First Gas Limited
42 Connett Road West, Bell Block
Private Bag 2020, New Plymouth, 4342
New Zealand
P +64 6 755 0861
F +64 6 759 6509

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BEPS – Interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

By email: policy.webmaster@ird.govt.nz

Submission: "BEPS - strengthening our interest limitation rules" discussion document

We outline in this letter our submission on the Government discussion document "BEPS - strengthening our interest limitation rules", which was released on 3 March 2017 (the **discussion document**).

We welcome the opportunity to make this submission, and would be happy to discuss further with officials if that would assist in understanding and appropriately taking into account our key concerns as part of the consultation process.

Introduction – overview of First Gas

First Gas Limited (**First Gas**) owns and operates New Zealand's entire high-pressure natural gas transmission network, as well as more than 4,800 km of gas distribution pipelines across the North Island which, on behalf of gas retailers, deliver gas to more than 60,000 customers.

First Gas, formerly Vector Gas Limited, was acquired in 2016 by a consortium of foreign investors including two wholesale unlisted infrastructure funds managed by First State Investments (**FSI**) group entities, along with a co-investment from two Canadian institutional fund managers. FSI (known as Colonial First State Global Asset Management in Australia) is the investment management business of the Commonwealth Bank of Australia.

First Gas subsequently acquired the Maui gas pipeline from its long term owners, and has recently acquired further gas distribution pipelines in the Bay of Plenty.

Summary of submission

We summarise our key submission points as follows:

- The non-debt liabilities proposal will inequitably penalise infrastructure businesses - which are by nature highly geared and capital intensive - and will result in unjustifiably prejudicial treatment of foreign vs locally owned businesses in that and other highly geared sectors.
- Deferred tax liabilities, which can be disproportionately significant for owners of regulated infrastructure as compared with other taxpayers, are analogous to equity and should not be subtracted from asset values.
- If the non-debt liabilities proposal goes ahead, the availability of different asset valuation methods should be reconsidered, in the interests of most accurately identifying the value of assets that are funded by those liabilities and debt.
- Abolishing asset and liability measurement at the end of the income year imposes significant additional compliance costs: the status quo does not impose an unreasonable burden on

taxpayers in terms of assessing their thin capitalisation position, which in turn encourages compliance.

- The interest rate cap is without international precedent and may cause inequities at the boundary / increase the risk of double taxation: it should not proceed. It appears to be based on an unreasonable assumption that New Zealand entities are implicitly supported by their foreign parent/related parties.

- If the interest rate cap proposal proceeds, this should only be as a safe harbour backstop for existing transfer pricing rules. In addition, the rules concerning the allowable margin should not result in different treatment depending on different ownership structures, and the five year term should be reconsidered because it is not commercially realistic (particularly for infrastructure debt financing: a one-size-fits-all approach, although attractive for its simplicity, does not reflect commercial reality).

- The issue being addressed by the "strengthened" interest limitation rules is best solved through the application of orthodox transfer pricing principles.

- Significant investment decisions with a long-term horizon have been made by FSI and other infrastructure investors based on then current New Zealand tax law. The current tax treatment of existing financing arrangements entered into by FSI and other infrastructure investors should be preserved through appropriate grandparenting measures. This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. First Gas' significant capex needs mean they require ready access to debt and equity funding from the global capital markets. Given the importance of infrastructure to New Zealand's economic growth and productivity in the future, tax settings should be encouraging further foreign direct investment (via both debt and equity) into New Zealand infrastructure assets – not discouraging it.

General comments

First Gas recognises the significance of the OECD's BEPS project and Inland Revenue's work programme in that regard. Clearly it is important that all New Zealand tax resident businesses (including those that are owned or controlled by offshore investors) are subject to an appropriate level of taxation in New Zealand.

However, First Gas is concerned that the discussion document's proposals will result in horizontal inequity between businesses owned/controlled by offshore investors as compared with those in New Zealand ownership. In particular, long term infrastructure businesses with regulated asset bases (such as in the energy industry) are significantly supported by overseas capital and accordingly are likely to be disproportionately impacted by the proposals.

The proposals in their current form do not recognise that infrastructure businesses are invested into on a long-term basis, and by their nature are capital intensive and highly geared. With a relatively low regulatory WACC allowed by the regulator and the need to reinvest capital to maintain and expand the asset, it is inevitable that infrastructure businesses (in particular regulated utilities) will need to borrow significantly to achieve a commercial return demanded from its global financial sponsors: it does not reflect any lack of commerciality in terms of debt levels (but, rather, a sensible investment decision and a norm). If the proposals are enacted in their current form, there is a real and appreciable risk of an adverse impact upon offshore investment decision-making as regards whether to invest in New Zealand-based infrastructure, or elsewhere globally.

Given that New Zealand is heavily reliant on foreign direct investment as a capital importing nation, the proposals warrant serious reconsideration. This is particularly the case given New Zealand's very shallow capital market, and First Gas' (and other regulated infrastructure firms') capex-intensive business models that demand constant and unimpeded access to vitally important investment capital. Any tax policy settings that make New Zealand infrastructure assets an unattractive destination for that capital pose serious risks to the infrastructure sector's economic viability, for New Zealand's energy needs and correspondingly our country's economic growth and prosperity.

If the proposals are enacted in their current form, First Gas has serious concerns regarding the impact on the availability and cost of capital for itself and other New Zealand infrastructure businesses.

Assets net of non-debt liabilities

The discussion document proposes to subtract the value of non-debt liabilities from a firm's asset value for the purposes of the thin capitalisation rules (**thin cap**). This is based on an international comparison which indicates that a 'gross assets' basis for thin cap is unique to New Zealand.

We do not support this proposal, which materially reduces the long-standing 60% safe harbour threshold. Beyond stating that the proposal seems to make thin cap more consistent with its "core objectives", we are concerned that the discussion document does not set out a properly reasoned case for this change.

Further, the proposal does not recognise that the funding of business assets via non-debt liabilities is a legitimate investment decision. Non-debt liabilities generally (but not always: deferred tax liabilities being one example) reflect the existence of real obligations for taxpayers, which are required to be met by equally real business assets. It is difficult to see why these assets should be effectively excluded from a firm's thin cap calculation.

Conversely, certain non-debt liabilities that would be subtracted in arriving at net assets under the current proposals do not actually fund assets on the balance sheet (for example, an unrealised liability recorded in respect of an out-of-the-money derivative). In these cases we do not consider it is appropriate to arbitrarily exclude a corresponding amount of assets from the thin cap calculation. Such an approach could also encourage firms to make tax-driven decisions in relation to their accounting policies (again, hedging/derivatives is an obvious example), in order to ensure that corresponding assets are reflected in their balance sheet, thereby mitigating or eliminating the impact of a net assets measurement.

As a general observation, we consider that the existing 60% thin cap safe harbour is already too low for the infrastructure industry. Long term infrastructure businesses (particularly regulated utilities) are by their very nature likely to be geared above this level. As explained above, the use of debt is a sensible approach to balancing the need of consumers (e.g. low WACC / tariff setting, proper maintenance and expansion of assets) and the need for acceptable commercial returns of financial sponsors. The high level of gearing is acceptable to lenders due to the stable, long term nature of infrastructure businesses, and given that the ability to service debt is ultimately determined by cash coverage rather than balance sheet type ratios. Given these settings, the industry will therefore be disproportionately penalised as a result of these changes.

Rather than changing the basis for the current 60% safe harbour, we suggest instead an additional arm's length safe harbour test to allow taxpayers to gear at higher levels where this is supportable as being a commercial level of debt. This is a feature of thin cap regimes in a substantial number of jurisdictions. We consider that this would address Officials' concerns regarding industry specific rules noted at paragraph 4.29 of the discussion document. Further, this proposal would be more consistent with Officials' stated goal of ensuring taxpayers (including different types of taxpayers) have commercial levels of debt. It is also consistent with other features of the New Zealand taxation system that require taxpayers to demonstrate qualitative matters such as a "market value" (depreciable property/trading stock rules on disposal and dividend rules), an "arm's length amount" (transfer pricing) or "arm's length terms" (on-lending concession for thin cap purposes).

However, if the non-debt liabilities proposal does proceed, we strongly submit that a more considered approach should be taken to identifying which such liabilities are subtracted from the value of assets. For example, as is the case in Australia, deferred tax liabilities should not be carved out from the total asset value as they are normally not regarded as a 'real liability' by a debt funder and can be classified as equity for debt covenant purposes. Contingent liabilities to pay amounts upon redemption of redeemable shares, related party trade creditors and shareholder current accounts (if not already covered by interest-free loans) are additional examples.

Further, if the proposal is implemented, we submit that other aspects of the thin cap rules should be reconsidered to ensure that taxpayers are able to value their asset base in a commercially realistic manner. In particular, Officials recommend at paragraphs 5.24 to 5.27 of the discussion document that asset valuation should now be restricted to financial statements values only. By contrast,

Australia offers a more generous market valuation option for assets in certain circumstances, subject to obtaining appropriate third party valuation support. This should be considered by Officials as a way of ensuring that thin cap measures interest bearing debt against the true value of shareholders' investment.

Measurement date for assets and liabilities

We do not support the proposal to remove the current default (annual) asset valuation measurement date. This will in effect require taxpayers to prepare IFRS-based values on at least a quarterly basis, in most cases solely for tax purposes. Because IFRS requires a number of complex calculations (e.g. impairment testing, fair value and mark to market calculations), it would otherwise be very unusual to prepare these values so frequently. This proposal will therefore impose significant additional compliance costs for taxpayers. By contrast, the status quo represents a sensible approach for taxpayers to assess their thin cap position (i.e. simply based on their annual accounts – with the current value approach as an option as submitted above), which in turn encourages compliance.

The discussion document indicates that Inland Revenue's concern with the year end measurement date arises from perceived shortcomings in the existing anti-avoidance rule in section FE 11 of the Income Tax Act 2007. As these concerns are presumably relevant in only a small number of isolated cases (the discussion document does not cite anecdotal evidence supporting what is otherwise a theoretical concern), it is vastly disproportionate to impose significant additional compliance costs on all taxpayers. We submit that targeted amendments to the anti-avoidance rule would be a more appropriate policy response.

Interest rate cap – assumptions

As a starting point, we consider that the proposed interest rate cap appears to assume the implicit support of New Zealand entities by their foreign related parties. This assumption ignores the separate legal entity principle, as well as business and economic reality. Except where an enforceable guarantee is provided by a foreign owner, it is fundamentally flawed to assume that a multinational parent (and especially a consortium investor such as is the case in relation to First Gas) will always support a New Zealand related party.

Interest rate cap – use of transfer pricing principles

As a result of concerns that 'traditional' thin cap regimes are vulnerable to excessive interest rates on related party loans, the discussion document proposes a cap on the deductibility of such interest. However, as in Australia and numerous other jurisdictions with thin cap regimes, we consider that orthodox transfer pricing rules are adequate to ensure that related-party lending is conducted on arm's length terms.

As a result, we do not support the proposed interest rate cap. We are concerned that the cap is a blunt instrument which will increase horizontal inequity between locally and foreign owned businesses. The proposal is untested and to our knowledge is without international precedent (and in this regard we have identified fundamental/conceptual concerns above, and further specific concerns below). We are also concerned that, particularly when combined with the other proposals, the interest rate cap will introduce a unique level of complexity to New Zealand thin cap relative to other jurisdictions.

The cap also introduces a substantial double taxation risk where the lender's jurisdiction applies transfer pricing principles. Although the same could be true for thin cap interest apportionment to a certain extent, it is relatively straightforward for a taxpayer to manage debt levels within thin cap thresholds. The mutual agreement process has also historically allowed competent authorities to resolve more complex double taxation issues. However, we are concerned that the impact of the interest rate cap, together with the proposed treatment of non-debt liabilities, introduces a more substantial risk of double taxation.

As a way of addressing these deficiencies, we submit that the concerns sought to be addressed by the proposed interest rate cap should be dealt with instead through orthodox transfer pricing rules. We consider that this more closely aligns with, and less invasively gives effect to, the stated policy objective of preventing profit shifting by way of excessive interest deductions.

We note the discussion document's warning that if an interest limitation rule will not achieve its stated objectives, then an EBITDA based rule (as suggested by the OECD) may need to be adopted. We do not agree that an EBITDA based rule is a necessary result of rejecting the interest rate cap. As recognised in the discussion document, such a rule has its own challenges and, as noted above, the policy concern can be adequately addressed via existing transfer pricing rules.

Further, given the recent bolstering of the NRWT rules with respect to related party debt, we consider that New Zealand should be less concerned with base erosion and profit shifting resulting from interest on related party debt. New Zealand's comprehensive application of NRWT to passive income streams (including now where consortia will not be able to access the approved issuer levy regime) can be contrasted with the difficulties of European Union members and some other nations, who are unable to use withholding tax with similar efficacy[1]. Further, in certain related party situations (i.e. involving associated persons) where NRWT is only a minimum tax, investors may nevertheless be subject to a full New Zealand income tax burden on the relevant income stream. As a result, we consider that some of the concerns leading to the recommendation of an EBITDA based measure (or indeed, an interest cap rule) are not relevant in a New Zealand environment.

Finally, if the interest rate cap proposal does proceed, First Gas considers that it should have application only as a 'safe harbour' backstop for the existing transfer pricing rules. Taxpayers who are willing and able to undertake a full transfer pricing analysis to support arm's length pricing for related party debt should not have interest rate deductions limited by an arbitrary cap. The cap should therefore be limited to circumstances where a taxpayer does not undertake full transfer pricing analysis. We consider this would mitigate some of the concerns with the cap detailed above.

Interest rate cap – design matters

If the interest rate cap proposal does proceed, we submit that the proposed five year maximum term (when looking to senior unsecured debt issuance pricing as a base from which to notch) is too short, particularly in industries with stable cash flows and a solid long term asset base. Too short a term is uncommercial and risks giving rise to non-arm's length outcomes.

Particularly from an infrastructure perspective, a five year term is demonstrably too short. In a New Zealand specific context (e.g. PPPs), Officials will be aware of senior debt with terms of seven years or longer. In Australasian markets, ten year infrastructure bonds are not unusual and longer terms up to thirteen years are available in overseas capital markets. Similarly, First Gas understands from FSI (and in First Gas' own experience) that related party loans will normally have a term between five to ten years. Hence a five year term represents an overly restrictive assumption.

Given New Zealand's status as a net capital importer, we consider it would be unwise to restrict taxpayers' interest rate cap calculations from being based on appropriately priced overseas debt financing in the manner proposed by Officials (or, indeed, to restrict access to such financing itself).

As a result, we consider that the appropriate term needs to vary across industries and across credit cycles. As has been the practice with transfer pricing matters, Inland Revenue could provide more tailored guidance on what it considers uncommercial in the context of intercompany debt.

Alternatively, if a hard cap is imposed, this should err on the side of being higher than the proposed five year term to avoid arbitrarily and unduly penalising investors.

The proposed approach for adding a margin also raises horizontal equity issues. In particular, the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating is inequitable. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. This is preferable as a matter of tax policy to minimise the extent to which investment decisions are impacted by tax rules.

Grandparenting for existing arrangements

[1] For further comments in this regard, see for example: OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

The current long-standing tax policy settings have critically informed a number of significant investment decisions, including the FSI-managed consortium's own recent investment in New Zealand.

For any infrastructure investor, the pre and post-tax yields of an investment are significant outputs from the valuation and modelling process that is undertaken prior to making, and in ascertaining the viability of making, that investment. Based on those settings, resulting yields and other factors, FSI made a significant commercial decision to financially sponsor a material investment into New Zealand's energy infrastructure and recommend the investment accordingly to the current consortium members (comprising wholesale infrastructure funds and various institutional/sovereign or quasi-sovereign agency investors).

Uncertainty and risk is of course inherent in any investment, particularly over the extended modelling horizon that is used by long term infrastructure investors. The consortium that has invested into First Gas has already been affected by the changes to availability of the approved issuer levy regime. The impact of the proposals in the discussion document, if enacted in their current form, would further materially affect the post-tax return on the significant investment that the consortium has made in a core feature of New Zealand's infrastructure landscape. As a result, we submit that the proposals, if enacted, should include grandparenting, particularly for arrangements entered into before the release of the discussion document and in particular in the infrastructure sector where long-term investment decisions are made.

This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. As noted above, First Gas' significant capex needs mean require ready access to debt and equity funding from the global capital markets. Given the importance of infrastructure to New Zealand's economic growth and productivity in the future, tax settings should be encouraging further foreign direct investment (via both debt and equity) into New Zealand infrastructure assets – not discouraging it.

The rationale and case for grandparenting for non-PPP infrastructure investment is just as compelling as for the PPP projects referenced at paragraph 5.12ff of the discussion document (except we would submit that owner-linked debt should not be non-deductible as proposed by the discussion document and instead a section FE 31D-style regime should apply as is referenced in paragraph 5.14 of the discussion document: transfer pricing measures can constrain any quality of debt issues). If similar grandparenting is not introduced, then a horizontal inequity will arise as between Government-sponsored and private sector-sponsored key infrastructure investment in New Zealand. To this end First Gas also supports the grandparenting of the operation of section FE 31D in relation to non-resident owning body debt entered into prior to enactment of the proposed reforms. First Gas also submits that for non-grandparented consortia arrangements it is a disproportionate policy response to deny all interest deductions on shareholder debt.

Concluding comments

Thank you again for the opportunity to submit on the discussion document. Should you have any further queries or wish to discuss this submission further, please contact me on (06) 755 0861 or by email at david.smith@firstgas.co.nz.

Yours faithfully

David Smith
Chief Financial Officer
First Gas Limited