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Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
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Dear Cath

BEPS – Strengthening our interest limitation rules

Deloitte ("We" or "Our") is writing to submit on Chapter 3 of the Government Discussion Document of March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document). For all other aspects of the Discussion Document, we support the submissions made by the Corporate Taxpayers Group.

We appreciate the opportunity to submit on this Discussion Document and would be happy to meet with Officials to discuss any of the matters raised in this submission further.

Summary

We submit that:

The problem of excessive interest rates identified by the Discussion Document should be addressed through the application of transfer pricing rules and the arms-length principle. Proposed changes to transfer pricing rules and guidelines that New Zealand has separately proposed to adopt, should themselves resolve the problem of excessive interest rates.

The proposed approach, capping allowable interest based on a five year term and on the interest rate that would apply to an associate parent entity when raising senior unsecured short term debt, is inconsistent with the OECD's recommended approach, the rest of the world (ROW) approach (including Australia) and with commercial practice. It also seems to be inconsistent with double taxation agreements. A poorly targeted thin capitalisation regime that is out of step with the ROW will undermine New Zealand's ability to attract capital for higher risk and longer term investments. It also creates the potential for double taxation.

A parent company's credit rating is relevant to related debt in only very limited circumstances, where the parent guarantees lending arrangements. It should not be arbitrarily applied to all related party debt without regard to the ability of the parent company to control the subsidiary and to provide credit support to the subsidiary.

In any event, any changes made should be subject to grandparenting, due the long term nature of existing investments which have been made in reliance on the existing thin capitalisation rules and which cannot be easily unwound. The regime should not penalise compliant taxpayers within the 60% thin capitalisation threshold. In our view, the appropriate treatment would be for arrangements entered into prior to the date of enactment to be excluded from any new rules.

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Interest rates should be governed by transfer pricing and the arms-length principle

An interest rate cap is proposed to limit allowable interest deductions on non-commercial loans. We submit that changes to transfer pricing rules and guidelines that New Zealand has separately proposed to adopt (including those in the Inland Revenue's transfer pricing discussion document: *BEPS – Transfer Pricing and Permanent Establishment Avoidance*), should themselves resolve any problem of excessive interest rates On non-commercial loans. Under the new proposals, transfer pricing will require consideration of the interest rates, quantum of debt and the terms of the debt. In other words, price (interest rate), quantum (level of gearing) and the terms of the debt need to be considered from a commercial perspective in an integrated approach. Moreover, transfer pricing will seek to disregard the legal form if it does not align with economic substance.

If the interest rate cap proposal is adopted in its current form, it would itself give rise to a result that is inconsistent with a comparable third party transactions and would price debt on an uncommercial basis.

The proposed approach is inconsistent with the OECD's recommended approach and inconsistent with the rest of the world approach

The Discussion Document approach is different from the OECD's recommended EBITDA approach for limiting interest deductibility.

The proposed approach is also inconsistent with the rest of the world approach. In general the rest of the world has "thin cap rules" to determine the overall level of deductible debt or quantum (i.e. 60% of assets/net assets as the safe harbour which is a variant to the EBITDA approach). It is then up to the "transfer pricing" rules to determine arms-length rate.

As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". We submit there is no rational basis for New Zealand to be out of step with the ROW by not applying the arms-length standard.

Australia applies transfer pricing to limit related party cross border interest rates and in doing so can adjust such rates in accordance with identified uncommercial terms along the lines set out in the Discussion Document - the loan being highly subordinated, repayable on demand, having extremely long terms, convertible into shares.

The Australian thin capitalisation rules, including using an arms-length approach for setting maximum debt levels, were recently subject to a comprehensive review by the Australian Board of Taxation[1]. This concluded that the arms-length test is the "central plank of the thin capitalisation rules". While further changes in Australia are possible, we expect the approach to be adopted will be for a parent company's credit rating to be just one factor to be considered, where relevant, when determining whether an interest rate is an arms-length rate. A like approach could be adopted in New Zealand by including reference to the interest rate cap and the five year loan term in the proposed guidelines for the purpose of assessing transfer pricing risk in respect of related party loans.

The proposed approach will raise the possibility of international double taxation

The issues identified above will also increase the risk of international double taxation. For example, New Zealand denies an interest deduction to a parent and in effect treats part of the interest as a non-deductible dividend. The parent company is taxed on interest but not dividends. It could also give rise to a taxable interest stream in a foreign subsidiary which follows the arm's length standard but a denial of interest deductions to the NZ parent.

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[1] Australian Board of Taxation[1] – Review of the Thin Capitalisation Arms-Length Debt Test December 2014

Adjusting interest deductions within the transfer pricing framework has the very significant advantage of incorporating measures to reduce the risk of double international taxation. If the New Zealand adjustment to interest deductibility is made under transfer pricing rules then under paragraph 2 of Article 9 of the Model convention a collateral adjustment is required by the parent company jurisdiction so as to avoid double taxation. No such adjustment seems possible under the approach proposed in the Discussion Document.

The proposed changes go beyond the problem identified in the Discussion Document

The policy concern that underlies the thin capitalisation rule changes is that debt can be substituted for equity so that what would in the absence of tax be taxed as an equity return (28% plus any NRWT) is instead taxed at the much lower rates on interest.

We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent, there is an increased risk associated with parent lending which may be used to justify a higher interest rate while not altering the parent's overall investment risk. The underlying assumption in the Discussion Document seems to be that a parent would borrow from third parties using its better credit rating and then on-lends the funds to its subsidiary; and the parent has an implicit duty to support its subsidiary.

However, in most circumstances this assumption will not apply, for example:

> Where an offshore entity does not control or hold all of the shares in the New Zealand entity. The thin capitalisation ownership test does not properly target control of subsidiaries and for example under current rules, non-voting preference shares can be attributed control ownership status;
>
> An offshore parent (such as a Unit Trust) that is precluded by regulatory or fiduciary obligations from providing support to the subsidiary entity; or
>
> Institutional investors which will shield themselves from stand-alone investment risk so as to limit risks to the fund's overall exposure, as part of the "enterprise risk management policy".

In these cases the commercial cost of funds of the New Zealand entity will not reflect the cost of funds of any overseas investor in that entity.

We submit that any interest cap based on the parent's cost of borrowing should be limited to situations where any increase in debt risk can reasonably be viewed as not altering the overall risk assumed by any investor so that the increased interest rate can in substance be viewed as a dividend return on equity. This will clearly not be the case for non-controlled entities and where there are legal, regulatory or other prohibitions to providing support to the New Zealand entity.

Further, the Discussion Document proceeds on the basis that a term over 5 years is uncommercial. Limiting the term to 5 years will give rise to pricing which is not consistent with comparable third party transactions noting that debt instruments such as bonds, tend to have terms exceeding five years. Longer term debt instruments are clearly relevant for longer term investments. We submit that the arbitrary five year term should be removed. The term of the loan should be determined by reference to arms-length standards.

The proposed approach will result in interest adjustments beyond the problem identified in the Discussion Document and will make New Zealand less attractive as an investment destination. The economic costs of unduly restricting the deductibility of the interest costs of New Zealand enterprises are, in our view, high.

Grandparenting

We submit that, if any changes are to be made, they should be subject to grandparenting. Significant investment decisions have been made based on existing settings and a lot of these arrangements involve external commitments (not necessarily internal group arrangements) that cannot be easily unwound.

Uncertainty and risk is of course inherent in any investment, particularly for long term investments. However, the impact of the proposals in the discussion document, if enacted in their current form, would materially affect the post-tax return on significant investments. This would also undermine the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand projects in the future.

As a result, we submit that the proposals, if enacted, should include grandparenting. In our view, the appropriate treatment would be for arrangements entered into prior to the date of enactment to be excluded from any new rules.

Concluding remarks

We have strong reservations about the proposed changes to New Zealand's thin capitalisation regime and in particular on the departure from the arms-length basis which is the global transfer pricing standard.

For any queries in relation to this submission, please contact Teresa Farac (09 303 0845).

Yours sincerely

Teresa Farac
Partner
for Deloitte Limited *(as trustee for the Deloitte Trading Trust)*