on income earned by New Zealand resident companies that are controlled by non-resident investors. This gave rise to significant incentives for non-resident investors to avoid New Zealand tax by adopting income shifting arrangements such as transfer pricing and thin capitalisation.

Despite the incentives to adopt such income shifting arrangements, until 1996 New Zealand tax law has contained few provisions to attack such arrangements. Transfer pricing rules until 1996 have been largely weak and there were no explicit provisions in force to address thin capitalisation. Given this environment it was assumed that non-resident controlled companies (NRCCs) would adopt income shifting strategies to avoid New Zealand tax.

A financial database of NRCCs operating in New Zealand was obtained for the period 1983-1992. Tests were applied to determine whether NRCCs had higher debt/equity ratios than comparable resident-controlled companies (RCCs), thereby implying that thin capitalisation had been adopted by NRCCs to avoid New Zealand tax. Results obtained showed that NRCCs did have higher debt/equity ratios than comparable RCCs but often the debt owed by NRCCs was non interest-bearing. Thus it cannot be concluded that NRCCs used thin capitalisation to avoid New Zealand tax in this period. Evidence was obtained that NRCCs may have used manipulative transfer pricing rather than thin capitalisation to shift profits.

Keywords: Taxation, tax avoidance, debt/equity ratios, non-residents, thin capitalisation, earnings stripping, transfer pricing, income shifting.

1.0 Introduction

New Zealand, in common with most other countries, taxes non-residents on a combined source/schedular basis. Non-residents are liable to New Zealand tax only if their incomes have a New Zealand source. The rate of tax applying to that income differs according to the type of income earned. This source/schedular basis of taxation provides non-resident investors with opportunities to avoid New Zealand tax by either shifting their income out of New Zealand so that it is no longer liable to New Zealand tax, or by arranging for their New Zealand-sourced income to be of a type that attracts a lower rate of tax.

In the latter case, interest or royalties derived by non-residents attracts a lower tax rate than does business income. This has provided incentives for non-resident investors convert business profits derived from New Zealand sources into interest by financing their New Zealand operations with debt rather than with direct equity financing -a technique which is known as "thin capitalisation". Despite the incentives to thinly capitalise, until 1996 New Zealand tax law contained few provisions for the Commissioner to attack such arrangements.

Given this environment it seems reasonable that non-resident controlled companies (NRCCs) would have adopted income shifting strategies to avoid New Zealand tax. The objective of this paper is to determine the extent to which non-resident investors have thinly capitalised their New Zealand subsidiaries to avoid New Zealand tax from 1983 to 1992. An examination will firstly be made of the New Zealand tax regime for non-resident investors, the existing anti-avoidance provisions that could potentially apply to thin capitalisation arrangements and the empirical literature on income shifting by multinational companies. This will provide a framework for examining the financial structures of NRCCs to see if there was any evidence of thin capitalisation during the period under review.

2.0 What Is "Thin Capitalisation"?

"Thin capitalisation" is a tax avoidance technique where multinational enterprise subsidiaries are financed primarily by debt from the parent company instead of equity capital. It can also include cases where high debt-to-equity ratios are obtained by using arms' length borrowing secured by a parental guarantee. As a result the subsidiary company has a higher debt-to-equity ratio than if the company obtained funding on a stand alone basis. In economic substance the related-party debt has the characteristics and bears the risks of equity. Thin capitalisation is sometimes referred to as "hidden capitalisation" or "hidden equity".

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3.0 Thin Capitalisation Arrangements Under New Zealand Tax Law

In common with many other countries, the New Zealand tax regime has favoured debt-financing of New Zealand businesses owned or controlled by non-resident investors. This is because New Zealand taxes interest paid to non-residents very lightly, while business profits earned in New Zealand are taxed at 33%.¹

The New Zealand taxation of interest paid to non-residents is dependent upon whether the interest is paid between "associated persons"². If interest is paid between non-associated persons, non-resident withholding tax is imposed as a final liability to New Zealand tax at a rate of 15%³. Under most double tax agreements this rate is limited to 10%.

If interest is paid between associated persons, the non-resident withholding tax becomes a minimum tax.⁴ The interest is also subject to New Zealand income tax at ordinary rates (33%) on the net interest income (as opposed to gross interest payment) derived by the non-resident.⁵ This secondary assessment of income tax is designed to prevent business profits being converted into interest to avoid New Zealand tax. Under most double tax agreements (DTAs) this additional tax cannot be assessed because of the limits specified in the interest article.⁶

In 1991 the "Approved Issuer Levy" ("AIL") regime was introduced. This provides an option to New Zealand borrowers to seek the approval of the Commissioner⁷ to pay interest to non-residents without any deduction of non-resident withholding tax.⁸ Instead the interest is liable to a stamp duty of 2%.

¹ Non-resident withholding tax is also imposed upon dividends when paid by a resident company to a non-resident shareholder. Changes to the international tax regime also enacted along with revised transfer pricing rules and new thin capitalisation rules, now allows tax relief where dividends are paid by resident companies to non-resident shareholders under the Foreign Investor Tax Credit (FITC). This allows the NZ company to pay a supplementary dividend which equates to a tax credit given by the paying company so that the total tax burden does not exceed 33%. Refer Smith (1995a) *Asia-Pacific Tax Journal*, Part II B.

² As defined in section OD7 of the Income Tax Act 1994.

³ Section NG3.

⁴ Section NG4.

⁵ A credit for non-resident withholding tax paid is given against any further New Zealand income tax. Because the secondary assessment is based upon net interest income (instead of gross interest) by arranging sufficient expenditure to be charged against the gross interest income derived by the non-resident lender, no further income tax need be payable.

⁶ Under some New Zealand DTAs the reduced rate of withholding tax for interest does not apply if the interest is paid between associated persons.

⁷ Sections NG5 and NG6.

⁸ Section NG2(1)(b).

The differences in the New Zealand tax rates for business profits earned by non-residents and interest derived by non residents provides considerable incentives for thin capitalisation arrangements. The following table provides an example of the tax savings potentially available to non-resident investors by thinly capitalising their New Zealand subsidiaries:

-- INSERT TABLE 1 HERE --

Thus the magnitude of tax savings to be derived from thin capitalisation arrangements can be substantial.

4.0 Anti-Avoidance Provisions Against Thin Capitalisation

Until 1996 the New Zealand Income Tax Act contained very few provisions to prevent tax avoidance by non-resident investors.⁹ There were no specific anti-avoidance provisions to attack thin capitalisation arrangements and thus the Commissioner had limited scope to attack such arrangements. The only provisions that he could potentially use were the specific anti-avoidance provisions in the non-resident withholding tax and Approved Issuer Levy regimes, the transfer pricing rules, and the general anti-avoidance provision in section BB9.

The Commissioner did not have any general power to reclassify debt as equity when debt has equity characteristics. This remains the case despite the introduction of new thin capitalisation rules in 1996. In two situations the Commissioner can deny a deduction for interest paid on debt securities which have certain specific equity characteristics¹⁰, but neither can be applied to attack thin capitalisation arrangements.¹¹

4.1 Anti-Avoidance Provisions in Non-Resident Withholding Tax and AIL Regimes

Although both the non-resident withholding tax and AIL regimes have been designed to prevent interest paid between associated persons qualifying from the reduced tax rates, these anti-avoidance are ineffective for several reasons. The non-resident withholding tax regime on interest can be avoided entirely by using the offshore branches of New Zealand banks as a conduit for interest flows between New Zealand borrowers and non-resident lenders. Such arrangements can also be useful to avoid the secondary assessment of New Zealand income tax on interest paid between associated persons. Similarly back-to-back

⁹ Revised transfer pricing rules and new thin capitalisation rules take effect from 1 April 1996. Refer Smith (1995a).

¹⁰ This is where the interest paid on debentures varies according to the profitability of the borrower (section FC1) and debentures issued in substitution for shares (section FC2).

¹¹ These two provisions have not been revised as part of the new transfer pricing and thin capitalisation rules.

loans also qualify for the reduced withholding tax rate. Most interest paid to associated persons in DTA countries will also qualify for the reduced tax rate.

Although the AIL regime is not available where interest is paid between associated persons, because the legislation only requires the payer and payee to not be associated persons,¹² if a non-associated person is interposed between the associated payer and payee, it appears that the interest will be eligible for the AIL regime.

4.2 Transfer Pricing Rules

The Commissioner could potentially invoke the transfer pricing rule in section GC1 to attack thin capitalisation arrangements. This section allowed the Commissioner to assess tax on a comparative basis where non-residents control a business carried on in New Zealand that appeared to produce insufficient taxable income or an excessive loss. The section was first introduced in 1939 and underwent little change until 1996 despite significant changes in the world economy, international trade and finance. The section was never considered by a New Zealand Court in this period.¹³

4.2.1 The Scheme of the Transfer Pricing Rule

The Commissioner could invoke section GC1 where a business carried on in New Zealand was either:

- (a) controlled exclusively or principally by non-residents; or
- (b) carried on by a non-resident company or a company under the control of non-residents; or
- (c) carried on by persons having control of a non-resident company.¹⁴

If the "business produces no taxable income or less than the amount of taxable income which in the opinion of the Commissioner might be expected to arise from that business", the person carrying on that business in New Zealand was liable to pay income tax on that income as the Commissioner determined. The Commissioner could choose to make such a determination according to the proportion of the total receipts (cash or credit) or total purchase money paid (whether in cash or by credit granted) by the taxpayer in the conduct of their business.

4.2.2 Deficiencies in the Transfer Pricing Rule

The section GC1 transfer pricing rule contained numerous deficiencies which were highly likely to result in it being ineffective against manipulative transfer pricing and thin capitalisation. This point is largely supported by the fact that in 1995 the Government

¹² Section NG2(1)(b)(i).

¹³ New transfer pricing rules will apply for income years beginning from 1 April 1996.

¹⁴ Subsection (3).

decided to enact new transfer pricing rules and some of the deficiencies of the old rules were conceded in the discussion paper on transfer pricing.¹⁵

For the section to have applied there must have been a "business" be carried on in New Zealand controlled in a manner specified in section GC1(3)(a), (b) or (c). There were numerous deficiencies in these three control tests which made them easy to circumvent and thus largely ineffective. A summary of these deficiencies appears in Appendix 1.

Even if a taxpayer fell within section GC1(3)(a), (b), or (c) by meeting one of the control tests, there were further conditions the Commissioner had to satisfy to assess tax under section GC1. The Commissioner must have held the opinion that the "business produces no taxable income or less than the amount of taxable income" that he might otherwise expect from that business based upon "returns made" to him. A number of limitations arose here in making an assessment under section GC1 which may have resulted in this transfer pricing rule being ineffective:

- (1) The Commissioner appeared to be restricted in forming his opinion to using only information supplied by taxpayers in their tax returns.
- (2) In making an assessment under section GC1(3), the Commissioner was restricted to doing so on the basis of a proportion of the total receipts or the total expenditure of the business concerned.
- (3) It was not necessary for the Commissioner to identify specific transactions that took place at non-arm's length prices between associated parties to make an assessment under section GC1. Similarly, the existence of transactions that did not take place at arm's length prices was not sufficient for the Commissioner to invoke section GC1.
- (4) The Commissioner was not required to identify whether trading between related parties was referable to arm's length trading terms. This contradicts the requirements under the "Associated Enterprises" articles of double tax agreements which normally only permit the adjustment of profits of associated enterprises on an arm's length basis. Adjustments of profits using comparative or unitary methods appear to be prohibited unless consistent with the arm's length principle.
- (5) An assessment under section GC1 could also be challenged on the grounds of discrimination against non-residents which may have be prohibited under non-discrimination articles in certain DTAs.
- (6) The proviso in section GC1(3) prevented the Commissioner making an assessment if it gave rise to double taxation. An assessment under section GC1(3) was restricted to instances where income was shifted offshore without being assessed to New Zealand tax.

Thus even when applied to manipulative transfer pricing arrangements section GC1 was likely to have been ineffective.

¹⁵ Refer Birch and Creech (1995). Bowker and Glazebrook (1992) and Martin (1994) also identify some of the deficiencies in the old transfer pricing rule.

4.2.3 Applicability of Section GC1 to Thin Capitalisation

Even if the taxpayer fell within one of the control tests in subsection (3)(a), (b) or (c), the assessment provisions made it difficult for the Commissioner to apply section GC1 to thin capitalisation. There was no provision which allowed the Commissioner to substitute a different debt/equity structure to reassess the amount of tax payable by a New Zealand business. The wording referring to total receipts and purchase money appeared to contemplate manipulated transfer pricing of sales to or purchases from related parties. It did not refer to capital structure or other transactions with related or associated parties.

Further, under the "associated enterprise" article of a double tax agreement the Commissioner may have been required to identify transactions that have taken place at non-arm's length terms in order to make an adjustment under the transfer pricing rule (assuming that the associated enterprise article is relevant to thin capitalisation). Additionally, the proviso to section GC1(3) may have prevented the Commissioner making an adjustment to thin capitalisation arrangements, as the interest could arguably have been assessed to New Zealand tax in the hands of another person.

Thus there were significant obstacles to the Commissioner applying section GC1 to attack thin capitalisation arrangements.

4.3 General Anti-Avoidance Provision -Section BB9

The New Zealand Income Tax Act contains a general anti-avoidance provision which the Commissioner can invoke to attack any arrangement that has as one of its purposes or effects tax avoidance. It was expressly recognised by the Privy Council in *CIR v Challenge Corporation Limited*¹⁶ that section BB9 has a back-up role to prevent tax avoidance where taxpayers had been able to avoid specific anti-avoidance provisions contained elsewhere in the Act.

4.3.1 Applying Section BB9 to Thin Capitalisation

The key issue in the application of section BB9 is whether a court will hold that a thin capitalisation arrangement has the "purpose(s) and/or effect(s)" of tax avoidance. While thin capitalisation arrangements are clearly entered into with the objective of avoiding tax, it is uncertain whether such arrangements would constitute tax avoidance in the statutory sense.

There are two approaches the courts have adopted to the application of section BB9. The first is the "Newton Predication Test" formulated by Lord Denning in *Newton v FC of T*.¹⁷ Under this test, arrangements were caught if it could be predicated that they were

¹⁶ (1986) 8 NZTC 5,219.

¹⁷ (1958) 98 CLR 1.

implemented in a particular way so as to avoid tax. But if they could be explained in terms of "ordinary business or family dealings" without being labelled as a means to avoid tax, then the section did not apply.

It is difficult to apply this test to an arrangement involving thin capitalisation because of the need to refer to "ordinary business" dealings. The key issue becomes whether the resulting debt/equity ratio is one commensurate with arm's length dealing or instead artificially high because part of the debt supplied by the associated party is disguised equity. As it is possible to observe a wide range of debt/equity ratios arising from arm's length financing arrangements, then presumably tax avoidance could be predicated only if the ratio obtained were extremely high and one which could not be observed in an arm's length situation. In this respect the matter may rest entirely with a comparison of arm's length debt/equity ratios. The point at which the high debt/equity ratio arose may also have some bearing given the distinction in some cases between new sources of income and rearrangements of existing financing structures.¹⁸

A later approach to the application of section BB9 was formulated by the Privy Council in *Challenge* based upon a dichotomy between tax mitigation and tax avoidance. While this approach was easily applied in *Challenge*, most tax avoidance schemes rely upon the creation of some expenditure between related parties in order to shift income. In these situations taxpayers will deliberately incur and bear a loss that will reduce their assessable income to avoid tax.

If the Privy Council's approach in *Challenge* was applied, tax savings enjoyed by thinly capitalising a subsidiary would arguably constitute "tax mitigation" as the subsidiary would be seeking a tax deduction for interest expenditure it had actually borne. Therefore thin capitalisation would fall outside the scope of section BB9. This conclusion illustrates how the tax mitigation/avoidance dichotomy used in *Challenge* is supportive of tax avoidance arrangements involving income transfers between associated parties.

Even if thin capitalisation can be regarded as an arrangement which falls within section BB9, problems may arise under the income reconstruction provision under section GC1(1). Further problems may arise from a reconstruction of income under a thin capitalisation arrangement with double tax agreements.¹⁹

¹⁸ Refer *Halliwell v CIR* (1977) 3 NZTC 61,208 and *Europa Oil (NZ) Ltd v CIR* (No 2) (1976) 2 NZTC 61,066 (PC).

¹⁹ If section BB9 were applied to deny a deduction for interest that was not contrary to any double tax agreement, problems could occur if that disallowed interest were subsequently recharacterised under section GC1 as a dividend and taxed accordingly.

The law concerning the application of section BB9 is still shrouded with some uncertainty, arising from the different approaches adopted by the courts in earlier decisions. However it is certain the general anti-avoidance provision plays a back-up role to other anti-avoidance provisions in the Act. Depending upon the circumstances in which a thin capitalisation arrangement was entered into, it may be possible to argue that the arrangement was one to which section BB9 applied. It is unlikely that the general anti-avoidance provision would apply to all instances of thin capitalisation.

Even if the provision did apply, problems may arise under the reconstruction provisions in section GB1(1). Problems may also arise if a taxpayer could obtain relief under a double tax agreement.

4.4 Conclusions About Anti-Avoidance Provisions

In conclusion, the existing anti-avoidance provisions in the non-resident withholding tax and AIL regimes are ineffective and the transfer pricing rules contain significant defects which are confirmed by the Government's decision to enact completely new transfer pricing rules from 1996. The general anti-avoidance provision also appears to provide little protection. Thus there appear to be very few obstacles for non-resident investors to shift profits out of New Zealand through the adoption of either manipulative transfer pricing or thin capitalisation arrangements.

5.0 Empirical Studies On Transfer Pricing & Income Shifting

There is a substantial body of literature on transfer pricing practices. This literature has, however, largely concentrated on surveying the methods and practices of multinational companies in setting transfer prices rather than on tax motivated transfer pricing manipulation. However it is relevant to note that in studies undertaken by Kim and Miller (1979), Tang (1979, 1982), Burns (1980), Yunker (1983), and Al-Eryani, Alam and Akhter (1990), cross-border taxation differentials, among other factors, were identified as having a significant influence on transfer pricing decisions.

More recently researchers have directed attention towards detection of income shifting by multinational enterprises. The studies have almost exclusively been based upon US data, which undoubtedly reflects the greater detail and disclosure in publicly available information in the US. The studies have also been undertaken at a time when there has been much greater public and political attention being paid to tax avoidance by US multinationals.

Turro (1990) reports a simple study undertaken by the US House Ways and Means Oversight Subcommittee into the tax burdens of 36 foreign owned US distributors of motor vehicles, motorcycles and electronic equipment. The results showed that some foreign-owned US companies never paid US taxes, and the ratio of income to total receipts of such companies were significantly below the ratios of similar US-owned companies.

Grubert and Mutti (1991), using 1982 data relating to US multinationals on a cross-section of countries, regressed two profitability measures of non-resident (US) associates against two measures of the applicable tax rate in their host country: the statutory corporate income tax rate, and the ratio of foreign taxes paid to book income. They found a significant, negative relationship between either measure of foreign affiliate profitability and either measure of foreign taxes, providing clear evidence of income shifting.

Hines and Rice (1990) extended Grubert and Mutti's (1991) analysis by using regression analysis on 1982 country-level data pertaining to foreign US multinational affiliates and their host countries. They found significant negative correlations between host country tax rates and all measures of profitability.

Rather than focusing on the identification of income shifting between foreign affiliates based on their reported income, aggregated by country location, Harris, Morck, Slemrod and Yeung (1993) examined the extent of income shifting between US-based parents and their foreign affiliates by utilising parent-level financial data. Utilising financial data of 200 manufacturing corporations over a five year period (1984-1988), Harris *et al* regressed a parent firm's US tax liability, as a fraction of either US sales or US assets, against a representative tax rate attributable to foreign affiliates. They found a strong negative (positive) co-relationship between annual firm-specific average US tax rates and the presence in low (high) tax jurisdictions, suggesting US multinationals shift income from the US to low-tax jurisdictions and from high-tax jurisdictions to the US.

Grubert, Goodspeed and Swenson (1993) sought to determine the extent to which the abnormally low earnings, and subsequently low tax payments, returned by foreign controlled companies²⁰ could be explained by manipulative transfer pricing practices. Using the financial data of 1300 domestically (US) controlled firms and 100 foreign controlled firms over the sample period 1980 to 1987, Grubert *et al* empirically investigated commonly advocated explanations of the differential in returns between foreign and domestically controlled companies, including differences in financing costs, various effects of mergers and acquisitions (such as asset revaluations), start-up costs, fluctuations in exchange rates, and differences in the cost of capital. They found that those explanations that could be empirically validated accounted for approximately half the differential in returns between foreign and domestically controlled companies, but the remaining difference could not be explained other than by manipulative transfer pricing practices.

²⁰ Grubert *et al* (1993) provide evidence that the ratio of taxable US income to assets was only 0.58 for foreign controlled companies compared with 2.14 for domestically controlled companies in 1987.

Klassen, Lang and Wolfson (1993) also examined income shifting behaviour by using an annual regional analysis based upon geographic disclosures of multinational companies. Their results are generally consistent with results obtained in earlier studies but were not consistent in every year, particularly after the reduction of US corporate tax rates in 1986.

Harris (1993) examined that impact of US tax law revision in 1986 on US multinational companies' capital location and income-shifting decisions. He found evidence that US MNEs shifted substantial amounts of income into the US as a result of 1986 tax changes, and that after 1986 those companies most affected by the changes invested more in foreign countries compared to the US, which was consistent with the predicted effect. This increased investment was not at the expense of US investment.

Jacob (1995) examined the level of global taxes paid by firms and geographic profitability to the volumes of intra-firm transactions. He found that firms with large volumes of international intra-firm sales paid less overall tax than other similar firms. Firms with large international intra-firm sales paid lower overall US taxes in the 1982-84 period and higher US taxes in 1988-90 period, which is consistent with the reduction of US tax rates in 1986. Thirdly, the profitability of various geographic segments of MNEs was consistent with transfer price manipulation to minimise taxes.

These studies provide considerable evidence for income shifting by MNEs to jurisdictions with lower statutory tax rates, largely achieved by manipulated transfer prices. Only one of these studies considered whether thin capitalisation had been used to shift profits. Grubert *et al* (1993) examined the extent to which thin capitalisation accounted for the differential return exhibited by foreign and domestically controlled companies. Based on a 1987 cross-section of non-financial corporations, they found no significant difference between foreign and domestic leverage ratios, holding age and industry constant. Furthermore, they found that for a given level of debt, the interest expense of foreign-controlled companies was significantly lower than their domestic counterparts. The authors consequently concluded thin capitalisation was an invalid explanation of the differential in returns between foreign and domestically controlled companies. This leaves doubt as to whether transfer pricing is preferred over thin capitalisation, or whether the methods adopted in these studies were not able to detect thin capitalisation.

6.0 Results From New Zealand NRCC Company Database

From the earlier analysis in Section 3, it is clear that non-resident investors can save substantial amounts of New Zealand tax by thinly capitalising their New Zealand subsidiaries. Existing anti-avoidance provisions in effect until 1996 were analysed in Section 4 and appeared to be weak and offer little protection to the New Zealand tax base against both thin capitalisation and manipulative transfer pricing. The empirical literature

using US data has provided evidence that multinational companies do shift profits to reduce their overall tax burdens.

These three factors all provide grounds for assuming that non-residents are likely to be avoiding New Zealand tax through both manipulative transfer pricing and thin capitalisation. Thin capitalisation arrangements are more transparent than transfer pricing manipulation because debt and interest expense is normally disclosed in financial statements. Manipulative transfer pricing is very difficult to detect from publicly available information because of the difficulty in determining whether the transfer prices adopted are reasonable and commensurate with similar uncontrolled market prices.

6.1 Data

The data samples utilised in the study were from a database of publicly available consolidated financial statement information for resident controlled companies (RCCs) and NRCCs, covering financial years ending in the calendar years 1983 to 1992 inclusive. No attempt was made to control for differing balance dates.

The NRCC database was compiled from financial statements filed with the Registrar of Companies in accordance with the Companies Act 1955²¹. Section 133 of the Companies Act 1955 requires companies to present audited financial statements meeting certain disclosure standards. However, under section 354(2A) private companies are exempted from this requirement unless they are non-exempt private companies. A non-exempt private company is defined in section 354(3B) to include any private company:

- (b) That is a subsidiary of any company or body corporate incorporated outside New Zealand; or
- (c) In which shares are held by any such subsidiary or any company or body corporate incorporated outside New Zealand or any person not ordinarily resident in New Zealand, if those shares, in the aggregate, carry the right to exercise or control the exercise of 25 percent or more of the voting power at any general meeting of the company.

Accordingly, public companies and private companies which are 25% or more controlled by non-residents are required to file financial statements with the Registrar of Companies.

Despite this requirement for non-resident controlled companies to file accounts with the Registrar of Companies, this appears not to have been actively enforced. A large proportion (50% approximately) of the NRCCs surveyed had not filed accounts by the required date.

Because there no longer exists any centralised lists of companies required to file accounts with the Registrar, the database was compiled by identifying New Zealand subsidiaries of

²¹ Although subsequently superseded by the Companies Act 1993, and Financial Reporting Act 1993, the Companies Act 1955 was solely applicable for the duration of the sample period.

foreign multinationals from trade directories. The NRCC sample ranged from 69 companies in 1992 to 155 companies in 1990. The 1990 sample represents 27.6% of the total number of NRCCs (excluding branches) operating in New Zealand in August 1994²². Although the sample is not statistically random it incorporates companies of varying nature and size, and is presumed an adequate proxy for the general NRCC population.

The New Zealand RCCs in the sample were taken from Standard and Poors Global Vantage database, and other NZ listed companies not included on this database were added by collecting data from their annual reports. The RCC sample ranges from 41 companies in 1983 to 136 in 1991.

Both the NRCCs and the RCCs were required to prepare their financial statements using New Zealand accounting standards and were audited by members of the New Zealand Society of Accountants, so it can be assumed that the financial statements of both groups are reasonably comparable.

6.2 Evidence Concerning Capital Structure

The first issue relates to capital structure: do NRCCs tend to be financed with relatively less equity and more debt than RCCs? There may also be differences in the type of debt, and so the proportions of equity, current liabilities and term liabilities will be considered.

Capital structure is often measured by the debt/equity ratio. However, this is unsuitable for the present purpose, because it can make firms with similar capital structures appear quite different. To see this, consider two firms with the following structures:

Firm:	A	B
Term Liabilities	2,000	2,000
Share Capital	1,100	1,000
Retained Earnings	(1,000)	(1,100)
Equity	100	(100)

Although these firms are clearly very similar in their capital structure, the debt/equity ratio of Firm A is 20, while that of Firm B is -20; the firms appear as outliers at opposite ends of the distribution for the ratio. This is not a technical statistical problem to be coped with by deleting outliers or using robust estimation methods, but is a fundamental fault in the nature of the debt/equity ratio as a tool for ranking firms by their capital structure.²³

²² According to Inland Revenue Department figures.

²³ A related technical issue is that any ratio whose denominator can plausibly be zero is likely to have an infinite mean, so that tests for the difference in means between two populations are meaningless. This problem can be worked around, for example by comparing medians rather than means.

An alternative measure of capital structure is the proprietorship ratio, that is equity divided by total assets. With this ratio, the denominator cannot be negative and could only be zero for a completely asset-less company. In the preceding example, the two firms would have proprietorship ratios which are both close to zero: 0.048 for Firm A and -0.053 for Firm B. Thus, the proprietorship ratio gives similar values to firms with similar capital structures.

Although it would be preferable to look at debt rather than at all liabilities (which include various non-interest-bearing accruals and provisions such as accounts payable and deferred taxes), data availability required us to consider current and term liabilities as proxies for short-term and long-term debt.

Accordingly, the hypotheses to be tested are formulated as follows:

$H_0^{(1)}$: The ratios Equity/Total Assets (Current Liabilities/Total Assets; Term Liabilities/Total Assets) do not differ between NRCCs and RCCs.

$H_1^{(1)}$: The ratios tend to be smaller (larger; larger) for NRCCs than for RCCs.

A *t*-test could be used to test these hypotheses, but the non-parametric equivalent, the Mann-Whitney U test, is preferred because it does not require the ratios being tested to be normally distributed. The U statistic can be transformed to a normally distributed equivalent in large samples (Conover 1980, p. 452).

If the null hypotheses are rejected, this implies that NRCCs have relatively less equity and more debt in their capital structure. It does not, however, establish that this capital structure is tax-driven, because the transfer of income requires that greater debt be associated with greater amounts of deductible interest. Accordingly, this first step of the investigation merely seeks an indication of tax-driven capital structures.

The corporate income tax rate fell significantly in 1988. If capital structure differences are tax-driven, one would expect a different pattern to emerge after that date. For that reason, the sample period was broken into two sub-periods, 1983-1988 and 1989-1992.

-- INSERT TABLE 2 HERE --

The results are presented in Table 2 for each year 1983 to 1992, for the two sub-periods, and for the entire ten-year period. For each year, Table 2 shows the number of RCC and NRCC firms in the sample, and then for each of the three ratios it shows the means of the RCC and NRCC groups and the normally distributed *z* statistic from the Mann-Whitney

test. In every case, the difference between RCC and NRCC firms is significant at 0.001 or better.²⁴

In summary, the table shows that NRCC firms have tended to have less equity and more current liabilities than RCC firms, but less term liabilities. The first two findings are consistent with the alternate hypothesis H_1 , but the third finding is not in the expected direction. Over the sample period, the mix of equity:current liabilities:term liabilities averaged about 59%:26%:16% for RCCs and 36%:54%:9% for NRCCs. The lower use of term liabilities by NRCCs is a possible indication that these differences in capital structure, while real and persistent, are not driven by tax considerations.²⁵ This view is reinforced by the observation that the mean proportion of equity was several percent less in the 1989-92 sub-period than then the 1983-88 sub-period, while term liabilities were larger in the later sub-period (for RCCs as well as for NRCCs). A reduction in corporate tax rates would reduce the tax benefits from debt and thus the tax incentive to thin capitalisation; that is not consistent with the observations.

6.3 Evidence Concerning Interest Expense

A high level of debt is not evidence of thin capitalisation. Interest must be charged on such debt in order to effect income-shifting. This section of the study looks for evidence that NRCC firms have distributed their operating income more to lenders in the form of interest and less to governments and shareholders in the form of taxes and profits.

The operating income measure that we use is Earnings before Interest and Taxes (EBIT), that is Net Income²⁶ plus Interest Expense plus Income Tax Expense. As in the previous section, we must scale these variables by an appropriate denominator which cannot be zero or negative. We are interested in the allocation of EBIT, but EBIT is not itself a suitable scale factor because it can often be negative. Another obvious scale factor would be turnover, but this is also unsuitable because it can be effectively zero: a small but important proportion of firms had very little turnover in years of large losses. Instead, the denominator used is:

²⁴ The hypotheses being tested are directional and so a 1-sided significance level would be appropriate. A 2-sided statistic is quoted because some of the differences are in the opposite direction to that expected, and the 2-sided test shows how likely such differences are to arise by chance. The 1-sided significance levels are more extreme than those quoted.

²⁵ An alternative explanation for the use of current debt is that it may give more flexibility as to whether interest is charged or not, and hence allow more flexibility in the use of income shifting. However, it is not obvious that the parent company has much choice in whether debt will be interest-bearing unless the debt is provided by the parent itself or by an associated party.

²⁶ Net income after extraordinary items. The classification of income items as ordinary or extraordinary is irrelevant for our purpose and is highly subjective, especially in the early years of the study.

$$\text{Total Distributions} = |\text{Interest Expense}| + |\text{Tax Expense}| + |\text{Net Income}|$$

The use of absolute values guarantees that Total Distributions is positive and at least as large as any of the numerators. Thus, the three ratios Interest/Total Distributions, Tax/Total Distributions, and Net Income/Total Distributions are all constrained to lie between -1 and +1, and firms with similar patterns of distribution will have similar values of these ratios.

If RCCs and NRCCs are similarly profitable, but NRCCs are using thin capitalisation to transmute profits into interest, we would expect that NRCCs have higher Interest/Total Distributions, lower Net Income/Total Distributions, and lower Tax/Total Distributions than RCCs.

The hypotheses to be tested are formulated as follows:

- $H_0^{(2)}$: The ratios Interest/Total Distributions (Net Income/Total Distributions, Tax/Total Distributions) do not differ between NRCCs and RCCs.
- $H_1^{(2)}$: The ratios tend to be larger (smaller; smaller) for NRCCs than for RCCs.

-- INSERT TABLE 3 HERE --

The results are shown in Table 3. The table shows the number of RCCs and NRCCs each year (numbers differ slightly from Table 2 because of different data availability), the mean of each ratio for the RCCs and for the NRCCs, and the z statistic from the Mann-Whitney test of $H_0^{(2)}$. The evidence for individual years is not as strong as for the capital-structure investigation; only for four individual cases is the difference significant at the 0.01 level. However, NRCCs consistently have smaller Interest Expense/Total Distributions and larger Net Income/Total Distributions, and when the data from several years are pooled these findings are highly significant. On the other hand, there is no significant difference between Tax Expense/Total Distributions for the two classes of firms, even when the data are pooled. Thus $H_0^{(2)}$ is not rejected for Tax, while both $H_0^{(2)}$ and $H_1^{(2)}$ are rejected for Interest and Net Income. Far from transmuted profits into interest to reduce taxes, NRCCs appear to have been transmuted interest into profits, while paying much the same share in taxes as RCCs do. For both RCCs and NRCCs, interest was relatively larger, while profits and taxes were relatively smaller, after the 1989 reduction in the statutory tax rate; this again is not consistent with tax-driven thin capitalisation.

Taken together, the results of this and the previous section suggest that NRCCs do indeed tend to use less equity than RCCs, but that the reasons for this difference in capital structure have little to do with tax.

6.4 Evidence Concerning Transfer-Pricing Manipulations

Manipulative transfer pricing is less transparent than thin capitalisation. If it is as effective at reducing taxes (with both methods being about equally affected by anti-avoidance provisions), NRCCs would presumably prefer to use manipulative transfer pricing. If investigated by revenue authorities, there are much greater grounds for a firm to dispute a transfer pricing audit or assessment on grounds of arms' length criteria than would be the case with thin capitalisation.

We assume that the gross amount of related-party transactions is a measure of a firm's scope for transfer-pricing manipulations. On that assumption, if NRCCs are exploiting this to reduce profits, we expect a relationship of the form:

$$\text{Profits} = a.\text{Size} + b.\text{RPT} + \dots$$

where RPT is the amount of Related-Party Transactions, and the Size variable is left unspecified for now. Both Profits and RPT, as well as the omitted variables, are proportional to firm Size, so a regression model based on the above equation will be heteroscedastic and hence inefficient. Dividing by Size, however, gives a homoscedastic model:

$$\text{Profits/Size} = a + b.\text{RPT/Size} + e$$

where e is an error term. A negative sign for b implies that profits are being reduced through related-party transactions, presumably involving the manipulation of transfer prices.

Companies in New Zealand were not required to disclose related party transactions until 1989, when SSAP 22 came into effect. Almost no RCCs disclosed related-party information before that time, but a few NRCCs did so. We need to estimate the regression only for NRCCs, because RCCs have much less opportunity to move profits out of New Zealand by transfer-price management through related-party transactions.²⁷ Fortunately, the requirements of this study match the available data.

The regression was estimated taking Profits to mean Net Income, and was estimated again taking Profits to mean Earnings Before Interest and Taxes. The choice of the Size variable is more difficult. The only purpose of dividing by Size is to eliminate heteroscedasticity in the regression; no particular interpretation of the Size variable is

²⁷ Transactions between a RCC parent and a foreign-based subsidiary will be eliminated in the consolidated statements and will not trigger related-party disclosures.

necessary. A poor choice, however, can cause outliers in the ratio RPT/Size; these outliers act as high-leverage points which can cause the equation to depend almost entirely on one or two data points. There is no good solution for the problems of bias and inefficiency thus introduced (Huber, 1981, p.195). Further, a poor choice of Size can also cause outliers in the dependent ratio so that the regression residuals are not normally distributed but instead follow unknown distributions with very long tails and possibly infinite variance. This invalidates all of the usual inferences about the significance of the regression coefficients.

The existence of outliers in either the dependent or independent variable was taken to indicate a defective choice of Size. After some experimentation, we defined Size to be the largest of Assets, Turnover, and the magnitude of Net Income. This choice eliminated all outliers. Although the residual distributions may be non-normal, they will be short-tailed with finite variances, and the effects on statistical inference should not be serious.

-- INSERT TABLE 4 HERE --

The results of the regressions are shown in Table 4. For each year, each sub-period, and the entire 10-year period, Table 4 shows the sample size (limited by the number of NRCCs that disclosed related-party transactions) and the regression coefficients, their standard errors and *t* values and the coefficient of determination for regressions with each choice of dependent variable.

Because of the small sample sizes, none of the single-year models has a significant slope. When the data are pooled, however, the slope for the regression of Net Income/Size has a negative slope, significant at the 0.02 level. The r^2 of the regression is always very small, so that very little of the variance in Net Income/Size is explained by variations in RPT/Size. Nevertheless, the regression results are evidence that related-party transactions have a negative effect on profitability of NRCCs. This result is consistent with the view that transfer-pricing manipulations reduce the profits of NRCCs.

Obviously other factors have had a significant effect on profitability and it is possible, especially in the latter period, that profits were not being transferred out of New Zealand. The tax regime that the non-resident investors faced in their home country may have had some influence, for example, foreign tax credits may have been allowed for underlying tax paid on foreign subsidiaries' earnings, such as in the US. This may have made non-resident investors indifferent in what country they paid tax especially if the New Zealand statutory tax rate and home country statutory tax rate were reasonably similar. Another factor to consider is that because an investor's New Zealand operations may have been so small in comparison to their worldwide operations it may not have been worthwhile to put into place

complex transfer pricing arrangements for just their New Zealand operations unless the same arrangements were instituted for other foreign operations as well.

7.0 Discussion

The empirical results may be summarised as follows:

- (a) NRCCs are financed with less equity, less term liabilities, and more current liabilities than are RCCs;
- (b) when tax rates were lowered in 1989, there seems to have been a move away from equity and towards relatively more term liabilities in the capital structure of NRCCs;
- (c) as compared with RCCs, NRCCs pay less interest, have higher net incomes, and incur about the same taxes (relative to the total magnitude of these components of distributions);
- (d) the profitability of NRCCs falls as the amount of related-party transactions increases.

Findings (a), (b) and (c) are not consistent with a tax motivation for the observed differences in capital structures. Finding (d) is consistent with the assumption that firms manage their transfer pricing policies so as to minimise tax. Together, these findings suggest that firms prefer to manage their tax affairs through the transfer pricing mechanism rather than through thin capitalisation. This is broadly consistent with the previously cited findings of Grubert *et al* (1993) and Jacob (1995).

If the observed strong differences between the capital structures of RCCs and NRCCs are not due to tax motives, what may cause them? At least five explanations seem possible, and more than one may be correct:

- (1) There may be systematic industry differences between the NRCC and RCC firms, since it is well-known that capital structure is contingent on industry for agency-theory reasons.²⁸
- (2) The parent companies of NRCCs may be taking advantage of their limited liability, minimising their investment in their New Zealand affiliates in order to minimise their losses if the New Zealand affiliate should fail.
- (3) The parent companies may be hedging their exchange risk by matching their New Zealand-denominated assets and liabilities, thus restricting their equity investment.

²⁸ For a discussion see Weston and Copeland (1992), pp 597-600.

- (4) The parent companies may be providing capital by way of short-term advances, giving them greater flexibility to withdraw capital from New Zealand at short notice.
- (5) The parent companies may be providing capital by way of short-term advances, giving them greater flexibility to charge interest on a discretionary basis. This may be tax-driven, or it may keep open the option of minimising political costs, which can be severe if foreign-controlled companies are seen to be highly profitable.

Although as tax specialists we tend to expect tax-driven explanations, the findings of this study remind us that tax is only one of the factors that influences corporate decision-making.

Another issue arising from this study is whether these results obtained justify the introduction of the revised transfer pricing and new thin capitalisation rules from 1 April 1996. There is some tentative evidence that profit-shifting through manipulative transfer pricing has occurred and thus if this is perceived to be a problem for New Zealand then the Commissioner needs effective legislation to attack such arrangements. It may well be that our study is not sensitive enough to detect manipulative transfer pricing arrangements and the problem may be greater than our results suggest.

If the revised transfer pricing rules deter NRCCs from shifting income using manipulative transfer pricing, a theoretical analysis suggests that thin capitalisation will become more attractive and therefore anti-avoidance provisions would be necessary to address both tax avoidance methods. While the results obtained regarding the debt/equity ratios of NRCCs and RCCs do not show evidence income shifting through thin capitalisation for the period 1983-1992, the higher debt/equity ratios of NRCCs show there is ample scope to shift profits through inter-company interest payments if non-resident investors so desire. The introduction of the AIL regime which allows interest to be paid offshore with a 2% tax impost and more open capital markets than before increases opportunities for such income shifting in future. Additionally changes in the New Zealand and international economic environments since the 1980s may provide greater incentives and opportunities for income shifting using both manipulated transfer pricing and thin capitalisation than before which may become more apparent in further studies using data from subsequent income years.

Table 1: Net Returns To Non-Resident Investors By Thinly Capitalising A New Zealand Subsidiary

Assume: Total capital required: \$700 Corporate Tax Rate: 33%
 Pre-tax and Interest Profits: \$100 pa. NRWT on Dividends: 15%
 Borrowing Interest Rate: 10% AIL: 2%
 Loan from parent eligible for AIL using independent intermediary. ^{\$1}
 Investor from country that has DTA with New Zealand. ^{\$2}

	100% Equity from parent	50/50% Debt to Equity, both from Parent	95/5% Debt to Equity, both from Parent
Pre tax & Interest profits	\$100.00	\$100.00	\$100.00
less interest on loan	0.00	35.00	66.50
Profit Before Tax	100.00	65.00	33.50
Tax @ 33%	33.00	21.45	11.06
Tax-Paid Net Profit	67.00	43.55	22.44
Dividend Declared	67.00	43.55	22.44
less Dividend NRWT @ 15%	10.05	6.53	3.37
Net Equity Return	\$56.95	\$37.02	\$19.07
+ interest on loan		\$35.00	\$66.50
less AIL @2%		<u>0.70</u>	<u>1.33</u>
		34.30	65.17
Total Return To NR Investor After NZ Taxes	<u>\$56.95</u>	<u>\$71.32</u>	<u>\$84.24</u>
Effective NZ Tax Rate on Distributed Profits	43.05%	28.68%	15.76%

^{\$1} If interest paid on the loan from the parent was subject to non-resident withholding tax at 10% (assuming the maximum permitted under the DTA) the NZ effective tax rates would be 31.48% and 21.08% respectively.

^{\$2} If the investor had been from a country without a DTA with New Zealand, a higher rate of NRWT on dividends (30%) would have applied. Thus the effective NZ tax rates would have been 53.10%, 35.22% and 19.12% respectively.

Table 2. Capital Structures of Resident and Non-Resident-Controlled Companies, 1983-1992.

The z value derived from the Mann-Whitney test is a standard normal variable. It is negative if NRCC firms tend to have smaller values than RCC firms, positive if the NRCC values tend to be larger. All z values for the Mann-Whitney tests are significant at the 2-sided 0.001 level.

Year	Number of firms		Equity/Total Assets			Current Liabilities/Total Assets			Term Liabilities/Total Assets		
	Resident	NRCC	Mean Resident	Mean NRCC	M-W z value	Mean Resident	Mean NRCC	M-W z value	Mean Resident	Mean NRCC	M-W z value
1983	41	97	0.60	0.43	-3.42	0.28	0.51	4.98	0.12	0.06	-3.59
1984	52	96	0.60	0.40	-4.06	0.29	0.54	5.94	0.11	0.06	-3.82
1985	62	106	0.59	0.37	-4.63	0.28	0.57	6.93	0.13	0.06	-4.70
1986	67	109	0.59	0.38	-4.67	0.28	0.55	6.49	0.13	0.07	-3.76
1987	83	120	0.62	0.38	-5.23	0.26	0.54	6.58	0.12	0.08	-3.34
1988	107	131	0.61	0.40	-4.98	0.25	0.52	7.06	0.14	0.09	-4.52
1989	114	145	0.58	0.36	-5.81	0.23	0.55	8.62	0.19	0.09	-5.17
1990	125	155	0.56	0.31	-6.28	0.27	0.56	7.15	0.17	0.13	-3.47
1991	136	147	0.59	0.33	-5.86	0.23	0.54	7.94	0.18	0.12	-3.54
1992	135	69	0.58	0.30	-4.20	0.24	0.58	6.50	0.18	0.11	-3.57
1983-88	412	659	0.60	0.39	-11.11	0.27	0.54	15.72	0.13	0.07	-9.68
1989-93	510	516	0.58	0.33	-11.48	0.24	0.56	15.41	0.18	0.11	-7.88
All years	922	1175	0.59	0.36	-15.89	0.26	0.54	22.49	0.16	0.09	-12.58

Table 3. Distribution of Earnings Before Interest and Tax of Resident and Non-Resident-controlled Companies, 1983-1992.

EBIT = Net Income + Interest Expense + Tax Expense. The table shows the allocation of EBIT to lenders, shareholders, and the government. The scale factor, "Total Distributions", is the sum of the absolute values of the three components, which is always positive and may be greater than EBIT. The z value derived from the Mann-Whitney test is a standard normal variable. It is negative if NRCC firms tend to have smaller values than RCC firms, positive if the NRCC values tend to be larger. Values marked * are significant at the 2-sided 0.001 level.

Year	Number of firms		Interest/Total Distributions			Net Income/Total Distributions			Tax Expense/Total Distributions		
	Resident	NRCC	Mean Resident	Mean NRCC	M-W z value	Mean Resident	Mean NRCC	M-W z value	Mean Resident	Mean NRCC	M-W z value
1983	41	94	0.22	0.17	-1.46	0.19	0.20	1.21	0.41	0.31	-0.76
1984	52	96	0.18	0.15	-1.82	0.19	0.25	2.23	0.27	0.38	0.97
1985	60	104	0.22	0.19	-1.87	0.18	0.25	2.52	0.29	0.32	0.00
1986	66	107	0.29	0.26	-1.35	0.14	0.20	1.87	0.31	0.16	-1.91
1987	82	116	0.26	0.24	-0.96	0.15	0.26	3.19*	0.35	0.18	-3.25*
1988	103	127	0.31	0.26	-1.70	0.08	0.17	3.42*	0.11	0.18	0.57
1989	115	144	0.33	0.26	-1.84	0.06	0.12	3.37*	0.19	0.16	-0.16
1990	124	155	0.30	0.29	-0.72	0.10	0.13	1.32	0.09	0.09	0.39
1991	131	147	0.35	0.27	-2.36	0.09	0.09	0.49	0.07	0.05	0.33
1992	131	69	0.29	0.24	-1.33	0.12	0.14	1.18	0.18	0.20	0.59
1983-88	404	644	0.26	0.22	-4.01*	0.14	0.22	6.28*	0.27	0.25	-1.44
1989-93	501	515	0.32	0.27	-3.00*	0.09	0.12	2.74*	0.13	0.11	0.43
All years	905	1159	0.29	0.24	-5.31*	0.12	0.18	6.97*	0.19	0.19	-0.08

Table 4. Relation Between Profits and Related-Party Transactions for NRCCs, 1983-1992.

The regression model is Profit/Size = a + b RPT/Size + error, where "Profit" is either Net Income or EBIT, and "Size" is the largest of Assets, Turnover, Profit, or Loss. Values marked * are significant at the 1-sided 0.01 level.

Year	Number of NRCC firms	Based on Net Income			Based on Earnings before Interest and Taxes		
		a (s.e.) t	b (s.e.) t	r2	a (s.e.) t	b (s.e.) t	r2
1983	15	0.089 (0.035) 2.55	-0.038 (0.082) -0.46	0.02	0.050 (0.019) 2.68 *	-0.018 (0.044) -0.41	0.01
1984	12	0.113 (0.031) 3.60 *	-0.123 (0.069) -1.79	0.24	0.052 (0.022) 2.39	-0.047 (0.048) -0.98	0.09
1985	14	0.164 (0.043) 3.82 *	-0.162 (0.080) -2.01	0.25	0.095 (0.025) 3.77 *	-0.101 (0.047) -2.13	0.27
1986	13	0.141 (0.043) 3.27 *	-0.166 (0.102) -1.62	0.19	0.066 (0.025) 2.59	-0.083 (0.060) -1.38	0.15
1987	17	0.088 (0.017) 5.26 *	-0.033 (0.037) -0.88	0.05	0.027 (0.018) 1.50	0.019 (0.039) 0.49	0.02
1988	20	0.058 (0.021) 2.82 *	0.003 (0.065) 0.04	0.00	0.017 (0.014) 1.18	0.028 (0.045) 0.61	0.02
1989	40	0.041 (0.022) 1.90	0.009 (0.046) 0.20	0.00	-0.002 (0.018) -0.11	0.035 (0.038) 0.92	0.02
1990	64	0.043 (0.025) 1.73	-0.043 (0.052) -0.83	0.01	0.000 (0.026) 0.01	-0.018 (0.055) -0.33	0.00
1991	66	0.037 (0.020) 1.82	-0.062 (0.049) -1.27	0.02	0.002 (0.020) 0.10	-0.049 (0.049) -0.99	0.01
1992	40	0.041 (0.016) 2.64 *	-0.031 (0.029) -1.05	0.03	0.008 (0.016) 0.50	-0.023 (0.030) -0.76	0.02
1983-88	91	0.099 (0.012) 8.15 *	-0.071 (0.028) -2.52 *	0.07	0.044 (0.008) 5.52 *	-0.023 (0.018) -1.24	0.02
1989-92	210	0.040 (0.011) 3.72 *	-0.034 (0.023) -1.47	0.01	0.002 (0.011) 0.20	-0.017 (0.023) -0.73	0.00
All Years	301	0.057 (0.009) 6.62 *	-0.042 (0.019) -2.24	0.02	0.015 (0.008) 1.78	-0.018 (0.018) -1.00	0.00

APPENDIX 1:

Summary of Major Deficiencies in Section GC1(3) Transfer Pricing Rule Control Tests

- (1) The test in (3)(a) does not specify the level or nature of the "control". In an Australian decision *FC of T v Commonwealth Aluminium Corporation Ltd* (1979-80) 143 CLR 646 concerning a similar provision in Australia, the Court made a distinction between the ability to control a business and the ability to control a general meeting of the shareholders, and also between "defacto" control and the capacity to control. It held that defacto control was held by the directors of the taxpayer as the articles of association vested the management of the company's business with them.
- (2) Under (3)(b) it is possible to adopt a number of different shareholding structures so that a non-resident controlled company will not be "under the control of non-residents", by inter-posing another New Zealand company or trust between the New Zealand subsidiary and the foreign parent company.
- (3) Subsections (3)(a) and (c) do not specify how companies which that have both resident and non-resident shareholders are to be treated. Nor is any indication given whether control arises from one shareholder or a group of shareholders.
- (4) Subsection (3)(a) does not specify when the control test is to be applied.
- (5) The control test in subsection (3)(c) must be applied only at the end of the income year. This opens up opportunities for manipulation of shareholdings at the end of the income year to arrange for a company to fall outside subsection (3)(c).
- (6) Nowhere in subsections (3)(a) and (c) is any mention made of indirect control methods nor of associated persons. The use of indirect control methods and holdings by associated parties could enable a company that is in essence controlled by non-residents to escape the application of section GC1.
- (7) The level of control is not specified in subsection (3)(b). It can be argued that the type of "control" being referred to is the control of the company at its general meeting rather than its company's business. Because the wording refers to "any other means", it must be a method that is outside the other limbs of section OD1(2) and thus focuses on de facto control. This could refer to indirect means of control such as shareholdings through a chain of companies, but this is not clear.
- (8) Subsection (3)(c) can be easily avoided because the person who carries on the business must have control of a non-resident company. If the person who controls the non-resident company also controls a New Zealand company which carries on that New Zealand business, then GC1(3)(c) cannot apply.
- (9) It is unclear how businesses operated by trusts are to be treated under GC1(3).

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