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#017

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By email

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SUBMISSION: BEPS – INTEREST LIMITATION RULES – A GOVERNMENT DISCUSSION DOCUMENT

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document "BEPS – Interest limitation rules" (March 2017) ("**Discussion Document**"). We would be happy to be contacted to discuss any aspect of the submission.

1.2 In summary, our submissions are:

General comment

(a) There have been a number of reforms over the past few years that will have increased the effective tax rate on foreign direct investment into New Zealand. These include broadening the scope of (and reducing the safe harbour threshold under) the thin capitalisation rules, and broadening the scope of NRWT (and reducing the availability of AIL). Consideration should be given to whether measures that will further increase the rate of effective tax (such as those proposed in the BEPS discussion documents released in March 2017, including the Discussion Document) are appropriate, particularly given New Zealand's headline corporate tax rate is now relatively high by international standards, at a time when there is a tendency towards corporate tax rate reductions by many countries.

(b) The measures proposed in the BEPS discussion documents include layers of overlapping measures, which seek to address the same perceived problem in multiple different ways. The proposed interest rate cap is an example of this, in that it addresses the same concerns as would be addressed by proposed amendments to the transfer pricing rules. Adopting multiple measures to address the same concern results in unnecessary complexity and increased compliance costs which will likely be a barrier to investing in New Zealand.

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Limiting the interest rate on related-party loans (Chapter Three)

(c) New Zealand should not adopt an earnings-based (eg, EBITDA) interest limitation test. Such a test would result in significant volatility and uncertainty for taxpayers.

(d) The proposed interest rate cap should not proceed, but instead consideration should be given to adopting a safe harbour. It is critical that any interest rate cap be adopted as a safe harbour only, because if not, the interest rate cap:

(i) would be inconsistent with OECD transfer pricing principles and transfer pricing rules applied in other jurisdictions, and could therefore result in double taxation (where New Zealand denies a deduction under the cap, but there is no corresponding reduction in the amount of interest income subject to tax in the lender's jurisdiction);

(ii) would make it difficult for certain entities (such as banks and insurance companies) to comply with regulatory capital requirements;

(iii) would have the perverse consequence that the borrower could raise debt at a higher price from third parties than from a related entity. This in turn could result in the tax system driving commercial behaviour (since businesses would have an incentive in cases to incur a higher pre-tax cost under borrowings from an unrelated party (because that cost is fully deductible) whereas borrowing from a related party may have a lower pre-tax cost but a higher after-tax cost due to being only partially deductible); and

(iv) would, contrary to what the Discussion Document proposes, require grandparenting provisions for existing arrangements.

Each of these concerns could be addressed by adopting the interest rate cap as a safe harbour.

(e) If the interest rate cap is adopted as a safe harbour, it should be buttressed by other measures to increase certainty. In particular:

(i) the existing safe harbour credit margin published by Inland Revenue (which applies where a group of companies has cross-border related-party debt totalling less than $10m principal in the relevant year) should be retained; and

(ii) for loans having a principal value below a certain monetary threshold, Inland Revenue could publish (and periodically update) tables setting out safe harbour guidance as to the credit spread that corresponds to each possible credit rating and tenor, to assist in applying the interest rate cap.

Treatment of non-debt liabilities (Chapter Four)

(f) The proposed adjustment for non-debt liabilities will effectively result in a reduction in the permitted debt-to-assets percentage. Officials

should take this into account in any analysis undertaken to determine the overall impact of proposed reforms on the tax burden imposed on foreign investment in New Zealand.

(g) Taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating total assets and total debt for thin capitalisation purposes.

(h) RPS and deferred tax liabilities should be excluded from "non-debt liabilities". (In the case of deferred tax, both deferred tax liabilities and deferred tax assets should instead be excluded from total debt and total assets, respectively.)

Other matters (Chapter Five)

(i) The net current valuation method should not be removed from the list of available asset valuation methods. If officials are concerned that net current values adopted under this method are inaccurate, rather than removing the method, a requirement to obtain an independent valuation when applying the method could be introduced.

2. GENERAL COMMENT

2.1 A number of reforms have been introduced over the past few years which have the effect of increasing the effective tax rate on foreign direct investment into New Zealand. These include broadening the scope of (and reducing the safe harbour threshold under) the thin capitalisation rules, and broadening the scope of NRWT (and reducing the availability of AIL). The question that now arises is the extent to which any further reform to New Zealand's international tax rules is required, and if so, how it should be implemented.

2.2 As Inland Revenue and the Treasury have acknowledged (see "New Zealand's taxation framework for inbound investment: a draft overview of current tax policy settings" (June 2016) at page 3):

> 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. Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to New Zealand.

2.3 This passage highlights that tax reform can hamper foreign investment in two ways: first, if the effective tax rate is too high (ie, too much tax is collected), and second, if the tax laws are poorly designed (ie, the tax is collected in an inefficient or economically distortionary way).

2.4 Careful consideration should be given to how the reforms proposed in the BEPS discussion documents released in March 2017 (including the Discussion Document) will perform, judged against each of these two criteria:

(a) With respect to the first point, consideration should be given to whether measures that will further increase the rate of effective tax are appropriate given New Zealand's headline corporate tax rate is

now relatively high by international standards, at a time when the general trend is rate reduction.

(b) With respect to the second point, the measures proposed in the BEPS discussion documents include layers of overlapping measures, which seek to address the same perceived problem in multiple different ways. The proposed interest rate cap is an example of this, since it would address the same concerns as are being addressed by proposed amendments to the transfer pricing rules (in particular the proposed power to align the rules with economic substance, to allow reconstruction of transactions and to refer to arm's length conditions as well as to the arm's length amount of consideration).

These measures reflect similar amendments that have been made to Australia's transfer pricing rules. Experience in Australia (see in particular the decisions of the Federal Court and more recently the Full Federal Court in the *Chevron Australia* case) suggests that concerns regarding high-priced debt can be addressed under the transfer pricing rules. Australia does not have and is not proposing a cap that would limit deductible interest expenditure to an amount that is less than an arm's length amount. For the reasons given below, New Zealand should not adopt such a rule either (or should do so only as a safe harbour).

3. LIMITING THE INTEREST RATE ON RELATED-PARTY LOANS (CHAPTER THREE)

First submission: interest rate cap should be adopted as a safe harbour only

Overview

3.1 New Zealand should not adopt an earnings-based (eg, EBITDA) thin capitalisation test (which would create significant volatility and uncertainty). The proposed interest rate cap could be adopted, but as a "safe harbour" only.

3.2 It is critical that the interest rate cap be adopted as a safe harbour only, because if not, the interest rate cap:

(a) would be inconsistent with OECD transfer pricing principles and the rules of other jurisdictions, and could therefore result in double taxation (where New Zealand denies a deduction under the cap, but there is no corresponding reduction in the amount of interest income subject to tax in the lender's jurisdiction) (see paragraphs 3.6 to 3.21 below);

(b) would make it difficult for certain regulated entities (such as banks and insurance companies) to comply with regulatory capital requirements (see paragraphs 3.22 and 3.23 below);

(c) would have the perverse result that the borrower could raise debt at a higher price from third parties than from its parent (see paragraphs 3.24 to 3.30 below); and

Russell McVeagh

(d) would, contrary to officials' assertion, require grandparenting provisions for existing arrangements (see paragraphs 3.31 to 3.33 below).

3.3 Adopting the interest rate cap as a safe harbour would alleviate the above concerns, by allowing a borrower to pay and obtain deductions for a higher rate of interest than that given by the cap if it can show that in its particular circumstances the arm's length rate of interest exceeds the cap. At the same time, it would retain many of the potential advantages of a cap (by providing an incentive to taxpayers to price related party debt conservatively in order to reduce uncertainty and potential disputes with Inland Revenue).

3.4 Any concern that (if the interest rate cap is a safe harbour) taxpayers could seek to adopt a rate exceeding an arm's length rate can be addressed under the transfer pricing rules. Reforms to those rules have been proposed in a separate discussion document ("BEPS – Transfer pricing and permanent establishment avoidance" (March 2017)) ("**TP and PE Discussion Document**"). We submit that the proposed changes to the transfer pricing rules (subject to our comments in our separate submission in respect of that discussion document) are sufficient to address the concerns officials have with the use of high-priced debt.

3.5 If required, the safe harbour could be buttressed by additional procedural protections for Inland Revenue. For example, taxpayers that do not follow the safe harbour could be required to make a disclosure in their returns so that Inland Revenue is on notice in respect of debt being priced over the cap.

Interest rate cap is inconsistent with OECD transfer pricing principles and with New Zealand's double tax agreements

Inconsistencies between interest rate cap and OECD transfer pricing principles

3.6 The proposed interest rate cap is inconsistent with OECD transfer pricing principles, because it would take no account of:

(a) the relationship between the ultimate parent and the subsidiary in the particular case (instead assuming that a "one-size-fits-all" adjustment, such as a one notch downgrade, is appropriate in all cases due to implicit credit support from the parent);

(b) the actual terms of the related-party debt, including subordination, convertibility, tenor (where exceeding five years) and other terms allocating risk between the borrower, lender and third parties; or

(c) other relevant circumstances, for example, the fact that the subsidiary may have a different asset base or be in a different industry (and accordingly have a different risk profile) to that of the ultimate parent.

3.7 With respect to the first point (implicit parent credit support), international transfer pricing practice recognises that the differential in credit risk between a parent and a subsidiary will be a matter of fact and degree. This is confirmed in one of the leading cases (the Canadian Federal Court of Appeal's decision in *The Queen v General Electric Capital Canada Inc.* [2010] FCA 344). The Court in that case rejected the argument that implicit support from the parent company meant that an explicit guarantee had no value.

Russell McVeagh

3.8 The proposed interest rate cap would assume that in all cases the New Zealand subsidiary's assumed credit rating should be the same as that of its parent (less a "one-size-fits-all" adjustment, such as the one notch downgrade proposed). This would be inconsistent with the reality (recognised in the *General Electric Capital Canada* case) that there is no one size fits all approach, and that the facts and circumstances must be considered in each case to correctly determine the arm's length rate for the relevant arrangement.

3.9 With respect to the second point (that the proposed interest rate cap would disregard the actual terms of the related-party debt), OECD transfer pricing guidance makes clear that, other than in exceptional cases, pricing should be based on the terms of the actual transactions undertaken (OECD Transfer Pricing Guidelines for multinational enterprises and tax administrations, as amended by the BEPS Actions 8-10 2015 Final Reports entitled "Aligning Transfer Pricing Outcomes with Value Creation") ("**OECD TP Guidelines**") at [1.123]):[1]

> The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. **Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured**. …
>
> [Emphasis added]

3.10 The OECD TP Guidelines also indicate that every effort should be made to "ensure that non-recognition is not used simply because determining an arm's length price is difficult" (at [1.122]). On the face of it, that is what the interest rate cap seeks to do.

Consequences of inconsistency with OECD transfer pricing principles

3.11 If New Zealand adopts the interest rate cap (otherwise than as a safe harbour), and as a result denies deductions for interest on debt that is determined in accordance with OECD transfer pricing principles, this would result in double taxation, as the lender would not be entitled to a reduction in interest income in the jurisdiction in which its income is taxable.

3.12 It would also result in New Zealand breaching its obligations under the "Associated Enterprises" articles (typically Article 9) in its DTAs. Article 9(1) of the OECD Model Tax Convention reads:

> Where

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1 The amendments set out in the BEPS Actions 8-10 2015 Final Reports entitled "Aligning Transfer Pricing Outcomes with Value Creation" were approved for incorporation into the OECD TP Guidelines by the OECD Council on 23 May 2016: see http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm (accessed 19 April 2017).

Russell McVeagh

> a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly.

3.13 The proposed interest rate cap would breach this article because it would result in New Zealand including in the profits of the borrower, and taxing, amounts in excess of those which would accrue if its related party transactions were priced in the same way as transactions between independent enterprises.

3.14 The Discussion Document argues that the interest rate cap would not breach New Zealand's DTAs either on the basis that it is a "thin capitalisation" rule which "aims to approximate a similar overall level of interest expense for a taxpayer as would arise in arm's length situations" (paragraph 3.57) or that, to the extent going beyond a strict application of the arm's length principle, it is a "domestic anti-avoidance rule" which is permitted to override New Zealand's DTAs (paragraph 3.59).

3.15 We do not agree with this analysis. The proposed interest rate cap is neither a thin capitalisation rule nor a domestic anti-avoidance rule:

(a) The proposed cap is not a thin capitalisation rule, because thin capitalisation rules (including the EBITDA rule) determine the overall permissible levels of debt or equity funding of an entity, whereas the interest rate cap instead addresses the *pricing* of a *particular* loan.

(b) The proposed cap is not a domestic anti-avoidance rule, because anti-avoidance provisions require some threshold to be met so that the provision applies to transactions having tax-induced features altering the incidence of tax in some way (whereas the proposed interest rate cap is subject to no such threshold).

Rather, the proposed cap is simply a transfer pricing rule, but one that produces results inconsistent with OECD transfer pricing principles and is therefore inconsistent with Article 9 of New Zealand's DTAs.

3.16 The fact that the proposed cap would breach Article 9 is illustrated by two extracts from OECD commentary set out below.

3.17 The first relevant OECD commentary is the report entitled "Thin Capitalisation" (adopted by the OECD Council in November 1986 and published in OECD Model Tax Convention on Income and on Capital 2014 (Full Version) (Vol II, OECD Publishing, Paris, 2014) R(4)-1). This report indicates that thin capitalisation rules ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit (at paragraph 77):

> … the question whether Article 9 may inhibit the operation of … thin capitalisation rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this. One group of countries takes the view that where a provision similar to Article 9(1) is included in the convention, it simply prohibits an adjustment of the profits of the resident company to any amount exceeding the arm's length profit. Another group of countries takes the view that while Article 9(1) permits the adjustment of profits up to the arm's length amount it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. A third group, while accepting that there is an absence of such a prohibition in the language used, nevertheless takes the view that the practical effect of Article 9 must be to impose such a restraint. … **The Committee generally agreed that, in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit** …
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> [Emphasis added]

Accordingly, even if (which we do not accept) the interest rate cap were a thin capitalisation rule, it would still be required to be consistent with the arm's length principle in Article 9.

3.18 Second, and more recently, the OECD TP Guidelines make clear that adopting for transfer pricing purposes a non-elective safe harbour (ie, a cap) that is set below an arm's length rate without providing a mechanism for alleviating relief from the double taxation that could result would be inconsistent with double tax relief provisions of DTAs (OECD TP Guidelines at [4.115]):

> Where safe harbours are adopted unilaterally, care should be taken in setting safe harbour parameters to avoid double taxation, and the country adopting the safe harbour should generally be prepared to consider modification of the safe-harbour outcome in individual cases under mutual agreement procedures to mitigate the risk of double taxation. At a minimum, in order to ensure that taxpayers make decisions on a fully informed basis, the country offering the safe harbour would need to make it explicit in advance whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbour. **Obviously, if a safe harbour is not elective and if the country in question refuses to consider double tax relief, the risk of double taxation arising from the safe harbour would be unacceptably high and inconsistent with double tax relief provisions of treaties.**
>
> [Emphasis added]

3.19 This passage is directly relevant here, and is difficult to reconcile with the Discussion Document's assertion that the interest rate cap would not breach New Zealand's DTAs.

3.20 For completeness, there is nothing in the OECD BEPS Action 4 Final Report ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments") or in the OECD BEPS Actions 8-10 Final Reports ("Aligning Transfer Pricing Outcomes with Value Creation") which alters the position set out in the passages above, or indicates that the arm's length pricing rules under the OECD TP Guidelines should not continue to apply with respect to interest. Indeed, any suggestion that the OECD transfer pricing rules cannot apply to cross-border funding, or that the OECD BEPS project has in some way

"abandoned" the arm's length principle with respect to cross-border debt, would seem difficult to sustain. As the TP and PE Discussion Document itself explicitly acknowledges, "the new OECD [TP] guidelines have a particular focus on funding" (TP and PE Discussion Document, paragraph 5.30).

3.21 Adopting an interest rate cap that results in double taxation and breaches New Zealand's DTAs would create increased uncertainty and potential for disputes, for both taxpayers and Inland Revenue. This concern could be addressed by adopting the interest rate cap as a safe harbour, as this would provide a mechanism for alleviating double taxation where the interest rate cap gives a result inconsistent with OECD TP Guidelines.

Interest rate cap does not make sense where particular conditions are required for regulatory reasons

3.22 In addition to being inconsistent with New Zealand's DTAs, adopting an interest rate cap that does not take into account the actual terms of the relevant related-party debt would be problematic for entities such as banks or insurance companies, that have regulatory capital requirements that are satisfied by issuing debt on certain terms prescribed by the regulations. For example, New Zealand registered banks are required to raise capital meeting certain requirements with respect to their terms such as tenor (which may be required to be perpetual), subordination and convertibility or write-off. These features may be critical to the debt qualifying as regulatory capital, and so it would be anomalous and punitive for the interest rate cap to effectively disregard these features in pricing the debt for tax purposes.

3.23 If the interest rate cap were instead adopted as a safe harbour, this concern would not arise, as regulated entities would be able to elect not to apply the safe harbour, and could instead show that a higher rate should be allowed.

Interest rate cap could result in related-party debt being priced lower than third party debt

3.24 The proposed interest rate cap does not permit regard to be had to the particular terms of the related-party debt, including the fact that the debt may be subordinated, or may have a tenor exceeding five years. Given that New Zealand corporates do in fact issue debt on such terms to third parties, this could have the perverse result that a borrower could issue debt to third parties at a higher rate than to its parent.

3.25 We provide examples of third party debt that is subordinated, and/or has a term exceeding five years, below.

<u>Subordination</u>

3.26 As noted above, the proposed interest rate cap requires loans to be priced based on the credit rating for senior unsecured debt, without adjustment for the fact the related-party debt may be subordinated.

3.27 However, New Zealand corporates do issue subordinated debt to third parties. For example, Genesis Energy Limited has both subordinated and unsubordinated bonds on issue that are listed on the NZDX, being:

(a) subordinated capital bonds having a maturity date in 2041, and paying a coupon of 6.190% (NZDX code: GPLFA); and

Russell McVeagh

(b) unsubordinated bonds having a maturity date in 2022, and paying a coupon of 4.14% (NZDX code: GNE030).

3.28 For the interest rate cap to disregard (in pricing related-party debt) the fact that debt is subordinated, in circumstances where corporates do in fact issue subordinated debt to third parties (as illustrated above), would be inconsistent with OECD transfer pricing principles and have the perverse result that New Zealand corporates could issue subordinated debt to third parties at a higher interest rate than to a related party.

Tenor exceeding five years

3.29 The Discussion Document proposes that a related-party loan with a term of longer than five years will be treated as having a term of five years for the purpose of determining the appropriate interest rate under the interest rate cap. This is based on the incorrect assertion that "it is unusual for a commercial loan to be committed for longer than five years" (at paragraph 3.53). In fact:

(a) in addition to the Genesis example given above, there are currently over 40 instruments[2] listed on the NZDX that have maturity dates after April 2022 (and therefore were issued with a term of more than 5 years) or are perpetual. These are set out in the Appendix to this submission;

(b) as noted above, for regulatory reasons it may be necessary to issue debt having a tenor exceeding five years. For example, in order for debt issued by New Zealand registered banks to qualify as Additional Tier One capital, it must be perpetual;

(c) we understand that in practice, a senior lender may require that any debt issued by a borrower have a tenor at least as long as that of the senior debt (so that the related party debt cannot be repaid before the senior debt).

3.30 These issues would not arise if the interest rate cap were adopted as a safe harbour, because (where appropriate) a taxpayer would be able to price related-party debt taking into account the above features.

Grandparenting provisions should apply if interest rate cap adopted other than as safe harbour

3.31 The Discussion Document indicates that existing related-party cross-border debt will be subject to the interest rate cap, with the relevant rate required to be determined based on historic interest rate data for the day on which the interest rate was struck (see paragraphs 3.54 and 3.55).

3.32 We submit, however, that grandparenting rules should be included so that the proposed cap does not apply to arrangements entered into prior to enactment of the relevant amending legislation. There are two reasons for this:

(a) Interest rate cap will apply to non-wholly owned groups: First, the definition of related-party debt to which the interest rate cap would

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2 Note that certain of the instruments listed on the NZDX and included in this figure are preference shares. In addition, while we have not analysed the terms of each of the instruments listed, certain of them could be expected to include rights of repayment, or interest rate resets, prior to their stated maturity date.

apply is broad. It includes arrangements where the borrower and lender are not commonly owned, such as where the lender is a member of a non-resident owning body, or where a limited partner lends to a partnership in which it has a 25% partnership share. It cannot be assumed that the borrower and lender will be in a position to easily renegotiate the terms of that loan at a lower interest rate. Where the interest rate cannot be renegotiated, this would likely result in double taxation (in that a portion of the interest would be non-deductible to the borrower, but assessable to the lender).

(b) Restrictions in lender's jurisdiction may prevent renegotiation of existing debt: Second, even in the case of debt lent within a wholly-owned group, issues could arise in the jurisdiction in which the lender is taxed if the borrower and lender renegotiate the terms of existing debt without payment of a break fee, due to the need for the lender (under the transfer pricing rules of the lender jurisdiction) to act at arm's length from the borrower.

For example, suppose a wholly-owned New Zealand subsidiary had entered into a loan agreement under which it agreed to pay to its Australian parent for a ten year term an interest rate of BKBM plus a fixed margin (say, 4%). Suppose that this margin had been determined in accordance with OECD transfer pricing principles, but that under the proposed interest rate cap, the margin would be just 2%. The Australian Tax Office might argue that a third party lender acting at arm's length arguably would not agree to a reduction in the margin without receiving a break fee from the borrower. It might therefore seek to increase the lender's income by an amount equal to such break fee, or simply ignore the reduction in interest rate. In either case, double taxation would arise.

3.33 These issues would not arise (and grandparenting provisions would not be required) if the interest rate cap were adopted as a safe harbour, because the interest rate cap would be elective for the taxpayer.

Second submission: if the interest rate cap is adopted as a safe harbour, it should be buttressed by other measures to increase certainty and reduce compliance costs

3.34 If the interest rate cap is adopted as a safe harbour, this has the potential to reduce uncertainty and compliance costs for taxpayers and Inland Revenue. However, some uncertainty and compliance costs will remain.

3.35 That is because, in order to apply the interest rate cap, it will be necessary to both:

(a) determine the credit rating of the ultimate parent for senior unsecured debt (or the credit rating the ultimate parent would have, if it issued debt; or the credit rating the New Zealand group would have if there was no ultimate parent); and

(b) determine, for the tenor of the related-party debt, the arm's length price corresponding to the credit rating identified at paragraph (a) above.

3.36 There is potential for uncertainty at both stages of the inquiry: first, when determining a credit rating (where the ultimate parent does not have one, or

there is no ultimate parent), and second in determining the interest rate corresponding to that credit rating.

3.37 With respect to this second step, the Discussion Document indicates that regard should be had to the yield derived from "appropriate" senior unsecured corporate bonds, and explains that (at paragraph 3.23, footnote 11):

> … the margin on bonds at the same credit rating can vary across industries. A taxpayer should be able to demonstrate that their choice of comparator bonds is appropriate.

3.38 In the New Zealand debt market, there will often be no comparable that perfectly matches a given loan's credit rating, tenor and industry. It will therefore often be necessary to either use a less-close domestic comparable, or use an international comparable (eg, US bonds) and undertake a currency conversion. In either case, uncertainty and disputes can arise as to the appropriate comparable to use, and the appropriate adjustments to make. Indeed, it may be that there is more than one correct interest rate, depending on what comparables and methodology the taxpayer (or Inland Revenue) chooses to adopt.[3]

3.39 Accordingly, we submit that:

(a) the existing safe harbour credit margin published by Inland Revenue (being, currently, 250 basis points over the relevant base indicator, where a group of companies has cross-border related-party debt totalling less than $10m principal in the relevant year) should be retained.[4] This means that for very low value loans, it will not be necessary to undertake the detailed analysis described at paragraphs 3.35 to 3.38 above); and

(b) for loans having a principal value below a certain monetary threshold (eg, $50m), Inland Revenue should publish (and periodically update) tables setting out safe harbour guidance as to the credit spread that corresponds to each possible credit rating and tenor. This would alleviate the uncertainty and compliance costs that would otherwise arise when applying the second step in the analysis under the interest rate cap (described at paragraph 3.35(b) above), and therefore provide further incentive for taxpayers to adopt the interest rate cap.

4. TREATMENT OF NON-DEBT LIABILITIES (CHAPTER FOUR)

General comment

4.1 As a general comment, we note that the proposed adjustment for non-debt liabilities will effectively result in a reduction in the permitted debt-to-assets percentage for taxpayers. In other words, the proposed change is not merely a minor clarification to the way in which assets and liabilities are calculated (which could be beneficial for some taxpayers and not for others), but will in all

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3 It is for this reason that, currently, Inland Revenue bears the burden of proving that their method is more "reliable" than the taxpayer's in transfer pricing cases (section GC 13(4)). But this protection will not, as we understand it, apply with respect to the interest rate cap, and is proposed to be removed in transfer pricing cases generally.

4 See http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html.

cases where it applies result in an increased debt-to-assets ratio for the taxpayer.

4.2 The proposal is therefore one which will (in combination with the other proposals included in the BEPS discussion documents released in March 2017, and other amendments to international tax rules in recent years) further increase the tax burden imposed on foreign investment into New Zealand. Officials should take this into account in any analysis undertaken to determine the overall impact of proposed reforms on the cost of foreign investment in New Zealand, and should consider whether other taxpayer favourable changes (for example, permitting off-balance-sheet assets to be included in assets for thin capitalisation purposes) would also be appropriate.

First submission: taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities

Overview

4.3 The Discussion Document indicates (at paragraph 4.5) that out-of-the-money derivatives are an example of a non-debt liability that does not count as debt for thin capitalisation purposes, and so should be subtracted from assets in performing the thin capitalisation calculation.

4.4 This would exacerbate an existing issue that arises under the thin capitalisation rules, namely that fluctuations in the fair value of a financial arrangement (where the taxpayer applies the fair value method under IFRS) can lead to changes in the debt-to-assets ratio for thin capitalisation purposes from year to year. Accordingly, we submit that taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities

Example

4.5 We set out below an example of the volatility that could be created by the proposal to treat an out-of-the-money derivative valued at fair value (in this case, an interest rate swap) as a "non-debt liability".

4.6 Suppose on day one a taxpayer has assets of $170m, has borrowed $100m at a floating interest rate that is hedged under a fixed-floating interest rate swap, and $70m of equity. Suppose interest rates change, and the swap becomes out-of-the-money and so is recorded as a liability in the taxpayer's accounts (say, a liability of $30m). The taxpayer's balance sheet following the change in interest rates would therefore be as follows:

Assets		Liabilities and equity	
Assets	$170m	Loan	$100m
		Interest rate swap	$30m
		Equity	$40m

4.7 Under current law, the taxpayer's debt-to-assets ratio would remain, as on day one, 100/170 = 0.58 (ie, no breach of the thin capitalisation threshold). However, under the proposed change, its debt-to-assets ratio would have risen to 100/140 = 0.71 (ie, a breach of the thin capitalisation threshold).

4.8 Changes in the market value of the swap could therefore result in the taxpayer breaching the thin capitalisation threshold in a particular year. Notably,

however, if interest rates changed again (and the interest rate swap became an asset the following year), there is no "wash-up" mechanism for the taxpayer to reclaim the previously denied interest deductions in the following year.

Proposed solution

4.9 We submit that taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities. This would enable taxpayers to ensure that fluctuations in fair value (for those taxpayers applying fair value to an asset or liability under IFRS) do not lead to fluctuations from year to year in debt-to-asset ratios due solely to changes in the fair value of an asset or liability.

4.10 The exclusion should be:

(a) at the election of the taxpayer. That is because making the election could lead to increased compliance costs for the particular taxpayer, and may not be appropriate for all taxpayers in all cases;

(b) on a class basis. That is, the taxpayer should be required to make the election with respect to a class of derivatives. For example, a taxpayer might elect that the exclusion:

(i) applies to interest rate swaps (see the above example); but

(ii) does not apply to cross-currency swaps (on the basis that unlike interest rate swaps, fair value movements in the currency swap may match changes in the NZD value of a foreign currency loan, and so in fact act to prevent rather than increase fluctuations in debt-to-asset ratios caused by currency movements).

4.11 The requirement that elections are made on a class basis rather than in respect of particular financial arrangements will prevent taxpayers "picking and choosing" which particular financial arrangements the exclusion applies to based on whether that financial arrangement is likely to be an asset or liability. Restrictions on the ability to change the election between income years could also be included.

Second submission: RPS and deferred tax liabilities should be excluded from "non-debt liabilities"

4.12 The Discussion Document proposes to subtract interest-free shareholder loans from "non-debt liabilities" (at paragraph 4.22). We support the exclusion of interest-free shareholder loans, and submit that, in addition, the following should also be excluded from the definition of "non-debt liabilities":

(a) RPS;

(b) deferred tax liabilities. That is because deferred tax liabilities do not represent true liabilities in the same way as, for example, amounts owed to trade creditors. Rather, they result from differences between the tax and accounting treatments of amounts.

4.13 In the case of deferred tax liabilities, we submit that, instead, both deferred tax assets and deferred tax liabilities should be excluded from the measurement of

Russell McVeagh

total assets and total debt. This would align with the position in Australia (see the Income Tax Assessment Act 1997 at section 820-682).

5. OTHER MATTERS (CHAPTER FIVE)

5.1 The net current valuation method should not be removed from the list of available asset valuation methods. If officials are concerned that net current values adopted under this method are inaccurate, rather than removing the method, a requirement to obtain an independent valuation when applying the method could be introduced.

Yours faithfully
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APPENDIX

NZDX LISTED INSTRUMENTS WITH MATURITY DATE POST-APRIL 2022[5]
(See paragraph 3.29(a) of submission)

Company	NZDX code	Freq.	Coupon (%)	Maturity
ANZBANKNZ	ANBHA	2	5.28	Perpetual
ANZBANKNZ	ANBHB	4	7.2	Perpetual
CAS	CASHA	4	5.04	Perpetual
FONTERRA	FCGHA	4	4.38	Perpetual
INFRATIL	IFTHA	4	3.63	Perpetual
Kiwi Funding	KCFHA	4	7.25	Perpetual
MOTORFINANCE	MTFHC	4	4.47	Perpetual
NUFARM	NFFHA	2	5.89	Perpetual
QUAYSIDE	QHLHA	4	4.32	Perpetual
RABOBANK	RBOHA	4	2.88	Perpetual
RABOCAPITAL	RCSHA	4	8.34	Perpetual
WORKSFINANCE	WKSHA	4	6.29	Perpetual
IAG	IAGFB	4	5.15	15/06/2043
GPL	GPLFA	4	6.19	15/07/2041
LGFA	LGF080	2	3.5	14/04/2033
LGFA	LGF060	2	4.5	15/04/2027
SparkFinance	SPF570	4	3.94	7/09/2026
AUCKCITY	AKC100	2	3.34	27/07/2026
WGTNAIR	WIA050	2	5	16/06/2025
LGFA	LGF070	2	2.75	15/04/2025
WGTNAIR	WIA040	2	4	5/08/2024
NZXR	IFT230	4	5.5	15/06/2024
AUCKCITY	AKC070	2	5.81	25/03/2024
MERIDIAN	MEL040	2	4.88	20/03/2024
AUCKAIR	AIA210	2	3.97	2/11/2023
Z ENERGY	ZEL050	4	4.32	1/11/2023
INFRATIL	IFT210	4	5.25	15/09/2023
KiwiProperty	KPG020	2	4	7/09/2023
ANZBANKNZ	ANB130	2	3.71	1/09/2023
BNZBANK	BNZ110	2	4.1	15/06/2023

5 Source: http://www.anzsecurities.co.nz/directtrade/dynamic/fixedinterest.aspx, accessed 11 April 2017.

Russell McVeagh

WGTNAIR	WIA030	2	4.25	12/05/2023
NZGOVERN	GOV410	2	5.5	15/04/2023
LGFA	LGF050	2	5.5	15/04/2023
MERIDIAN	MEL030	2	4.53	14/03/2023
SparkFinance	SPF560	4	4.51	10/03/2023
FONTERRA	FCG040	2	4.42	7/03/2023
TRUSTPOWER	TPW150	4	4.01	15/12/2022
CONTACT	CEN040	4	4.63	15/11/2022
AUCKAIR	AIA200	2	4.28	9/11/2022
AIRNZ	AIR020	2	4.25	28/10/2022
SKYCITY	SKC040	4	4.65	28/09/2022
Transpower	TRP040	2	4.07	16/09/2022
Transpower	TRP030	2	4.3	30/06/2022
GMT BOND	GMB030	2	5	23/06/2022
INFRATIL	IFT190	4	6.85	15/06/2022