Corporate Office

Powerco Limited
Level 2
NPDC Civic Centre
84 Liardet Street
Private Bag 2061
New Plymouth 4342

0800 769 372
powerco.co.nz

18 April 2017

Cath Atkins
Deputy Commissioner, Policy & Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Dear Cath

BEPS - strengthening our interest limitation rules
Submission on the government discussion document

Powerco Limited is writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (discussion document). We are appreciative of the opportunity to provide comments and look forward to discussing the proposals with officials.

By way of background and introduction Powerco Limited (Powerco) is New Zealand's second largest Electricity and Gas Distribution Company, but the largest distributor in kilometres of line. Powerco owns infrastructure assets outside the national grid that electricity and gas flows through to reach residential customers. Powerco is owned via a holding company in New Zealand, Powerco NZ Holdings Limited (PNZHL), which is ultimately owned by five Australian superannuation funds and Queensland Treasury (being a political subdivision of the Queensland Government) via a number of unit trusts and companies.

1. Summary of our submission

The key points of our submission for your consideration are:

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact highly geared industries such as regulated infrastructure industries and reduce horizontal equity in the tax system;
- This is exacerbated by the inclusion of deferred tax liabilities which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity;
- The interest rate cap is a novel and untested approach that may cause inequities at the boundary. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap.
- In our view, the issue being addressed by the proposed interest limitation rules is best solved through the application of the current and proposed transfer pricing rules.
- We are supportive of the proposed grandparenting of existing financial arrangements for non-residents acting together.
- Other changes around measurement dates and asset valuations are not practical and contradictory and should not go ahead.
- The implementation date for any of the proposed amendments should be no earlier than 1 April 2019 to allow taxpayers time to restructure, should it be required.

2. Background

2.1 Powerco supports work done by Officials to ensure business are paying their appropriate level of tax, but as a company operating in a competitive environment with regulated returns on assets, it is a poor policy outcome when Powerco is put at a disadvantage simply because it is funded by foreign rather than domestic capital.

2.2 Powerco agrees with the comment at 2.1 of the discussion document “New Zealand relies heavily on foreign direct investment to fund domestic investment”. Powerco agrees that the New Zealand Government should remain committed to ensuring that New Zealand remains an attractive place for non-residents to invest. However, over the last couple of years we have seen through our own mergers and acquisitions processes the ability for various taxpayers/investors into NZ to build in tax efficiencies/inequities into their bid prices. Tax systems should not distort investment choices or discourage foreign investment into NZ.

3. Excluding non-debt liabilities from total assets – adoption of arm’s length test

3.1 The exclusion of the value of non-debt liabilities from total assets effectively reduces the thin capitalisation ratio for most companies to below 60%. The quantum of the reduction will vary, but for very few taxpayers will the impact be small. We do not see change in methodology and intended tightening of the rules as having any connection to BEPS.

3.2 The discussion document relies on international thin capitalisation precedent to exclude non-debt liabilities but does not present the analytical case for their exclusion. Non-debt liabilities are legitimate funding sources for business assets and we do not see the logic in excluding them. Or, put another way, genuine business assets are required by a company to ensure that the obligations represented by non-debt liabilities can be satisfied. Examples 4 and 5 in the discussion document seem to ignore this reality. They are mathematical exercises that are not reflective of the real world. In each example, the directors of the New Zealand subsidiary would be unlikely to approve the suggested dividends as the solvency test cannot be satisfied with dividends at that level.

3.3 The existing 60% gearing ratio is too low for the industry that Powerco operates in. Powerco’s Australasian peers in the regulated transmission and distribution sector consistently maintain an average gearing above 60%. While we recognise that Officials have rejected the identification of specific industries we consider it would be appropriate to introduce an arm’s length test to supplement the safe harbour test. If the nature of an industry supports higher commercial gearing (because it has a quality, long term sustainable asset base and inelastic cash flows) there is nothing offensive in allowing a tax deduction for interest incurred; either external debt or related party.

3.4 Further, we consider that the proposal to effectively reduce the acceptable debt to asset ratio by changing from a total asset to a net asset requirement, if it proceeds should be better designed. In Australia a similar test excludes deferred tax liabilities as they often do not reflect what a debt funder would consider a real liability and can be classified as equity for debt covenant purposes. We submit that a much more considered approach to which non-debt liabilities reduce the total asset base is required and in particular, a deferred tax liability should not be treated as a non-debt liability that would reduce the assets base for safe harbour purposes.

3.5 Both PNZHL and Powerco’s accounts reflect a significant deferred tax liability, the majority of which relates to adjustments required under IFRS on acquisition of the business or change in ownership. The “adjusted deferred tax liability” is not real in the sense that were the group’s assets to be sold (due to a debt default) no tax liability would crystallise (other than an amount of depreciation recovery; but that does not form part of the adjusted deferred tax liability). Banking funders of the group do not consider this as a liability when considering whether to provide finance or not to the group but reclassify it for debt covenant purposes as equity.

3.6 We disagree with Officials’ comments that the impact of this will be small (paragraph 4.27 discussion document). The impact is significant for PNZHL & Powerco, and while it may only impact certain taxpayers the nature of the adjustments (relating to asset revaluations and uplifts) are such that the impact is likely to be significant when it arises.

4. Limiting the interest rate on related party loans

4.1 We understand the principal concern to be addressed by the introduction of an interest rate cap is a "quality of debt" issue in that Officials consider that some related party loans feature necessary and uncommercial terms which result in excessive interest rates. Officials note that this concern is one of the reasons the OECD favours an interest limitation which links interest deductibility and EBITDA.

4.2 The introduction of an interest rate cap for related party lending is an excessive response to the non-pervasive use of uncommercial terms in relation to related party lending. We accept that those situations may arise and are potentially difficult to resolve under the existing transfer pricing rules but in a discussion document of 3rd March 2017[1] Officials recommend an alignment of the New Zealand transfer pricing rules with those in Australia to the extent that they have regard to the economic substance of the transaction. Reconstruction of transactions which are not commercially rational is proposed (5.40). All of this provides more than adequate legislative ability for the Inland Revenue to deal with the minority of cases where excessive rates are applied.

4.3 In Australia and other jurisdictions that use the asset based test transfer pricing rules are considered adequate to ensure that the lending is commercial. The proposed changes in the New Zealand transfer pricing rules should ensure that New Zealand Inland Revenue has similar level of confidence.

4.4 In addition we note that OECD in "Limiting Base Erosion Involving Interest Deductions and Other Financial Payment Action 4 – 2016 Update" recognise the need to minimise the risk of double taxation and favour a consistent approach between countries to ensure multinationals do not face excessive compliance costs and double taxation.

4.5 The introduction of an interest rate cap is inconsistent with all other countries and the NZ discussion document does not recognise or comment on the resulting double taxation under this method. Furthermore Officials do not acknowledge that NZ has a very different withholding tax environment to Europe and a number of other jurisdictions[2].

4.6 A fundamental principle applied in international taxation is that transactions need to be undertaken on an arm's length basis. Limiting the interest deduction available in New Zealand to the parent's credit rating plus a margin will result in double/over taxation. This is likely to occur when the foreign taxing jurisdiction demands a higher interest rate be charged to reflect the arm's length rate, which will likely differ to the rate under the interest rate cap. We submit that the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well support by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

4.7 We understand that thin capitalisation adjustments are typically unilateral but this cap is one sided by design and is much harder to manage than an absolute gearing limit. Furthermore it requires all companies with over $10m related party debt to go through additional compliance even if the gearing levels are well below the appropriate asset percentage.

4.8 Powerco considers that the term of the cap (the restriction of the rate to unsecured debt with a maximum term of 5 years) does not reflect commercial reality in a global context. Powerco submits that a commercial loan may commonly be up to ten years (NZ Government issues 10 year bonds) or at least be based on the borrower's average debt term. We note a number of Powerco's external debt issues are for a period in excess of 10 years, due to the nature of the infrastructure assets

4.9 Powerco's Treasury team have had discussions with our bankers to understand a benchmark rate currently for a 10 year unsecured bond for a BBB and are unable to source a reference rate within the NZ market. Powerco most recently issued debt within NZ for an 8 year period, but to get a NZ

---

[1] BEPS – Transfer pricing and permanent establishment avoidance

[2] Para13, page 24 Limiting Base Erosion Involving Interest Deductions and Other Financial Payment Action 4 – 2016 Update

benchmark based on a BBB rating for longer than this we would most likely need to go offshore, which means that for many organisations with longer debt profiles linking the interest rate cap back to the NZ market doesn't align with their external debt portfolio and is artificial in nature.

4.10 Clarification as to the impact of foreign exchange movements on related party debt and how they would apply in relation to the cap is also important (preferably by way of example). We also consider that officials should be clear how they view the use of derivatives (in particular interest rate swaps) and how they tie into the effective related party interest rate calculation for the purposes of the cap. We note that the current rules require revaluation of foreign denominated debt based on the spot rate and fail to take into account any hedging, which can cause significant fluctuations in the group debt percentage and interest expense depending on the exchange rate movement. For most taxpayers with significant offshore denominated borrowings, the debt and all associated payments would be largely hedged so that the taxpayer have a clear understanding of their obligations at each payment date. With the proposed tightening of the measurement rules, a policy solution is required to remove the fluctuations that are distorting a taxpayers true debt percentage and interest obligations.

4.11 We also submit that the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating also raises horizontal equity issues. 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. Tax systems should not distort investment choices.

4.12 Officials note at paragraph 2.19 that failure to address the problems with the rules may mean an EBITDA based rule is adopted. We do not accept that and EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by Officials there are also a number of problems with the EBITDA approach. Again, in our view using arm's-length principles under a transfer pricing approach solves these issues and has a much stronger alignment with the core policy principle of preventing excessive related party debt deductions.

4.13 In the discussion document "New Zealand's taxation framework for inbound investment" June 2016, Officials noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish". It our view imposition of an EBITDA based rule would fail that Government's own identified priority.

4.14 Further, in that discussion document the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to income tax…minimising the potential for base erosion by [related party interest] payments"[3]. The OECD 2016 update[4] emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is a limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules focused on closing a perceived gap in taxation of related party lending negates the need for New Zealand to consider an EBITDA.

5. Related Party Debt – Non-residents acting together

5.1 Currently the worldwide debt percentage safe harbour provides that where a group can support external gearing at high levels groups can have an additional level of shareholder debt. We understand that the comments in 5.20 that **any** owner linked debt should be disallowed in the event of gearing levels above 60%, refers only to the proportion of owner linked debt above the 60% level and so have not commented further on that aspect.

5.2 It is Powerco's view that equity investors should be able to take a debt interest in a company if it is at a level that a third party would bank. The tax system should not force investors to take bank debt and give debt margin away. There are legitimate reasons as to why an investor may want/desire equity and debt returns. On this basis Powerco submits that where related party debt is a substitute for third party debt (i.e. it would meet an arm's length debt test) it should remain deductible even with gearing levels about 60%.

[3] Page 15, New Zealand's taxation framework for inbound investment, June 2016
[4] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

5.3 We note that the use of multiple terms around related party lending is confusing and clarification should be provided as to the difference between related party and owner linked debt.

5.4 While this amendment may be seen as improving equity between foreign investors coming into New Zealand directly rather than as part of a collective of investors, there is still inequity in that thin capitalisation rules do not apply to all foreign investors (those co-investing by way of 49% shareholding with a New Zealand resident company for example); there is still a cut-off point. The logic behind just changing this position is not altogether clear.

5.5 Disallowing taxpayers who are deemed to be acting together access to the worldwide group test (for those arrangements not grandfathered or post maturity), also creates inequity for investment into NZ. We appreciate allowing a taxpayer access to the worldwide group test in the case of public private partnerships, but there seems to be no rationale to prevent a group of investors holding an interest in a new business access to the worldwide test, when if the same investment and capital structure had been used by two single foreign investors with a 51%/49% holding, they would have access to the worldwide group test.

6. Other matters

6.1 Officials propose that asset values should be restricted to the value in the accounts (rather than using a value that would be an option under IFRS but is not used in the accounts for various reasons). We consider that the rationale for introducing this restriction doesn't stack up. It is common and reasonable for Inland Revenue to request accounting and valuation opinions to support the use of different asset values for thin capitalisation purposes in this context.

6.2 To suggest that the independent third parties providing this support would misstate the value and that company officials would be lackadaisical because the numbers are for the Inland Revenue rather than for audited accounts is simply not correct.

6.3 Similarly the suggestion that the measurement date be moved to quarterly or daily is not commercially realistic, and contradicts the assertion above that numbers must be audited to be sensible. Most companies would not prepare IFRS compliant and audited accounts on a quarterly basis. A requirement to calculate thin capitalisation levels this often is simply not meaningful or practical.

7. Implementation Date

7.1 The discussion document notes that if implemented, the proposals will apply from the beginning of the first income year after enactment in most cases.

7.2 The proposed changes will materially impact on Powerco and a number of other foreign owned taxpayers and they should be given an opportunity to get their affairs in order. It takes time and consideration to work through the restructure of an organisation (especially where there is a group of un-related investors deemed to be acting together) to agree a proposed structure, obtain advice both locally and offshore and draft and review documentation prior to implementation. Also given the current tax environment often restructures require a level of certainty from Inland Revenue with regards to anti-avoidance arrangements.

7.3 For the above reasons taxpayers need at least 9-12 months from the time the legislation is finalised to work through these processes and as a result the implementation date for these proposals should be no earlier than 1 April 2019.

8. Concluding comments

We reiterate our concern regarding the breadth of the proposals. In our view, the issues being addressed by the discussion document is best solved through the application of the current and proposed transfer pricing rules combined with an arm's length debt test.

We would be happy to discuss the matters raised in this submission further with Officials. If you have any questions or would like to discuss any of our comments please do not hesitate to contact me on [redacted] or alternatively [redacted].

Yours faithfully

Anna Tootill
TAXATION MANAGER