28 April 2017

c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Policy.webmaster@ird.govt.nz

Dear Deputy Commissioner,

Submission on the discussion document "Strengthening our interest limitation rules"

Thank you for the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on the *BEPS – Strengthening our interest limitation rules Government discussion document* (the **Discussion Document**). We also appreciate discussion held to date with Officials in respect of the Discussion Document.

ANZ Bank New Zealand Limited (**ANZ**) recognises and supports the Government and IRD Official's work to combat base erosion and profit shifting out of New Zealand using excessively priced related party debt. ANZ considers that any such rules must appropriately balance combatting aggressive behaviour but not extend so far as to limit genuine commercial behaviour. If such a balance is not appropriately struck, the New Zealand economy will suffer through inefficient importation of capital, particularly compared to New Zealand's competitors of imported capital.

The reality of this balance for New Zealand is highlighted at paragraph 1.4 of the Discussion Document:

> *"While the majority of firms subject to the thin capitalisation rules have taken conservative debt positions, there is a minority that engages in more aggressive tax practices. Of particular concern is that some firms have borrowed from their foreign parent at high interest rates, resulting in very large interest deductions in New Zealand. A proposal to address this is discuss in chapter 3.*

It is chapter 3 of the Discussion Document that is the focus of ANZ's submission.

In summary, ANZ considers that the proposals in chapter 3 do not strike the appropriate balance referred to above. While the proposals may appropriately combat the minority of aggressive taxpayers, the blanket approach of the proposals will also penalise taxpayers that apply commercial terms and rates to cross border related party debt, in particular the banking industry where such debt, due to regulatory necessity, is priced above a senior unsecured rate. Such an imbalance has the very real effect of placing inefficiencies on importing capital.

Summary of key submission points

Our submissions, summarised below, focus on the impact of the proposed interest rate limitation on New Zealand registered banks. We provide further context to our submissions in Appendix 1.

1. The proposed interest rate limitation should not apply to New Zealand banking groups:

    - New Zealand banking groups are subject to significant prudential regulation that limits the level of, and requires arm's length pricing for, cross border related party funding. As such New Zealand banking groups do not present the risk that the proposed rules are seeking to target.
    - Bank regulatory capital, as a significant portion of funding from offshore parents, would become inefficient to raise if the proposals applied to New Zealand banking groups, resulting in tax outcomes that do not reflect commercial and regulatory positions, a disadvantage for New Zealand banking groups compared to other industries and double taxation.
    - Excluding New Zealand banking groups from the proposals would not be contrary to the position adopted by the OECD for the banking industry.

2. If our above submission is not accepted, we consider that the interest limitation proposals should apply as a safe harbour only and not over ride application of the transfer pricing rules.

3. If, contrary to the above submissions, the interest limitation proposals proceed, we submit that the limitation should not apply to related party debt arrangements in existence at the date of enactment of the amending legislation.

4. ANZ submits that funding from offshore branches of New Zealand banking group entities are not caught within the proposed rules.

5. ANZ submits that ongoing consultation of the interest limitation proposals continue before a Bill is introduced into Parliament.

About ANZ

ANZ is the largest financial institution in New Zealand and is a regulated bank subject to prudential supervision by the Reserve Bank of New Zealand (**RBNZ**). The ANZ group comprises brands such as ANZ, UDC Finance, ANZ New Zealand Investments, ANZ New Zealand Securities and Bonus Bonds.

ANZ offers a full range of financial products and services including a significant range of financial advisory services, personal banking, institutional banking and wealth management services.

Publication of submission

ANZ requests that this submission on the Discussion Document is kept confidential by the IRD on the grounds of commercial sensitivity.

Contact for submission

ANZ welcomes the opportunity to discuss any of our submissions directly with IRD officials. Please contact me on 9(2)(a) [redacted] if you would like to discuss our submission further.

Once again, we thank IRD for the opportunity to have input into the proposals on the proposals to strengthen New Zealand's interest limitation rules and look forward to ongoing consultation on this issue.

Yours sincerely

Philip Leath
GM Tax, New Zealand
ANZ Bank New Zealand Limited

APPENDIX 1 - Submission points

1. **The proposed interest rate limitation should not apply to New Zealand banking groups:**

    - **New Zealand banking groups are subject to significant prudential regulation that limits the level of, and requires arm's length pricing for, cross border related party funding. As such New Zealand banking groups do not present the risk that the proposed rules are seeking to target.**
    - **Bank regulatory capital, as a significant portion of funding from offshore parents, would become inefficient to raise if the proposals applied to New Zealand banking groups, resulting in tax outcomes that do not reflect commercial and regulatory positions, a disadvantage for New Zealand banking groups compared to other industries and double taxation.**
    - **Excluding New Zealand registered banks from the proposals would not be contrary to the position adopted by the OECD for the banking industry.**

1.1 ANZ considers the core premise behind the interest limitation proposals is that an offshore parent's average cost of funding is an appropriate approximation of the cost of funding for its New Zealand subsidiary, at least in respect of cross border related party funding. Relevantly, paragraphs 3.24 and 3.25 of the Discussion Document state:

> *"We consider that the interest rate that a multinational could obtain when raising senior unsecured debt (either determined with reference to its credit rating, or calculated based on other factors) is a reasonable approximation of the multinational's cost of funds."*
>
> *"This proposed rule would therefore anchor the deductible interest rate on intra-group debt to a multinational's actual cost of debt. We consider this reasonable. For example, one funding option available to a multinational would be to raise third-party debt and on-lend the debt to its New Zealand subsidiary.* ***We consider it unlikely that the multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational's cost of debt, since this would lower its overall profits."***

[emphasis added]

Such a premise appears to assume that the majority of funding for the New Zealand subsidiary is obtained from its offshore parent, the New Zealand subsidiary would only source, in an economic sense, senior unsecured debt and that there is a choice as to the form or legal terms of related-party debt issued to an offshore parent. This may well be the case for some foreign owned New Zealand corporates. Such a premise, however, is not the case for the ANZ New Zealand banking group.

ANZ's Source of funding

1.2 ANZ predominantly obtains its funding from 3 sources:

- capital (comprising ordinary equity and retained earnings (collectively common equity tier 1 capital) and other bank regulatory capital);
- domestic deposits; and
- offshore and onshore wholesale funding.

1.3 From an ANZ New Zealand geographic perspective, the level of debt funding from the ultimate offshore parent (including offshore subsidiaries) is ~2.4% of its total debt funding[1].

Regulation on funding sources

1.4 ANZ's source of funding is subject to significant prudential regulation. ANZ faces regulation from both the Australian Prudential Regulation Authority (**APRA**) and the RBNZ in respect of the limits and pricing of related party debt.

1.5 APRA's prudential standard APS 222 (Associations with Related Entities)[2] limits an Australian Authorised Deposit Taking Institutions' (**ADIs**) exposure to related ADIs (including overseas based equivalents) to 50% of the amount of the Australian ADI's Level 1 regulatory capital. APRA has imposed further limits on an Australian ADI's exposures to certain New Zealand foreign owned banks which require that, by 1 January 2021, no more than 5% of the Australian ADI's Level 1 Tier 1 Capital comprise non-equity exposures to its New Zealand operations (excluding regulatory capital instruments, which we address further below). As a result, the ANZ New Zealand group (including the New Zealand holding company) can only obtain a minority of its funding from its offshore parent.

1.6 The RBNZ impose various regulations that directly and indirectly impact the source of funding for New Zealand banks. New Zealand registered banks are required to maintain core funding ratios (refer RBNZ Document BS13 – Liquidity Policy)[3]. Broadly, core funding ratios (**CFR**) require banks to have diversity over sources of funding to manage appropriate liquidity within the New Zealand financial system. The calculation of CFR includes a preference for funding from deposits over wholesale funding (which, for CFR purposes, includes related party funding). In addition, a condition of registration for ANZ for New Zealand banking prudential purposes is that *"the bank's constitution must not contain any provision permitting a director, when exercising powers or performing duties as a director, to act other than in what he or she believes is in the best interests of the company (i.e. the bank)"*. This requirement logically requires ANZ to act on arm's length with its offshore parent and cannot deliberately source uncommercial or excessively priced related party debt, for doing so would not be in the best interests of ANZ.

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[1] From 30 September 2016 Australia and New Zealand Banking Group Limited – ANZ New Zealand Registered Bank Disclosure Statement (excludes debt allocated from ultimate parent to NZ Branch of ultimate parent, which must be reduced to ensure compliance with APRA's APS 222 standard by 1 January 2021).

[2] Australian Prudential Standard APS 222: Associations with related entities, January 2015, available at: http://www.apra.gov.au/CrossIndustry/Documents/141120-APS-222.pdf

[3] RBNZ Document BS13 regarding reporting of liquidity policy, including core funding ratios, available at http://www.rbnz.govt.nz/regulation-and-supervision/banks/prudential-requirements/liquidity-policy

1.7 ANZ considers that such prudential regulation strongly mitigates the risk that the proposals seek to counter.

Bank regulatory capital

1.8 A primary source of ANZ's debt funding from its offshore parent bank is regulatory capital. Regulatory capital contains unique features which are required by prudential regulators (often both RBNZ and APRA). The RBNZ framework for bank regulatory capital as set by the Basel Committee (referred to as the Basel III framework) requires banks to hold 10.5% bank regulatory capital over risk weighted exposures, at least 7.0% of which must comprise Common Equity Tier 1 (**CET1**) Capital (i.e. ordinary shares and retained earnings).

1.9 A bank's regulatory capital can also comprise Additional Tier 1 (**AT1**) and Tier 2 (**T2**) capital, provided such capital complies with the prudential regulations. These regulatory requirements include subordination, permanence, flexibility of payment and loss absorbency measures. These are mandatory requirements. From a cost of capital perspective, CET1 is the most expensive, followed by AT1 and then T2. As such, ANZ holds a mix of such bank regulatory capital for economic cost of capital reasons. ANZ has issued AT1 instruments ranging in tenor from 5 to 10 years before any redemption can be made, subject to RBNZ (and where relevant APRA) approval. As a consequence of the mandatory regulatory features, AT1 and T2 instruments are priced above senior unsecured debt.

1.10 While ANZ has issued regulatory capital instruments to the New Zealand market, the New Zealand market is not sufficiently deep or liquid to absorb the regulatory capital needs of all New Zealand banks (including ANZ). Consequently, it is necessary that regulatory capital funding is obtained from international markets. It is often preferable for ANZ to access offshore markets for regulatory capital through its foreign parent rather than doing so directly for the following reasons:

i. ANZ would not issue direct into the Australian market as doing so places ANZ in direct competition with its parent (who also regularly accesses the Australian market for its regulatory capital requirements).

ii. Bank regulatory capital issued directly by ANZ into the market will not count as Level 1 capital for our ultimate Australian parent (Level 1 capital is preferable). Further, our parent bank incurs a haircut or reduction in the amount of regulatory capital it can recognise for any regulatory capital externally issued by ANZ.

iii. If our parent issues regulatory capital externally and provides regulatory capital to ANZ, only one set of regulatory rules applies to each capital instrument (i.e. APRA for the parent issued instrument and RBNZ for the ANZ issued instrument). By comparison, if ANZ issues regulatory capital externally both APRA and RBNZ rules apply to that single instrument creating significant complexity and cost in applying 2 sets of regulatory rules which are not perfectly aligned.

iv. It is more economic for ANZ's foreign parent to raise regulatory capital in the international markets and then provide that regulatory capital to ANZ than it is for ANZ to issue regulatory capital direct into international markets. For completeness and as noted above, the Board of the New Zealand registered bank would only issue bank regulatory capital to its parent an arm's length to ensure the Board is acting in the best interest of the New Zealand registered bank.

1.11 At this point, it is worth noting that ANZ is owned 100% by a New Zealand holding company which, in turn, is ultimately 100% owned by our Australian parent ADI. Where ANZ's foreign parent provides regulatory capital to ANZ, this could occur by providing non-regulatory debt funding to the New Zealand holding company which then provides the regulatory capital funding to ANZ. The debt funding to the New Zealand holding company cannot be regulatory capital as the New Zealand holding company is not a registered bank. However, such debt should closely mirror the terms, and therefore pricing, of the regulatory capital issuances. If this was not the case (for example if the debt from the offshore parent to the New Zealand holding company was senior unsecured debt) the New Zealand Holding company could be left in a position that if interest is not paid on the regulatory capital it holds in ANZ (as noted above, interest on regulatory capital is subject to flexibility of payment and must be non-cumulative) it would still have interest payable on the debt it has issued to the offshore parent. This would present a non-commercial outcome and present risks of insolvency for the Board of the New Zealand holding company. Equally the offshore parent holding the debt in the New Zealand holding company would end up in a position of having borrowed at a higher interest rate but having on-lent at a lower interest rate, creating an uneconomic and uncommercial outcome, again presenting issues for the Board of the offshore parent company. The use of a New Zealand holding company, as above, should result in a similar position, economically and tax wise, as if our Australian parent ADI provided regulatory capital direct into ANZ (and not through the New Zealand holding company). Further, we note that the foreign parent's holding of debt in the New Zealand holding company remains subject to APS 222.

1.12 Due to the unique requirements of bank regulatory capital and the reliance on offshore parent banks to provide such bank regulatory capital for the New Zealand banking system, ANZ submits that New Zealand banking groups should be excluded from the proposals in the Discussion Document. If New Zealand banking groups are not excluded from the proposals, an absurd tax policy outcome will arise in that, on a post-tax basis, it will become more economic for New Zealand banks to raise capital direct from international markets at higher interest rates than to obtain bank regulatory capital from our offshore parents at lower interest rates. The proposals would create a tax divergence from true economic positions resulting in inefficient capital raising for New Zealand banks.

1.13 It is not possible to restructure bank regulatory capital to have terms that are commensurate to senior unsecured debt. The terms of bank regulatory capital are mandatory and it is these mandatory requirements that result in such debt carrying a commercial but higher interest rate than that for senior unsecured debt. The proposals would, therefore, place New Zealand banks at a disadvantage (at least in a tax sense) to other New Zealand taxpayers that can change the terms of cross border related party debt.

1.14 Further, the proposals will result in double taxation on bank regulatory capital obtained from our parent. As above, bank regulatory capital carries an interest rate higher than our parent's senior unsecured rate. Therefore, a denial of a full deduction on the interest rate (i.e. actual interest paid) would arise in New Zealand. However, Australia (in ANZ's case) would not be bound by New Zealand's interest rate limitation and would require an arm's length price based on appropriate commercial terms reflecting the interest rate for bank regulatory capital for the tenor of the capital issued. It would not be possible to simply reduce the amount of interest paid on such instruments for regulatory reasons. In this regard, the proposed interest limitation rules appear to apply unilaterally from New Zealand's double tax treaty network such that it would not be possible to invoke the relevant Tax Treaty competent authority procedures.

1.15 Referring back to paragraphs 3.24 and 3.25 of the Discussion Document, the senior unsecured debt rate reflecting our parent's credit rating does not approximate the commercial requirement to access regulatory capital from our parent and the unique mandatory regulatory requirements of such capital which result in a commercial interest rate above a senior unsecured rate. This unique position in the banking industry was noted by the OECD in a public discussion draft on Action 4 that the "excessive leverage in a bank or insurance company has not been identified as a key risk"[4]. As such, ANZ considers that excluding New Zealand banking groups from the interest limitation proposals is not contrary to OECD guidance.

2. If our above submission is not accepted, we consider that the interest limitation proposals should apply as a safe harbour and not override application of the transfer pricing rules.

2.1 We understand from officials that the proposed interest limitation is a formulaic approach to interest limitation to reduce the time and effort required for taxpayers and the IRD to mutually agree on an arm's length price under the transfer pricing (**TP**) rules and, accordingly, may increase certainty for taxpayers. Assuming this will be the outcome, this should not come at the expense of accuracy, especially by imposing real tax costs on compliant industries and, as above, for industries that have regulatory requirements that would result in the broad formulaic approach diverging from accuracy and commercial reality. The proposal would inappropriately override commercial positions, being an interest rate that, under TP pricing rules would be considered arm's length.

2.2 Alongside the Discussion Document, officials have also proposed changes to strengthen the TP rules. The proposed changes in the Government Discussion Document on *BEPS – Transfer pricing and permanent establishment avoidance*, provide broad powers for the IRD to consider a company's debt raising and to restate the quality of debt instruments to reflect the economic substance. On application of the proposed TP rules, transactions with excessively priced debt that are artificial and based on uncommercial terms would be ineffective. The interest rate would then be revised to reflect economic reality. There is

[4] OECD, *BEPS Action 4: Approaches to address BEPS involving interest in the banking and insurance sectors*, p.10, available at: https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf

significant overlap between what the TP changes and the interest rate cap are intended to achieve. In our view, the core principle is, and must continue to be, that interest rates be set on an arm's length basis. It is critical that taxpayers retain the ability to establish, through the TP rules and subject to the IRD's review, an interest rate on cross-border debt that is based on appropriate commercial terms. The proposed interest limitation should not override genuine analysis of arm's length terms and conditions.

2.3 ANZ considers that the interest limitation proposal will not result in a significant easing of compliance. Taxpayers are, in a practical sense, required to ensure cross border prices are arm's length through assessment of their own credit position and considering comparable prices. The interest limitation proposal will still require such an obligation but merely shift the entity of focus from the New Zealand taxpayer to the offshore parent entity. Further, ANZ considers that any comparable pricing should not be limited to secondary markets (i.e. traded bonds). For example, secondary markets do not reflect the reality of costs of issuing new debt, including new issue premiums.

2.4 If the above submission to exclude banks from the scope of the proposed interest rate limitation is not accepted, ANZ submits that the interest rate limitation should act as a 'safe harbour' threshold. It should not override the TP rules or prevent an arm's length price from being established. Debt instruments with interest rates within the limitation threshold should not need to be reviewed against TP principles (i.e. are deemed to be TP compliant). This may still reduce compliance costs for taxpayers and administrative costs for the IRD. For instruments with interest rates greater than the proposed interest limitation (such as bank regulatory capital), taxpayers should continue to have the opportunity to apply the TP rules to establish an arm's length price. If such a position is not accepted for all cross border related party debt, it should apply, at least, to transactions relating to banking regulatory capital for the regulatory reasons outlined above which make bank regulatory capital unique.

3. If, contrary to the above submissions, the interest limitation proposals proceed, we submit that the cap should not apply to related party debt arrangements in existence at the date of enactment of the amending legislation.

3.1 The Discussion Document proposes that the interest rate cap will apply from the first income year beginning after enactment of the legislation (refer paragraph 5.36). Officials consider that this should give companies sufficient time to rearrange their affairs.

3.2 For the New Zealand banking industry, it is highly unlikely to be possible to rearrange such instruments due to their regulatory overlay. Further, in ANZ's context, we regularly seek IRD approval on the pricing of cross border funding. It would be inappropriate to over-ride such existing agreed positions.

3.3 Therefore, if the proposals proceed as drafted, we submit that the interest limitation should not apply to existing funding arrangements which have been reviewed, or are in the process of being reviewed, by the IRD under the TP rules to establish an arm's length price. The proposals should only apply to new arrangements entered into after the date of enactment.

4. ANZ submits that funding from offshore branches of New Zealand bank group entities are not caught within the proposed rules.

4.1 ANZ accesses debt by raising securities and commercial paper in international markets through a foreign branch of a subsidiary of ANZ. The foreign branch on-lends this debt into ANZ. The on-lending into ANZ is subject to TP rules.

4.2 The proposal for "related-party" debt in the Discussion Document at paragraph 3.43, however, may be sufficiently broad that it will include the on-lending from the offshore branch into ANZ within the interest limitation proposals. Such on-lending has no association to our parent's funding costs and therefore, should not fall within the interest limitation proposals.

4.3 ANZ understand from discussions with Officials that it is not intended for such funding from offshore branches to be included within the proposals. ANZ, therefore, submits that if our submission above at paragraph 1 is not accepted, any amending legislation is drafted to ensure such on-lending is not captured.

5. ANZ submits that ongoing consultation of the interest limitation proposals continue before a Bill is introduced into Parliament.

5.1 ANZ recommends and would welcome ongoing consultation on any further development of the interest limitation proposals prior to drafting of legislation. Given the complexity of this topic and its deviation from long standing tax principles, ANZ would also welcome the opportunity to consider any draft legislation of exposure draft prior to introduction to Parliament as a Bill.