Corporate Taxpayers Group

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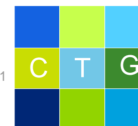

28 April 2017

BEPS – Strengthening our interest limitation rules
C-/ Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Cath

BEPS – STRENGTHENING OUR INTEREST LIMITATION RULES

The Corporate Taxpayers Group ("the Group") is writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). The Group is appreciative of the opportunity to submit on this discussion document and looks forward to discussing the proposals further with officials. The Group also appreciates having had the opportunity to talk to Officials[1] about the discussion document and those discussions have informed some of the comments in this submission.

We provide a summary of our submission below. Further detail is included in the following Appendices:

- Appendix One: General comments
- Appendix Two: Limiting the interest rate on related-party loans
- Appendix Three: Treatment of non-debt liabilities
- Appendix Four: Other matters
- Appendix Five: Comparison of New Zealand and Australian thin capitalisation rules

Summary of our submission

The key points in our submission are:

- The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector adequate time to fully work through the issues which may arise from these proposals.

- The Group supports some proposals in the discussion document, such as amendments for infrastructure projects, but does not support many of the other proposals as we

[1] Workshop held with Officials on 18 April 2017. Officials in attendance: Carmel Peters, Matt Benge, Casey Plunket, Hamish Slack, Phoebe Sparrow, Steve Mack and Matt Gan.

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We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

consider them not fit for purpose. They are, in our view, not in New Zealand's overall best interests as they increase uncertainty, increase compliance costs and reduce our competitiveness (especially given our relatively high corporate tax rate and other major tax reforms happening elsewhere in the world).

- The Group believes these proposals are a case of too much, too soon. Many proposals across the two BEPS discussion documents are targeted at the same behaviour. The Group believes a more cautious approach is required. Let one or two proposals bed down before changing our entire international tax landscape. We note the Minister's own comments that "It is important that these BEPS measures do not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation."[2] Such radical change can only give rise to significant uncertainty.

- The Group agrees with the comment at 1.3 of the discussion document that "we consider that our rules are serving us well. The rules are well understood and set clear and largely predictable limits on the amount of deductible debt allowable in New Zealand."

- The Group agrees with the comment at 2.1 of the discussion document that "New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment. FDI can also bring ancillary benefits to New Zealand, such as new technology and management practices." The Group agrees that the Government should remain committed to ensuring New Zealand remains an attractive place for non-residents to invest. It is our view that the proposals have the narrow focus of tax revenue enhancement and there is little evidence in the issues paper that the broader economic issues have been considered in any meaningful way. There must be a broader enquiry into the economic effect that these proposals would likely have before they proceed any further.

- While the Group does not support wholesale adoption of all OECD recommendations, the Group submits that the direction of reform in New Zealand should be consistent with the BEPS recommendations made by the OECD. By introducing an interest rate cap, which has not been recommended by the OECD, we are departing from the international norm of the arm's length principle. The OECD continues to support the arm's length principle.

- The discussion document states it does not consider whether New Zealand should change to an EBITDA-based interest rule, while asking submitters to provide a preference between an EBITDA-based rule or the proposals contained in the discussion document. The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred versus making some limited amendments to the existing thin capitalisation rules. That is, enhancements to the existing rules should be trialled before determining whether an EBITDA test is more appropriate.

- The Group appreciates two of the aims of the interest rate cap, being to provide certainty and reduce compliance costs. However, the fact that no other countries are contemplating an interest rate cap and it is inconsistent with OECD recommendations, transfer pricing and double tax agreements ("DTAs") means the Group cannot support this proposal.

- A fundamental principle applied in international taxation is that transactions need to be undertaken on an arm's length basis. The Group agrees with the principle mentioned at 3.17 of the discussion document that New Zealand should ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would

[2] http://taxpolicy.ird.govt.nz/news/2017-03-03-beps-consultation-documents-released#speech

agree with a third party. This is a rate set in accordance with the arm's length principle. In the Group's view, limiting the interest deduction available in New Zealand to the parent's credit rating plus a margin will result in over taxation in New Zealand and double taxation overall when the foreign taxing jurisdiction demands a higher interest rate be charged to reflect the arm's length differential in credit ratings.

- The potential for double taxation will also occur because the interest rate is to be set by reference to senior unsecured debt issued by the parent. If commercially the loan into New Zealand is required to be other than at senior unsecured (for example for regulatory purposes), then the interest rate charged must reflect that economic reality and cannot simply be set to the rate of senior unsecured debt issued by the parent.

- The only instance where the Group sees merit in the interest rate cap is if it were used as a safe harbour. Taxpayers who can support a different interest rate (having regard to the transfer pricing requirements) should continue to be able to deduct interest at that rate.

- The Group does not agree with a five year maximum loan term. Commercial loans may commonly be up to ten years or more. Corporates will ensure their debt is structured with a variety of term lengths to minimise re-financing risk.

- The Group does not support moving to a net asset approach. There are a number of liabilities which are either not real liabilities (e.g. deferred tax on buildings) or which are more appropriately characterised as equity (e.g. redeemable preference shares).

- The Group supports the key principle that third party funding provided to bankruptcy remote infrastructure projects should be excluded from thin capitalisation regardless of whether the entity in question is controlled by a single non-resident or multiple non-residents.

- The Group supports having a de minimis rule for inbound thin capitalisation rules, but does not consider the de minimis should be restricted to only entities with no related party debt (which includes third party debt guaranteed by a related party). The related party debt restriction is likely to make the de minimis very limited in application.

- The Group supports the proposed grandparenting of existing financing arrangements for non-residents acting together. This grandparenting is good practice. However, the Group fails to understand the rationale of denying any interest on owner-linked debt where the 60 percent threshold is breached. Any denial needs to be proportional to the breach.

- The Group does not support the proposal to only allow taxpayers to use asset values reported in financial statements. The discussion document does not provide any rationale for the change to the valuation options contained in section FE 16 of the Income Tax Act 2007. It is noted that subsection FE 16(2) requires all of the asset valuation options to accord with generally accepted accounting practice, with the exception of two particular types of assets (trading stock and finance leases).

- The Group does not support removing the ability of taxpayers to measure asset and liability amounts on the last day of the income year.

- The Group submits that more consideration should be given to aligning some of the positive features of the New Zealand and Australian thin capitalisation regimes.

- The Group does not support most application dates proposed. Taxpayers have legitimately entered into arrangements on the basis of the tax laws in place and the legitimate expectation that those rules would continue. To change tax laws too quickly without sufficient grandparenting or lead in time will damage New Zealand's reputation, which may have a chilling effect in relation to future foreign direct investment and current asset values.

We look forward to discussing this submission further with you.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ Bank New Zealand Limited
5. ASB Bank Limited
6. Auckland International Airport Limited
7. Bank of New Zealand Limited
8. Chorus Limited
9. Contact Energy Limited
10. Downer New Zealand Limited
11. Fisher & Paykel Healthcare Limited
12. Fletcher Building Limited
13. Fonterra Cooperative Group Limited
14. Genesis Energy Limited
15. IAG New Zealand Limited
16. Infratil Limited
17. Lion Pty Limited
18. Meridian Energy Limited
19. Methanex New Zealand Limited
20. New Zealand Post Limited
21. New Zealand Racing Board
22. New Zealand Steel Limited
23. New Zealand Superannuation Fund
24. Opus International Consultants Limited
25. Origin Energy New Zealand Limited
26. Pacific Aluminium (New Zealand) Limited
27. Powerco Limited
28. Shell New Zealand (2011) Limited
29. SKYCITY Entertainment Group Limited
30. Sky Network Television Limited
31. Spark New Zealand Limited
32. Summerset Group Holdings Limited
33. Suncorp New Zealand
34. T & G Global Limited
35. The Todd Corporation Limited
36. Vodafone New Zealand Limited
37. Watercare Services Limited
38. Westpac New Zealand Limited
39. Z Energy Limited
40. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely,

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE: DETAILED SUBMISSION POINTS – GENERAL COMMENTS

1. General comments

Timeframes

1.1 The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector adequate time to fully work through the issues which may arise from these proposals.

1.2 The timing of release of all three BEPS related documents (3 March 2017) was unfortunate as many taxpayers are heavily committed to tax compliance and financial reporting activities during the months of March and April.

1.3 Given the breadth of issues being consulted on and the potential overlap of proposals between this discussion document and *BEPS – Transfer pricing and permanent establishment avoidance* the Group believes that a further round of consultation should take place later in 2017, prior to any changes being included in a tax bill.

Wider economic concerns

1.4 The Group's overarching concern is that the proposals contained in the issues paper have the potential to significantly impact the flow of capital to New Zealand, the willingness of non-residents to establish business in New Zealand and may cause harm to New Zealand's reputation as place where it is easy to do business.

1.5 The Group agrees with the comment at 2.1 of the discussion document that "New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment. FDI can also bring ancillary benefits to New Zealand, such as new technology and management practices." The Group agrees that the Government should remain committed to ensuring New Zealand remains an attractive place for non-residents to invest. The Group is concerned that the proposals in this discussion document will actively discourage foreign direct investment, resulting in a detrimental effect on the wider economy.

1.6 Overall New Zealand is a net capital importer, and these changes penalise offshore investors with strong credit ratings. The Group notes that for organisations such as pension fund investors, the true cost of capital is the statutory obligation to provide a minimum rate of return to its stakeholders. The Group notes a larger tax burden on inbound investment will likely increase the cost of capital because non-residents will require a higher rate of return from their New Zealand investments to ensure they are no worse off due to the additional tax levied. We note the following comments from the 2001 McLeod Tax Review, which considered the taxation of inbound investment:

> *"Non-resident lenders will be willing to invest funds in New Zealand only if they receive a return after paying New Zealand tax that is at least equal to that they could achieve elsewhere.*
>
> *As a result, higher New Zealand taxes will mean non-residents will require a higher before-tax rate of return from their New Zealand investments. By driving up the required return from investment, New Zealand taxes raise the cost of capital to New Zealand businesses and lower the amount of investment.*

> *In these circumstances, the tax on the non-resident is not borne by the non-resident, but is passed on to other factors of production (for example, to labour in the form of lower wages). That is, the economic incidence of the tax falls on New Zealanders, rather than the non-resident on whom the tax is legally imposed."*[3]

1.7 The proposals may also affect the flow of foreign capital to New Zealand. Foreign investors have the choice of where to invest and what markets to establish in. New Zealand is a small market. We need to ensure that our tax rules do not discourage foreign direct investment into New Zealand or multinational corporations using New Zealand as a base for their operations. If foreign companies no longer invest into New Zealand because the tax rules are too onerous in comparison to the size of the potential market, this will have a direct impact on the New Zealand economy through reduced GDP (growth) and employment levels. There is an obvious negative effect of a loss of revenue for New Zealand (including GST) and a reduction of consumer choice.

1.8 In the Group's view, many of the proposed changes negatively influence the attractiveness of New Zealand as an investment destination. New Zealand's tax system plays a critical role in our competitive position with our trading partners and competitors. The unilateral, unprincipled interest rate cap proposals undermine our competitive position.

1.9 The economic costs of unduly restricting the deductibility of the interest costs of New Zealand enterprises are potentially high. It will often be the case that a New Zealand venture with potentially high returns but high risk (such as biotechnology or IT) will need considerable overseas capital to grow, especially if high profits are only available by scaling the venture up globally. An ideal foreign investor is often a globally diversified fund (or group of funds) with a high credit rating that is able to undertake risk because of its diversified portfolio. The extent of capital injection required means the fund(s) may need to take a controlling equity interest. However, the foreign fund will still want New Zealand investors to keep a substantial equity involvement in order to align incentives. This limits the amount of capital that can be raised by way of equity.

1.10 The remaining funding (capital) is therefore required to be provided by way of debt. Financial institutions are unlikely to provide such debt funding because of the risk – or if they did so only at very high interest rates. Outside of financial institutions, the most obvious source of debt funding is the foreign fund(s). The fund(s) ownership interest means that it has an in-depth and up to date knowledge of the New Zealand investment so that it has a better view than an external financier of the actual debt risk involved.

1.11 Obviously, however, from a purely commercial perspective the fund(s) will want an interest rate on this related party debt that reflects its actual commercial risk – which is the risk associated with the New Zealand firm, which will be considerably higher than the fund(s) cost of debt based on the fund(s) high credit rating. If interest on such related party debt is restricted to the interest rate that the fund(s) could borrow on standard terms (defined as the fund(s)'s credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin), a material part of the commercial interest cost of the New Zealand entity would become non-deductible. Arguably, in this scenario the interest rate cap would be lower than a rate charged by an unrelated third party. Applying the proposals in the discussion document in this way would amount to introducing a tax penalty on high risk/ high growth New

[3] McLeod Tax Review, 2001, page 76.

Zealand ventures with global potential. That seems clearly contrary to the government's economic growth strategy.

1.12 Tax changes that have the potential to increase the cost of capital and / or restrict the flow of foreign capital should not be made lightly, and full consideration must be given to the economic impact of these proposals. It is our view that the proposals have the narrow focus of tax revenue enhancement and there is little evidence in the issues paper that the broader economic issues have been considered in any meaningful way. There must be a broader enquiry into the economic effect that these proposals would likely have before they proceed any further.

1.13 The Group agrees with the comment at 1.3 of the discussion document that "we consider that our current rules are serving us well. The rules are well understood and set clear and largely predictable limits on the amount of deductible debt allowable in New Zealand." In the Group's view, only selected changes are required to be made to the rules and some of the changes proposed in this discussion document are in excess of what is actually necessary. The specific proposals are discussed later in our submission.

Certainty, compliance costs and competitiveness

1.14 The Group believes that a good tax system should be built around three principles in particular: certainty; compliance costs; and competitiveness. As noted further below, it is important that international competitiveness is maintained, especially in relation to Australia, as higher costs of doing business in New Zealand flow through to less investment, fewer jobs and lower wealth. New Zealand's tax system plays a critical role in the attractiveness of New Zealand for both inbound and outbound investment. For New Zealand to remain competitive it is important to recognise that taxes are a significant cost to businesses and any costs imposed must have a significant corresponding benefit.

1.15 It is also important that New Zealand doesn't rush into new rules before other jurisdictions, and also that any measures are proportional to the problem. As the Commissioner noted in the 2016 Multinational Compliance Focus Document: "*In the last few years Inland Revenue has placed an increased level of scrutiny on the tax practices of multinationals. I'm pleased we have found nearly all businesses open and willing to engage with us positively, and proud to contribute to New Zealand.*"[4] This is supported by recent research carried out in New Zealand which indicated that current debt levels of non-resident owned businesses are conservative and effective tax rates are close to the statutory rate of 28 percent[5].

1.16 It is important to consider the changes occurring / that have occurred in Australia and the potential impact (whether negative or positive) of those changes. As New Zealand's largest inbound investor, Australia's approach to this issue is very important. The Australian Government has stated that it will not be making any further changes to its existing thin capitalisation rules. If New Zealand proceeds with the proposals in the discussion document, our competitiveness with Australia will be significantly undermined.

1.17 The Group believes these proposals are a case of too much, too soon. Many proposals across the two BEPS discussion documents are targeted at the same behaviour. The

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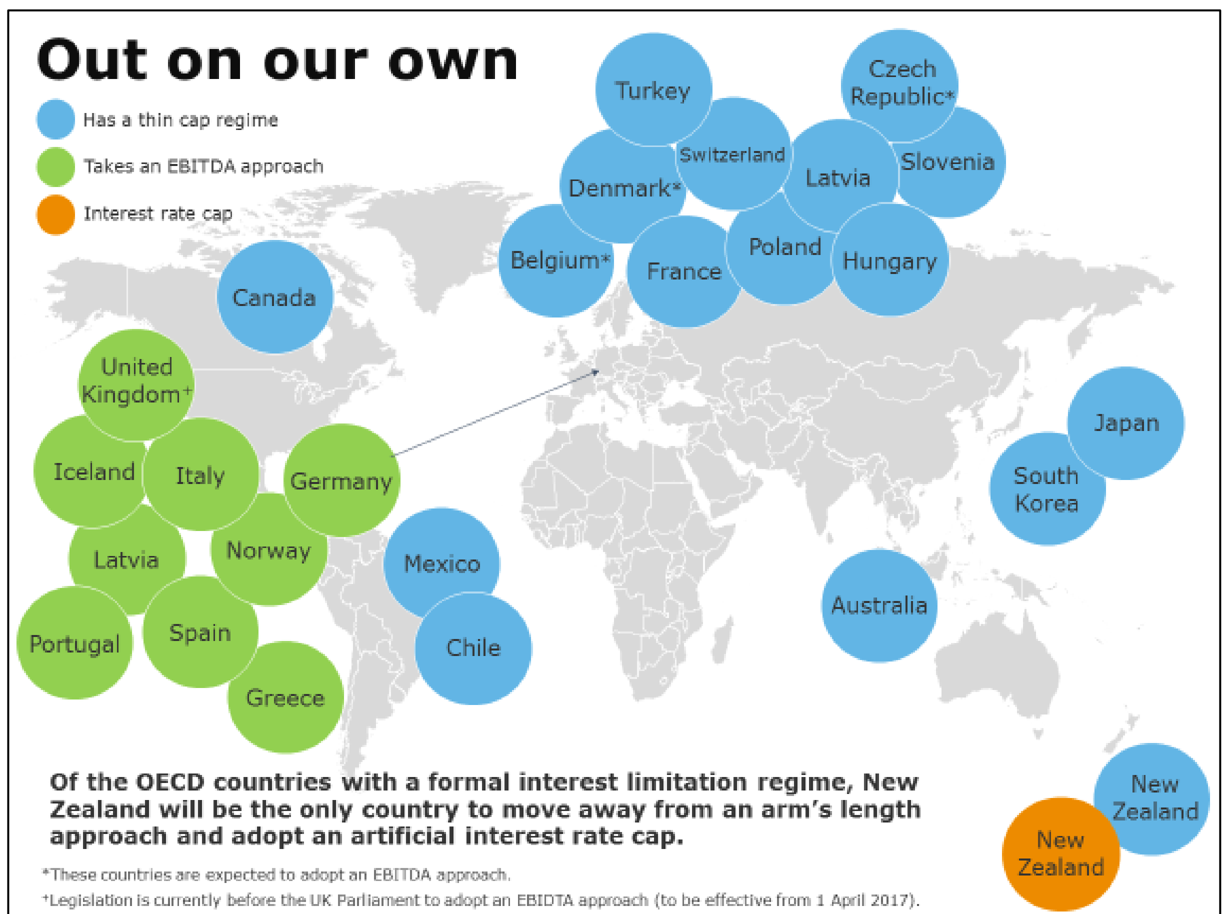
[4] http://www.ird.govt.nz/resources/6/2/62414b82-6ab8-4017-b04d-cc5d950cab47/compliance-focus-2016.pdf, Page 1

[5] Do corporates pay their "fair Share" of tax in New Zealand?: Effective tax rates in corporate New Zealand – domestic corporates versus foreign multinationals. EY, March 2017.

Group believes a more cautious approach is required. New Zealand should let one or two proposals bed down before changing our entire international tax landscape. We note the Minister's own comments that "It is important that these BEPS measures do not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation."[6] Such radical change can only give rise to significant uncertainty.

1.18 An interest rate cap puts New Zealand out of step with the OECD and the rest of the world. This proposal could result in a replication of what happened with New Zealand's previous controlled foreign company rules: "We had the best international tax system in the world if only the world had followed. Unfortunately we did a kind of reverse Star Trek: we went where no man followed." – Michael Cullen, 2007



Purpose of the thin capitalisation rules

1.19 The policy objective of inbound thin capitalisation rules was stated in the original 1995 Discussion Document (*International Tax – A discussion document*) to be to "limit the ability of non-resident investors to artificially reduce their net New Zealand-sourced income by allocating excessive interest costs to New Zealand". The policy aim was further stated as being "to accurately determine interest expense properly attributable to New Zealand without interfering with normal commercial behaviour, at minimal compliance cost, within the self-assessment system".

1.20 In effect, the thin capitalisation regime is an anti-abuse rule. Dividends are non-deductible (so that the New Zealand tax rate on the equity investment by a non-

[6] http://taxpolicy.ird.govt.nz/news/2017-03-03-beps-consultation-documents-released#speech

resident in a New Zealand company is the company tax rate of 28% plus NRWT on dividends, if any). Interest is deductible so that the New Zealand tax rate on debt finance is limited to the NRWT (or AIL) on interest. The policy concern that underlies thin capitalisation rules is that debt is 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. At the extreme, a non-resident could invest $1 of equity and repatriate all profits as interest paying minimum New Zealand tax on the investment.

1.21 As the 1995 discussion document made clear, concerns with protecting the New Zealand tax base need to be balanced by having a tax system that is attractive to foreign investors given New Zealand dependence on investment from abroad to generate economic growth. Thin capitalisation rules have therefore always been seen, from a policy perspective, as targeting situations where it could reasonably be concluded that investment was being undertaken by debt that was in substance equity or would have been by way of equity if based on normal commercial considerations.

1.22 When New Zealand introduced its thin capitalisation and transfer pricing rules in 1995, maximum debt levels were set under thin capitalisation and this explicitly excluded the operation of transfer pricing. This was for a number of reasons:

- The policy concern was to set a maximum gearing ratio rather than the price or interest rate.

- The policy was explicitly to include in maximum debt levels, debt from unrelated parties if a New Zealand enterprise was foreign controlled. Transfer pricing was seen as restricted to limiting only related party debt.

- Transfer pricing was relatively undeveloped internationally at that time and New Zealand had little background in operating such rules so that transfer pricing alone was seen as inadequate to protect the tax base especially given the limited experience of Inland Revenue in operating transfer pricing rules. It is understood there was a concern that since transfer pricing focused on price (the arm's length price) it might not limit the quantum of debt, and even if it did so, Inland Revenue might not have the technical expertise to manage transfer pricing rules that also covered the level of debt.

1.23 Further, since New Zealand's thin capitalisation rules did not override our double tax agreements ("DTAs"), where (principally by way of Article 24 – non-discrimination) DTAs required interest to be deductible if such interest met the arm's length transfer pricing test, New Zealand accepted that the arm's length test overruled the thin capitalisation rules.

1.24 Transfer pricing is now well developed internationally and New Zealand taxpayers and Inland Revenue have developed considerable expertise in operating transfer pricing rules. For example, the OECD is now clear that Article 9 of the Model Convention (the transfer pricing article) "is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital."[7] The rationale is that transfer pricing rules aim to establish a level of profits from a transaction that corresponds to the profits that would have resulted from an arm's length transaction

[7] 2014 Commentary pages 183-184

and to achieve this, the level of debt as well as the interest rate needs to be on an arm's length basis.

Transfer Pricing / Arm's Length Tests

1.25 At our workshop with Officials on 18 April 2017, it was suggested by Officials that the OECD has **explicitly** rejected transfer pricing as a tool to manage the pricing and quantity of debt. Extracts from the final BEPS report on interest limitations were cited as evidence of this conclusion. The relevant paragraphs are copied below[8]:

Use of interest and payments economically equivalent to interest for base erosion and profit shifting

11. Rules currently applied by countries fall into six broad groups, with some countries using a combined approach that includes more than one type of rule:

1. Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.

2. Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction.

3. Rules which disallow a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made.

4. Rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets.

5. Rules which limit the level of interest expense or debt in an entity with reference to the group's overall position.

6. Targeted anti-avoidance rules which disallow interest expense on specific transactions.

12. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately after arrangements are entered into, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules (e.g. in pricing the interest income and expense of an entity before applying other interest limitation rules). In particular, countries have experience of groups structuring intragroup debt with equity-like features to justify interest payments significantly in excess of those the group actually incurs on its third party debt. Additionally, an arm's length test does not prevent an entity from claiming a deduction for interest expense which is used to fund investments in non-taxable assets or income streams, which is a base erosion risk specifically mentioned as a concern in the BEPS action plan (OECD, 2013).

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[8] Limited Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report.

13. Withholding taxes are primarily used to allocate taxing rights to a source country, but by imposing tax on cross-border payments they may also reduce the benefit to groups from base erosion and profit shifting transactions. Withholding tax has the advantage of being a relatively mechanical tool which is easy to apply and administer. However, unless withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. In fact, in some cases withholding taxes can drive base erosion and profit shifting behaviour, where groups enter into structured arrangements to avoid imposition of tax or general additional tax benefits (such as multiple entities claiming credit with respect to tax withheld). Where withholding tax is applied, double taxation can be addressed by giving credit in the country where the payment is received, although the effectiveness of this is reduced if credit is only given up to the amount of tax on net income. This can impose a significant cost on groups not engaged in base erosion and profit shifting, if an entity suffers withholding tax on its gross interest receipts, but is unable to claim a credit for this because its taxable income is reduced by interest expense. In practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. It would also be extremely difficult for European Union (EU) Member States to apply withholding taxes on interest payments made within the European Union due to the Interest and Royalty Directive.[5] In addition, there are broader policy reasons why some countries do not currently apply withholding tax to interest payments, which could make the introduction of new taxes difficult. Taken together, these factors mean that in many situations withholding taxes would not be a suitable tool for completely tackling the base erosion and profit shifting risks which are the subject of this report. However, countries may still continue to apply withholding tax alongside the best practice.

14. Rules which disallow a percentage of all interest paid by an entity in effect increase the cost of all debt finance above any de minimis threshold. Therefore, entities with a relatively low leverage will be subject to the same proportionate disallowance as similar entities with very high levels of debt. This approach is likely to be more effective in reducing the general tax preference for debt over equity, than in targeting base erosion and profit shifting involving interest.

15. For the reason set out above, the rules in groups 1 to 3, on their own, do not address all the aims of Action 4 set out in the BEPS Action Plan (OECD, 2013). As such, they are not considered to be best practices in tackling base erosion and profit shifting involving interest and payments economically equivalent to interest if they are not strengthened with other interest limitation rules. However, these rules may still have a role to play within a country's tax system alongside a best practice approach, either in supporting those rules or in meeting other tax policy goals. Therefore, after introducing the best practice approach, a country may also continue to apply an arm's length test, withholding tax on interest, or rules to disallow a percentage of an entity's total interest expense, so long as these do not reduce the effectiveness of the best practice in tackling base erosion and profit shifting.

1.26 The Group strongly rejects the summation by Officials that the above paragraphs mean that OECD has rejected transfer pricing as a tool to manage the pricing and quantity of debt. The above extracts from the final report note the OECD's conclusion that transfer pricing rules ***"on their own"*** do not address all of the action 4 aims and therefore ***on their own*** are not best practice. These paragraphs do not suggest (as Officials have asserted) that transfer pricing principles have no role to play in addressing profit shifting and the pricing and quantity of debt. For countries that have introduced an EBITDA rule, this simply operates as a backstop to interest deductions.

That is, related party loans must first be priced on an arm's length basis which is then deductible up to a certain proportion of EBITDA. Clearly a jurisdiction would not be happy with an above arms-length rate being charged (and treated as deductible) simply because the entity was within the relevant EBITDA threshold.

1.27 The Group does not rely solely on transfer pricing to manage the amount of deductible interest in New Zealand. We have an existing thin capitalisation regime, which the OECD did not list as an ineffective option to manage the deductibility of interest from a base erosion perspective.

1.28 The Group also notes that OECD is expected to release transfer pricing guidance on financial transactions during 2017[9]. This work stream is one of the follow ups to the BEPS project and illustrates that OECD still sees transfer pricing as playing a role in debt pricing. This also demonstrates that New Zealand's work in this area is premature. We should be waiting for the draft guidance to be released, rather than stepping out on our own.

Interaction with our double tax agreements

1.29 Article 9 of the Model Convention provides that where an enterprise has related party transactions not on arm's length terms these can be adjusted by tax authorities to produce a profit that would have accrued to the enterprise if transactions were on an arm's length basis and that profit can be made liable to tax by a jurisdiction. As discussed in the OECD's 1986 "Report on Thin Capitalisation" and in the Commentary to Article 9, there have been differences of views as to the scope of this article. In particular as to whether Article 9:

- Allows a jurisdiction to adjust profits to those arising on an arm's length basis (in which case New Zealand would not be restricted to taxing profits in excess of those that would be calculated on an arm's length basis); or
- Whether the article prohibits countries from calculating and taxing profits in excess of those that would be calculated on an arm's length basis (in which case DTAs based on the Convention would overrule any attempt by New Zealand to impose a deductible interest rate cap not in conformity with the arm's length principle.

1.30 The OECD's conclusion was that the latter of the above alternatives is the correct way to interpret DTAs. This is reflected in the following statement on page 184 of the 2014 Commentary Update:

> *"the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and this principle should be followed in applying existing tax treaties."*

New Zealand has not lodged any observations on this aspect of the Commentary.

1.31 Article 24(3) of the Model Convention states that a permanent establishment of a non-resident cannot be less favourably taxed than a New Zealand company carrying on the same activities. Article 24(4) states that interest paid by a New Zealand company to a non-resident shall be deductible under the same conditions as if it had been paid to a resident of New Zealand. An exception applies if the transfer pricing article (Article 9) applies. It is generally accepted that these provisions override thin

[9] http://mnetax.com/oecd-officials-discuss-latest-international-tax-initiatives-20306

capitalisation / restrictions on interest deductibility (similar to those proposed in the Discussion Document) if such rules are inconsistent with the results under transfer pricing. For example, the OECD Commentary on Article 24 states that the article:

> *"does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible [with transfer pricing rules]. However, if such treatment results from rules which are no compatible with [transfer pricing rules] and which only apply to non-resident [lenders] (to the exclusion of resident [lenders]), then such treatment is prohibited." (2014 Commentary, page 367).*

1.32 The Discussion Document argues that its proposed cap on interest deductibility where the lender is non-resident would be consistent with our DTAs on a number of bases. The Group disagrees with Officials' analysis:

- As noted above, the OECD Commentary states that thin capitalisation rules are consistent with the arm's length principle to the extent the profit that results would have accrued in an arm's length situation (discussed at para 3.57 of the discussion document). In the simple parent/subsidiary example where both operate similar businesses it may be that the parent's cost of funds could be used to determine the subsidiaries cost of funds, but this does not apply to other arrangements where the Discussion Document approach seems to produce a result not in accordance with transfer pricing and the arm's length principle. If the discussion document did produce an arm's length approach it would then be more logical and clearer for New Zealand to adopt the arm's length approach to related party interest rates.

- The discussion document suggests that the interest rate cap would be a domestic anti-avoidance provision and because as a general rule there will be no conflict between domestic anti-avoidance rules and a DTA the proposed interest rate cap it consistent with our DTAs (para 3.59). This seems to suggest that a country can label any provision of domestic law "anti avoidance" on the basis it is expected to raise revenue that might not otherwise be raised and then ignore its DTAs. The end result would be that DTAs would be ineffective in limiting double taxation or protecting taxpayers. The OECD Commentary warns that *"it should not be lightly assumed that a taxpayer is entering into . . . abusive transactions"* (2014 Commentary page 63). Anti abuse provisions are consistent with DTAs only to the extent that they counter transactions that are contrary the object and purpose of the DTA provisions. The object and purpose of the OECD Model Convention is clearly to apply the arm's length principle to cross-border related party transactions. A domestic law provision that prevented the application of the arm's length principle would be contrary to the object and purpose of DTAs and such a provision cannot be justified on the basis that it does the opposite.

- The discussion document argues that given the OECD has recommended countries adopt an interest limitation rule the interest rate cap is consistent with our DTA obligations regardless of the fact the OCED recommends an EBITDA based rule. Clearly the Discussion Document approach is not consistent with international practice given the interest rate cap is unique in the world. 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". Whether or not an interest rate cap is seen as equivalent to what OECD recommends is not determinative of whether or not the approach would be overridden by a DTA. In any case the OECD EBITDA approach explicitly does not limit interest deductions to situations where the lender is non-resident. Instead the OECD recommends that the EBITDA approach apply at a minimum

to all entities that are part of any multinational group but the OECD also suggests it could usefully apply to all entities including stand-alone companies with purely domestic operations (OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – 2016 Update, page 37). The inconsistency with the provisions of the DTA thus does not arise with the OECD proposal. They do, however, arise with the Discussion Document proposal.

1.33 As such, the Group does not agree that the proposed interest rate cap is consistent with New Zealand's double tax agreements. It is submitted that given the arm's length test is our primary rule for limiting the deductibility of related party cross border interest rates under our DTAs it should be our primary provision under domestic law.

APPENDIX TWO: DETAILED SUBMISSION POINTS – LIMITING THE INTEREST RATE ON RELATED-PARTY LOANS

Disclaimer: no comments on practicalities or mechanics of the proposals is intended to be read as an endorsement of the proposals unless explicitly stated.

2. Limiting the interest rate on related-party loans

Summary

2.1 The Group does not support this proposal in its current form. The Group believes that it is unprincipled to abandon the arm's length pricing principle with respect to debt pricing. Such unilateral action is inconsistent with our treaty obligations and the work undertaken by OECD, and in many scenarios, may give rise to double taxation. If this type of measure is pursued, the Group submits that there should not be an *absolute* cap on the deductible rate of interest. Instead, the cap should provide a safe-harbour, with taxpayers being able to pay (and deduct) a higher arms-length price, if the taxpayer can substantiate the debt pricing by applying existing transfer pricing rules.

2.2 In our workshop Officials indicated that they believed Australia would be happy to accept the interest rate cap amount as the taxable interest income in Australia. The Group submits some form of binding undertaking should be received from Australia before this type of assumption is factored into decision making on this issue. The Group considers it unlikely that other jurisdictions will accept that an interest rate cap imposed by New Zealand represents an arm's length price, and that double taxation is the more likely outcome.

2.3 There is an inconsistency between the reforms being introduced and the scale of the problem to be addressed. The discussion document notes that only a small number of taxpayers are abusing the system. At paragraph 1.4 it is noted that "[w]hile 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." In the Group's view, the proposed interest rate cap is disproportionate to the mischief it is seeking to address and unfairly punishes taxpayers who comply with arm's length pricing. The Group would like to see Inland Revenue provide some evidence or workings to demonstrate the scale of the perceived problem. Given this rule will apply to all related party lending in the Group's view, Inland Revenue needs to demonstrate there is a significant problem before an interest rate cap that is inconsistent with OECD recommendations is pursued.

2.4 The 5 year term assumption is not valid for a number of reasons, which are outlined below.

2.5 In circumstances where you have two substantial shareholders, reliance on the majority shareholder's credit rating is inappropriate.

2.6 Many taxpayers do not have credit ratings, including large taxpayers such as members of the Group, and would be required to determine what the appropriate interest rate for the parent would be (as per paragraph 3.23). Taxpayers should not have to incur the costs of determining the appropriate interest rate when they otherwise would not be required to do so. This illustrates that the interest rate cap method may not be as easy to apply in practice as Officials suggest.

2.7 The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred over making some amendments to the existing thin capitalisation rules (but

not necessarily to the extent of the proposals contained in the discussion document) as a first step.

Proposal

2.8 Paragraph 3.17 of the discussion document summarises the proposal in respect of the interest rate on related party loans as follows:

> *We propose amending the thin capitalisation rules to limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower. We consider that such a cap is the best approach to ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would agree to with a third-party lender. We consider that such a rule would also reduce or eliminate costly disputes over what an appropriate interest rate is under standard transfer pricing.*

2.9 The proposed interest rate cap would be set at the interest rate the borrower's ultimate parent could borrow at on standard terms, plus a margin. The cap would not apply to third party debt.

2.10 As noted earlier in our submission, the OECD are releasing guidance in 2017 in relation to financial transactions transfer pricing. The Group submits that if the interest rate cap proposal goes ahead, no decisions should be made in relation to margin until this guidance has been released and can be considered fully.

Concerns with an absolute cap

2.11 We understand that Officials are concerned that despite New Zealand's existing thin capitalisation regime, profit shifting still occurs through the rate rather than quantum of related party debt. While the thin capitalisation rules limit the amount of debt, they do not regulate the quality of debt. The group appreciates the reasons why the proposal appears an attractive option to address this issue. At first glance, it is relatively simplistic and easy for taxpayers to apply, and more straightforward for Inland Revenue to audit. However, we strongly believe that the benefits of this proposal are significantly outweighed by the disadvantages associated with an absolute interest cap. The proposal is a blunt and unprincipled tool that will harm New Zealand's reputation as an inbound investment destination.

2.12 The Group accepts that the policy issue that is the objective of thin capitalisation rules is the level of interest deductions. This is determined by not only the level of debt (constrained by current thin capitalisation rules) but also the price of debt (the interest rate). We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent, increasing the risk associated with parent lending may be used to justify a higher interest rate but does not alter the parent's overall investment risk. We can understand the argument why in such a scenario high interest rates can be viewed as substituting non-deductible dividends for deductible interest. However, we consider that any policy response should be targeted at situations where there is this close substitutability of interest for dividends and should be reasonable in that context.

2.13 The Group considers that the proposed interest rate cap is inconsistent with the arm's length principle. It is a fundamental concept of international taxation that transactions between related parties need to be undertaken on an arm's length basis. A lending jurisdiction will, after reflecting on the true economic risks, require an arm's length margin (not one artificially set by notching down the parent's credit rating as is proposed). Furthermore, any analysis must remain focussed on the actual transaction being priced, not some hypothetical scenario where the NZ borrower is

put in the shoes of its overseas parent who has scale, geographical diversification and access to funding markets that its subsidiary does not have.

2.14 While the OCED has commented that transfer pricing may not be wholly effective to manage base erosion and profit shifting in the context of debt pricing, it has also not completely dispensed with transfer pricing / the arm's length principle for debt (as discussed earlier in our submission).

2.15 In our workshop Officials indicated that they believed Australia would be happy to accept the interest rate cap amount as the taxable interest income in Australia. The Group submits some form of binding undertaking should be received from Australia before this assumption is factored into decision making on this issue. The Group considers it unlikely that other jurisdictions will accept that an interest rate cap imposed by New Zealand represents an arm's length price and that double taxation is more likely to occur.

2.16 The underlying assumptions in the proposed test appear to be that the multinational parent will borrow from third parties using its better parent rating and then on-lend the funds to its subsidiaries, which appears to be coupled with an implicit duty on the multinational parent to support its subsidiaries. In the Group's view, this is an incorrect starting assumption for the majority of multinationals. For example, the Group notes that institutional investors (such as pension funds) will shield themselves from standalone investment risk so as to limit risks to the fund's overall exposure, as part of the "enterprise risk management policy".

2.17 The proposal also appears to implicitly assume that a third party commercial lender would factor in the creditworthiness of the parent entity to determine the appropriate interest rate when lending to a subsidiary. The Group submits that an assumption of implicit parental support is not valid. A rational commercial lender would never rely on implicit support and would require a guarantee to be signed if support of the parent was to be relied on. This undermines the credibility of what is proposed in the discussion document. It is a commercial reality that companies fail – limited liability exists for a reason. Implicit support "*is like a metaphorical invincible wallet. It is something investors believe exists and may be available to provide financial support if the right circumstances are present, but few investors are foolish enough to believe that it is equivalent to a guarantee*".[10] Further any parental support, either implicit or explicit can only be one factor amongst many which the commercial lender would consider.

2.18 The underlying assumption in the proposals is that subsidiaries / associates largely carry the same risk as the parent or materially the same risk as the parent. This is flawed. This is particularly so where the activities of the subsidiary differ in nature from those of the parent or the wider group. Debt and equity investors will consider (amongst other factors):

- The country (or countries) in which the company operates. Investors will typically seek exposure to particular countries and industries. Therefore, a parent borrower with international exposure is likely to attract a different investor base compared to a subsidiary with activities in one single country.

- The industry in which the company operates. Similarly, different industries present different risk profiles, which will appeal to different types of investors.

- The size and tenor or the loan/investment.

[10] General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563, at para 287

Parent and subsidiaries can therefore represent vastly different investment profiles to a lender/investor and using the parent's credit rating will often not be the most appropriate comparable to start with in order to assess a subsidiary's commercial interest rate. Likewise a multinational collective investment vehicle with a diversified portfolio would have a credit rating which would be materially different from the credit rating of a subsidiary holding a speculative petroleum mining permit in New Zealand. In such a case, it cannot realistically be argued that the correct market interest rate of the New Zealand entity is the interest rate the foreign lender would be required to pay on its borrowings. It cannot realistically be argued that the foreign entity's debt is substitutable for equity. Finally it cannot realistically be argued that in provided related party debt, the risks assumed by each investor remain the same as the investment equity finance.

2.19 The interest rate charged on debt is a matter of pricing. For all other related party transactions the arm's length principle is applied to determine the appropriate price. The Group submits that to disregard this approach would be unprincipled. The proposed approach in the discussion document is not used anywhere else in the world. If New Zealand pursues this approach, double taxation may arise. Where the price determined applying the arm's 's length principle is greater than the interest rate cap set, the deduction in New Zealand would be limited to the capped amount, however the corresponding overseas jurisdiction will almost certainly look to receive and tax the higher arm's 's length amount.

2.20 We understand that Inland Revenue is concerned that it does not have the tools available to address profit shifting through debt that is uncommercial. The Group does not agree with this sentiment. Inland Revenue is able, under current rules, to investigate, dispute and reassess taxpayers who are not complying with transfer pricing principles. Transactions which seek to artificially drive down the quality of the New Zealand balance sheet so as to drive up funding costs are ultimately ineffective if Inland Revenue uses the tools it already has. As such, an interest rate cap is not also needed to address this issue.

2.21 Beyond the broader fundamental concerns the Group has with the proposal, there are also issues in the detail of what is proposed, which we briefly comment on:

- The 5 year term assumption is not valid for a number of reasons, including:

  a) It is inconsistent with Treasury Management principles. "Fund early, fund long" is an important principle of debt maturity profile management which means companies should seek to refinance maturing debt early and try to secure the longest debt maturity possible for core debt funding. This is even more important today given the uncertain economic outlook.
  b) Funding may be required for a specific project or purpose such that a 5 year term is not appropriate.
  c) Where a mix of related and non-related party debt is used, the term of the related party debt will often need to be longer than that for the bank debt as the bank does not want shareholder debt repaid prior.
  d) Businesses will seek a range of funding options and may even take on debt for terms of 10 – 15 years as is often present in the USPP market.
  e) Many corporates have capital structures with staggered terms / maturities to minimise the risk associated with refinancing. As such, both short terms and long term debt can be arm's length.

- In circumstances where there are two substantial shareholders, reliance on the majority shareholder's credit rating is inappropriate. For example in a scenario

where you have two shareholders with 51% and 49% shareholdings respectively, reliance on the 51% shareholder's credit rating is inappropriate, particularly if that rating differs substantially from the 49% shareholder's credit rating.

- Many taxpayers do not have credit ratings, including large taxpayers such as members of the Group. As such, all this proposal will achieve is to shift the debate from being "what is the appropriate rate on the inbound debt into New Zealand" to what is the appropriate risk rating / credit rate of the relevant parent entity. The Group does not believe the proposal will be as simplistic in its application as the discussion document seems to suggest, and a credit rating of an overseas parent company is not something that can be easily determined by a New Zealand subsidiary if one does not already exist.

- How are appropriate interest rates to be determined? Based on the application of New Zealand interest rates or interest rates prevailing in the parent company jurisdiction? For example, World Bank data from 2016[11] indicates that on average a 5% interest rate applies in New Zealand, but a 1% rate applies in Japan and a 52% rate applies in Brazil. Would borrowing by a subsidiary of a Japanese company be capped based on the rate of interest applying to the parent's credit rating as if they were borrowing in New Zealand (i.e. 5%) or in Japan (i.e. 1%)? If the parent company was in Brazil, would the interest rate be capped based on 52% or 5%?

- There is not enough clarity on when the interest rate cap would be set. It should be confirmed that this is set at the outset and does not change in the event that the parent company credit rating changes.

- The discussion document does not comment on what occurs when a taxpayer still must pay an arm's length rate of interest. If interest deductions are denied, will NRWT be able to be calculated based only on the amount of deductible interest?

EBITDA approach

2.22 The discussion document states it does not consider whether New Zealand should change to an EBITDA-based interest rule, and asks submitters to provide a preference between an EBITDA-based rule and the proposals contained in the discussion document.

2.23 The objective of the OECD's EBITDA approach is to reduce what the OECD views as a tax preference for debt over equity. In the main we view that as a tax penalty on equity resulting largely from the classical double taxation of company income. The EBITDA-based rule can be seen as trying to level the international playing field by trying to imposing a tax penalty on an element of interest. However, these considerations are not relevant in the New Zealand environment where debt and equity have more equal tax treatment as a result of imputation. Instead the New Zealand focus should be purely on ensuring that our thin capitalisation rules do not allow New Zealand corporate income to be extracted as low-taxed interest in a manner contrary to the intent of our policy settings. We submit that this is best achieved through transfer pricing methodology with safe harbours to reduce compliance and administrative costs where the tax base risk is low.

2.24 The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred over making some amendments to the existing thin capitalisation rules (but

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[11] http://data.worldbank.org/indicator/FR.INR.LEND?view=chart

not to the extent of proposals contained in the discussion document). For example, an EBITDA-based rule may handicap groups that are heavily capitalised and have tangible fixed assets with long depreciation periods, as well unfavourably affecting industries with volatile earnings (for example primary production which is cyclical effected by adverse movements in commodity pricing or foreign exchange exposure).

2.25 Further, the Group considers that the complexity of the rules required to ensure that an EBITDA test is applied appropriately would make such a rule unnecessarily complicated for the issues at hand (given the existing and proposed tools that the Commissioner has to deal with excessive interest costs). An EBITDA test can be manipulated through aggressive accounting policies relating to revenue and expense recognition, timing of sales and asset write-downs and the related depreciation schedule adjustments. In the Group's view, an EBITDA approach would be susceptible to a range of accrual accounting adjustments (i.e. the valuation of debtors and variations due to financial hedging). Further it would be difficult to come up with and agree on particular ratios, as part of the EBITDA test, that would be suitable for a wide range of industries (and specific ratios for each industry would lead to uncertainty around which industry a taxpayer belongs to).

2.26 The Group notes that an EBITDA test will also be inappropriate depending on where a business is in its business life-cycle. For example a petroleum miner undertaking decommissioning will logically have negative EBITDA.

2.27 We note that in an article to be shortly published in the New Zealand Law Review[12], leading tax academic Professor Craig Elliffe evaluates the merits of an EBITDA test in the New Zealand context and concludes that there is no case for change from the existing debt to asset thin capitalisation regime. We suggest Officials contact Professor Elliffe for a copy of the paper to consider the points raised.

2.28 Notwithstanding the above, the Group does see a role for an EBITDA test in the context of determining an arm's length interest rate and a commercial balance sheet. An EBITDA ratio could be one of the factors considered by Inland Revenue when applying the arm's length test. However, the Group does not support an absolute cap on interest deductions based on an EBITDA test.

2.29 The Group notes there is some merit in considering an EBITDA test as an additional optional safe-harbour test. Some taxpayers are unable to reflect the true value of their business in their balance sheet (particularly if there are intangible assets or low historic costs which cannot be valued up) when those assets are valuable and generate income streams. An EBITDA test has merit in these circumstances. We discuss these issues further in our submission under the heading *Asset Valuations.*

Safe harbour[13]

2.30 The Group understands Officials' concerns that it is difficult to obtain sufficient comfort that profit shifting through debt pricing is not occurring. In this regard, the Group sees merit in the cap being used as a safe harbour only. Taxpayers who do not wish to undertake full transfer pricing analysis to determine an arm's length price would be free to apply a rate that meets the interest rate "cap" (or in this case safe harbour). However, a taxpayer should be able to exceed this safe harbour where

[12] Interest Deductibility: Evaluating the Advantage of Earnings Stripping Regimes in Prevent Thin Capitalisation, Craig Elliffe.

[13] A further alternative could be that the interest rate cap only applies for arrangements with non-DTA countries, with arm's length pricing preserved for lending from countries with which New Zealand has a DTA. We refer again to Craig Elliffe's paper in this regard.

(under transfer pricing rules) the interest rate reflects the commercial reality of the lending risks. I.e. where taxpayers can support a different interest rate having regard to the transfer pricing requirements, they should be able to use that interest rate.

2.31 The key advantage of this approach is that it would mean that Inland Revenue could focus its compliance / audit resources on those taxpayers who wish to use a rate over the safe-harbour and it would still allow taxpayers to use a greater interest rate where it is appropriate to do so on an arm's length analysis.

2.32 The Group believes that as part of this, Inland Revenue could issue guidance on the factors to be considered when determining the arm's length rate and whether a taxpayer's balance sheet would be regarded as commercial. One key indicator in this regard could be an EBITDA safe-harbour such that if interest deductions fall within the safe-harbour this would be an indication that the taxpayer has a commercial level of debt set at an arm's length rate. The Group would be happy to consult with Officials on these guidelines.

APPENDIX THREE: DETAILED SUBMISSION POINTS – TREATMENT OF NON-DEBT LIABILITIES

Disclaimer: no comments on practicalities or mechanics of the proposals is intended to be read as an endorsement of the proposals unless explicitly stated.

3. Treatment of non-debt liabilities

Summary

3.1 The Group does not support these proposals. The perceived issue is not one which has any connection to BEPS.

Examples

3.2 The Group has concerns with the examples contained within Chapter 4 of the discussion document, their relevance and their accuracy. In particular, examples 4 and 5 are premised on an example where a mining company pays out all cash earnings (before factoring in a decommissioning provision) and places itself in a negative equity position. In reality it would not be possible as the mining company cannot pay the level of dividend the example is suggesting because it would not satisfy the solvency test. These examples are used as justification for changing the rules because the outcome in these examples is different from an example where a taxpayer does not have a provision. However they don't reflect the commercial reality that the transactions in the example could not actually occur.

International comparisons

3.3 The discussion document refers to a recent study[14] by the IMF looking at 28 countries with thin capitalisation rules. This study is used to conclude that apart from New Zealand, all countries base their rules off either net assets or equity. The Group wishes to note that the study quoted, while published in 2014, involved the researchers constructing a data set of thin capitalisation rules in 54 countries for the period 1982 – 2004. The Group submits that there is limited relevance to a study analysing tax rules which are over 13 years old. The Group wishes to point out that there are other aspects of thin capitalisation rules which are important to consider, including the fact that many jurisdictions only apply the rules to related-party debt.

Commercial approach to lending

3.4 The Group disagrees with the sentiment that net assets are of more relevance to third party commercial lenders than gross assets. First and foremost banks are interested in the future cash-flows of a business. Thereafter the bank will be interested in the realisation value of assets that it can take first ranking security as a backstop should cash-flow forecasts prove incorrect. Banks will generally rank ahead of unsecured creditors and therefore non-debt liabilities relating to creditors will generally be disregarded unless they relate to an asset for which the bank cannot take a priority ranking security over.

3.5 The Group is concerned that this proposal will operate to dampen the exact economic activity that New Zealand should be trying to encourage, particularly in the context of outbound thin capitalisation. During periods of rapid growth, taxpayers will require access to substantial funds to support that growth and in particular fund large

[14] Blouin, J, Huizinga, H, Laeven, L, and Nicodeme, G, *Thin Capitalisation Rules and Multinational Firm Capital Structure*, IMF Working Paper WP/14/12.

increases in working capital. Often it is not an option for taxpayers to raise additional share capital and debt cannot be pushed down to the foreign jurisdiction. Banks are increasingly willing to provide additional types of finance such as invoice and inventory finance to help fund this growth, on the strength of future increases in cash flows, meaning that the bank may be lending at higher levels than it otherwise would. Taxpayers in this situation will be severely disadvantaged and may need to consider slowing the pursuit of growth opportunities. This would be detrimental to the New Zealand economy.

3.6 The Group is also concerned that this proposal will have a significant impact on the cost of capital for New Zealand exporters. Notwithstanding the increased threshold of 75%, the commercial reality is that often debt cannot be pushed down into the foreign subsidiary and borrowing must occur at the New Zealand parent level.

Exclusions

3.7 In terms of what non-debt liabilities should be captured in the thin capitalisation calculation we make the following comments:

- To the extent that liabilities have not been used to fund the taxpayer's balance sheet they should not be considered a "non-debt liability" and should not be factored into the thin capitalisation calculation. The obvious example is derivative instruments that are designated as a hedge. Fair value movements in these instruments may give rise to significant volatility in a taxpayer's balance sheet – some form of "expected value" adjustment may assist with volatility.

- The Group notes that cashflow hedges may relate to future items which are not yet included in the balance sheet.

- Interest free loans from shareholders (which are proposed to be excluded from "non-debt liabilities") should encompassed shareholder current accounts and trade receivables from shareholders.

- Deferred tax liabilities should also be excluded from non-debt liabilities. Deferred tax does not reflect a true cash liability. In addition, a number of New Zealand corporates are carrying large deferred tax liabilities on their balance sheet due to the removal of depreciation on buildings. These amounts are not liabilities and would not be taken into account when raising funds from a third party lender. We note that the Australian thin capitalisation rules exclude both deferred tax assets and liabilities[15].

- Amounts that are more akin to equity should also be excluded from "non-debt liabilities. As noted, Officials are already proposing to exclude interest free loans from shareholders. The Group submits that arrangements like redeemable preference shares should also be excluded on the basis that they are more akin to equity.

Application date

3.8 As we expand on in Appendix Four, this proposal has the potential to materially move taxpayers' thin capitalisation calculations. There needs to be sufficient lead in time in terms of application date for these proposals to allow taxpayers sufficient time to restructure their balance sheet.

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[15] Income Tax Assessment Act 1997 – Section 820.682

APPENDIX FOUR: DETAILED SUBMISSION POINTS – OTHER MATTERS

Disclaimer: no comments on practicalities or mechanics of the proposals is intended to be read as an endorsement of the proposals unless explicitly stated.

4. Other matters

Summary

4.1 The Group supports a de-minimis rule, but as currently proposed, most taxpayers will not be able to qualify.

4.2 The Group supports changes for infrastructure projects and suggests some further refinements. The Group submits that this change should apply from the date of issue of the discussion document (3 March 2017).

4.3 Firms which are controlled by non-residents acting together should be able to deduct all arm's length debt where the debt is not proportional to shareholdings.

4.4 Alternative methods of valuing assets should continue to be available.

4.5 The Group does not support removing the ability to measure assets and liabilities at year-end for compliance cost reasons. The Group believes any mischief should be targeted through minor amendments to the existing valuation avoidance rule in section FE 11.

4.6 Thought should be given to aligning to some of the positive features included in the Australian thin capitalisation rules.

4.7 Any taxpayer unfavourable changes requiring taxpayers to potentially restructure their affairs should not apply until at least one year after the rules have been enacted. The most recently enacted taxation act was enacted on 30 March 2017, giving some taxpayers only 2 days before the commencement of their next income year; this is an inadequate amount of time.

De minimis

4.8 New Zealand currently has a thin capitalisation de-minimis of $1 million of interest deductions that applies in the context of the outbound thin capitalisation rules. It is proposed that this rule be extended to have application in the inbound thin cap rules.

4.9 The Group supports having a de minimis rule for inbound thin capitalisation rules. However, we do not agree with the restriction that none of the debt can be owner-linked debt. The Group considers that the proposed related party debt restriction is likely to make the de minimis very limited in application.

4.10 There are a number of reasons as to why it may be necessary to have owner-linked funding. For example, a newly established entity or operations may not be able to borrow in New Zealand so the non-resident parent may need to advance some funds to get the business started. Alternatively, it may be that the only way that the New Zealand entity is able to obtain borrowed funds is by the parent guaranteeing the debt. For interest deductions of this level there is little scope to undertake profit shifting activities and it would not be worth Inland Revenue's time to review these deductions. In this context it would be appropriate to extend the de-minimis to

inbound investment without the owner-linked debt restriction on compliance cost saving grounds.

4.11 The Group notes that in Australia a flat $2 million de minimis applies, regardless of whether any lending is related party.

Infrastructure projects

4.12 The Group supports the proposal for a taxpayer to be able to exceed the 60% safe harbour ratio for infrastructure projects. As the Group has previously discussed with Officials, the current thin capitalisation rules have constrained participation in the Public-Private Partnership (PPP) market. The rules need to change to ensure that the market is open to all participants and to ensure liquidity amongst investors. We comment below on some of the issues that need to be taken into account when designing this exception.

4.13 The proposals recognise that limited recourse third party debt is by definition an arm's length amount of debt. The Group agrees with this analysis. However, the current proposals are written in the context of an inbound thin capitalisation applying to a corporate vehicle. The same proposition should equally be applied to:

- Outbound thin capitalisation, such that third party debt for PPP assets does not negatively impact thin cap;

- Inbound thin capitalisation, regardless of whether the investment into New Zealand is structure through a company or LP structure. Specifically in an LP structure a limited partner should have access to the third party debt carve out. In this regard we note that in a limited partnership the thin capitalisation rules are applied at the limited partner level. This is a layer of complexity that Officials will need to work through. We are happy to discuss this issue in further detail with Officials if that would be of assistance.

4.14 In terms of the criteria outlined at paragraph 5.12 of the discussion document, we make the following comments:

- Bullet point one: Generally speaking the SPV which operates or owns the asset (legally) will be newly established for the project but investors into that may not. The restrictions on sale must relate to sale of the Crown assets held by the SPV and not to the investors staying invested in the project. This will require careful rules where a limited partnership is used for the SPV vehicle as the limited partners (i.e. the investors) are deemed for the purposes of other tax rules to be disposing of the underlying assets of the SPV LP. If the investors are not permitted to sell down / out of their investment this proposal would be rendered relatively useless. In many instances investors entering a PPP will not contemplate holding their investment for the life of the project. For example an investor may take an equity interest during the build phase and may sell out once the operating phase has commenced. Any sell down criteria also needs to have regard to the standard form PPP contract. In that contract all fixtures created during the D&C Phase are sold to the Crown at service commencement.

- Bullet point two: we comment further below on other scenarios the Group would like to see this proposal apply to outside of Government projects.

- Bullet point three: we comment further below in respect of related party debt.

- Bullet point four: if deductible debt is limited to third party debt this requirement is not necessary. A bank will not lend unless it considered that the assets can support that level of debt. In this regard we note that a bank would consider more than just the asset value and will also consider the cash flows of the project which drives how much an asset will be bank funded.

- Bullet point five: Reference to entity for the purposes of this criteria has to be the SPV not the equity/investor entities.

4.15 The Group does not agree that all related party debt should be non-deductible. In the Group's view equity investors should be able to take a debt interest in the project 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 why an investor may want equity and debt returns. The Group 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 remained deductible even with gearing levels above 60%.

4.16 At a minimum *non-proportionate* shareholder debt (for example where only one shareholder of a group of shareholders lends to the investment vehicle) should remain deductible. In this scenario the shareholder is effectively taking on the role of third party lender. In a scenario where there are two or more total shareholders there will be a natural pricing tension to ensure that a fair, arm's length price for debt is struck because, as you would expect, the remaining shareholders would not be willing to accept an uncommercial rate of debt. Shareholder debt in this situation should be considered akin to third party debt and should remain deductible (even above 60% gearing).

4.17 In respect of whether the proposal should apply more widely than Government projects, we see no reason to limit to the proposal PPP assets. There are other infrastructure assets able to be project financed at higher levels than 60% and the existing thin capitalisation rules are constraining funding by third parties. The Group submits that the proposal should also apply to other long life assets (say 10 year project) with third party limited recourse debt - for example a university accommodation project that contains both build and operate phases.

4.18 In terms of application date, the Group submits that taxpayers should have the option to apply the rules from the date of the discussion document. If Officials are concerned that the proposals are not sufficiently formed, in the alternative the Group submits that taxpayer should be able to apply the rules from the date of introduction of the relevant tax bill.

Non-residents acting together: related party debt

4.19 The discussion document outlines a proposal to amend the way the thin capitalisation rules apply to "non-resident owning bodies". If such a firm exceeds the 60% safe harbour, any owner-linked debt will be non-deductible.

4.20 The Group is supportive of this proposal in respect of *proportional* shareholder debt (for example shareholder debt that each shareholder holds in proportion to their shareholding). We agree there is scope for manipulation in that context. We also agree the amendment should apply prospectively. Investors have made investment decisions based on existing tax rules. Those investment decisions should not be undermined.

4.21 Notwithstanding the above, we do not agree with the proposal in respect of *non-proportionate* shareholder debt (for example where only one shareholder of a group of shareholders lends to the investment vehicle). In this scenario the shareholder is effectively taking on the role of third party lender. As we have discussed above, the tax rules should not penalise someone wanting to take on both the role of shareholder and lender. Given there will be two or more total shareholders there will be a natural pricing tension to ensure that a fair, arm's length price for debt is struck because, as you would expect, the remaining shareholders would not be willing to accept an uncommercial rate of debt. Shareholder debt in this situation should be considered akin to third party debt and should remain deductible (even above 60% gearing). Any arm's length debt should remain deductible above the 60% safe harbour because these investors will not have the benefit of a worldwide group test to reflect an appropriate industry debt level.

4.22 The Group notes that paragraph 5.20 of the discussion document states:

> "We propose to amend the rules for firms controlled by a group of non-residents acting together. If such a firm exceeds the 60 per cent safe harbour, any *owner-linked debt* will be non-deductible."

4.23 The Group submits that paragraph 5.20 contains an error and it is not intended at all owner-linked debt will be non-deductible, only the excess above the safe harbour.

Asset valuation

4.24 The Group does not support the proposal to only allow taxpayers to use asset values as reported in financial statements. The discussion document does not provide any evidence to suggest that the net current value method is being abused by taxpayers and as such, the Group considerers that there is insufficient rationale to justify the removal of the net current value method. It is noted that subsection FE 16(2) requires all of the asset valuation options to accord with generally accepted accounting practice, with the exception of two particular types of assets (trading stock, and finance leases).

4.25 This proposal puts New Zealand significantly out of step with the Australian thin capitalisation rules. The Group notes that in Australia, as a general rule, an entity must comply with the accounting standards when revaluing its assets for the purpose of calculating its thin capitalisation liability. However, an entity can choose to recognise / revalue an asset, including an intangible asset as long as it meets stringent requirements (noting that in Australia intangible assets, other than internally generated goodwill, can be recognised for the purposes of the thin capitalisation regime).

4.26 The Australian approach is significantly more generous than the existing New Zealand approach in that it allows you to bring into the asset net for thin capitalisation purposes assets which cannot be recognised for financial reporting purposes. The Group does not understand the justification for the Government seeking to restrict our asset valuation rules further.

4.27 The Australian rules include the requirement that if the revaluation is not included in the financial statements, the assets must be revalued by a person who is an expert in valuing such assets. This expert must be someone whose pecuniary and other interests could not reasonably be regarded as being capable of affecting the person's ability to give an unbiased opinion in relation to the revaluation.

4.28 There is a theme running through the discussion document of the Government wanting to align the thin capitalisation rules with what a third party lender would consider when it was considering how much to lend. The Group submits that the values expressed in the financial statements would have little bearing on the amount of debt lent. A bank would firstly consider the future cash flows of the organisation and then, as buttress to this, would consider what the assets of the organisation could be realised for. This value may or may not be reflected in the financial statements. A third party lender would also consider the cashflows that may be generated from off balance sheet assets. The point we are demonstrating is that the aspiration of aligning the thin capitalisation rules with what a third party lender would consider when it was considering how much to lend is not achieved through this proposal. Various third party banking experts can be made available to discuss this with Officials.

4.29 The discussion document expressed concern that asset valuations that are solely adopted for thin capitalisation purposes (and not in the financial statements) are not sufficiently robust because they are not reviewed by auditors and there is no repercussions for material misstatements. The Group submits that there are a number of options available to address this concern, including:

- Requiring the taxpayer to obtain an independent valuation to support the value adopted.

- Requiring taxpayers to disclose with their tax return whether they have used the net asset value method (this would allow Inland Revenue to appropriately target its compliance / audit resource).

4.30 In the Group's view, there are a range of reasons why revaluations may not be included on an organisation's balance sheet. As discussed with Officials at our workshop, there can be significant costs associated with annual revaluation of assets where the revaluation model is adopted for financial reporting. The Group submits that entities taking this conservative approach should not be penalised by the removal of the net current valuation method from the list of available valuation methods for thin capitalisation. As noted at our workshop, independent valuations would only be required in years in which it is necessary to deviate from the (lower) reported financial statement values for thin capitalisation. If Officials would like greater transparency around the use of the net current valuation method we suggest that Inland Revenue require disclosure with the income tax return if this method has been used. Then Inland Revenue can appropriately target its resource to these taxpayers if concerns remain around the use of this method.

4.31 At a minimum the Group submits that the net asset value method should be retained. The Group also submits that New Zealand should adopt the same position as Australia on the recognition / revaluation of assets and include intangibles in the asset calculation that are not able to be recognised for financial reporting purposes.

Measurement date for assets and liabilities

4.32 Currently, taxpayers are able to measure their assets and liabilities for thin capitalisation purposes either daily, quarterly or at year end. The Group does not support removing the ability of taxpayers to measure asset and liability amounts on the last day of the income year as requiring taxpayers to use one of the two other methods will create significant compliance costs. The proposal is not justified and there are other options available to address any perceived concern.

4.33 Throughout the discussion document there is a reliance placed on the integrity of audited IFRS accounting values. As noted above, Inland Revenue justifies the removal of the net asset valuation method on the grounds that reported financial statements are subject to a degree of scrutiny. To require taxpayers to use quarterly or daily measurement is completely inconsistent with this. None of the largest taxpayers in New Zealand will be preparing audited quarterly financial statements, let alone the smaller corporates.

4.34 The Group notes that as a compliance cost saving initiative many taxpayers are no longer required to prepare financial statements that comply with GAAP. To require quarterly calculations will compound the additional compliance costs that those firms already face.

4.35 IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. We assume Inland Revenue is not trying to suggest that taxpayers undertake this work on a quarterly basis. To require these to be done solely for tax purposes at points in the year when they are not already being done for financial reporting purposes imposes additional and unnecessary compliance costs. This issue is exacerbated by the inclusion of non-debt liabilities in the thin capitalisation calculation.

4.36 In this discussion document no evidence is offered to suggest that taxpayers are currently taking advantage of the year-end valuation method by ensuring that debt is paid down / capitalised before balance date. The Group submits that any mischief is likely to be immaterial given at most it would be a one year deferral of the thin capitalisation rules applying. If there are truly material instances of this occurring the Group believes the best way to address this is by strengthening the anti-abuse rule in section FE 11 to ensure Inland Revenue has the tools to neutralise this sort of activity. It is unfair to penalise all taxpayers and force additional compliance costs on all taxpayers subject to this regime simply because a small group of taxpayers (if any) are abusing the rules.

4.37 A further option would be to require disclosure when the tax return is filed of whether taxpayers have paid down / capitalised debt at the end of the income year. This would allow Inland Revenue to appropriately target its review / audit resources.

4.38 At our workshop, Officials asked the Group to consider whether an average of the opening and closing values would be palatable. In light of the Group's comments above regarding the materiality of the issue we consider such an approach to be unnecessary. The Group also notes that this could disadvantage Inland Revenue in instances where the taxpayer breaches the thin capitalisation threshold towards the end of year. For the sake of simplicity the Group submits that the existing year-end measurement option be retained.

Australian thin capitalisation rules

4.39 The Group has mentioned a number of features of the Australian thin capitalisation rules which are more favourable than the New Zealand rules. The Group considers there is merit in considering an alignment in the rules between the countries. We set out in Appendix Five a summary of the rules in each country.

Application date / grandparenting

4.40 The discussion document notes that, if implemented, the proposals will apply from the beginning of the first income year after enactment (except for the proposals

relating to non-resident owning bodies). The Group submits that this application date is inappropriate for such fundamental proposals.

4.41 If the interest rate cap proceeds in its current form, at a minimum, all existing APAs with respect to debt pricing should be preserved for the term of the APA, particularly if they are bilateral APAs. Taxpayers incur significant costs to reach those agreements with Inland Revenue. It would significantly damage New Zealand's reputation on an international scale if the Government were to legislatively override those agreements. The Group also submits that existing debt arrangements that have a finite term should also be grandparented for the life of the arrangement. Investment decisions were made on the legitimate expectation of the continuation of New Zealand's existing tax rules. The changes have the potential to materially alter returns on investment which again may harm New Zealand's reputation as an investment destination.

4.42 We also submit that taxpayers should be afforded greater opportunity to restructure their balance sheets prior to the remaining proposals taking effect. The proposal with respect to non-debt liabilities will materially impact some taxpayers. Those taxpayers need time to get their affairs in order. The Group submits that the proposals should apply from a specified income year more than 1 income year into the future. This provides taxpayers with greater certainty as to when the rules will apply from. The Closely Held Companies bill was enacted on 30 March 2017, meaning that for March balance date taxpayers a number of reforms came into effect two days later, the Group does not want to see this happen with these proposals.

4.43 The Group notes that the last substantial changes to the thin capitalisation rules were included in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*. These rules received Royal Assent on 30 June 2014 and took effect from 1 April 2015 the 2015/16 and later income years. The Group submits that at least a similar lead in time should also apply to any taxpayer unfavourable changes.

APPENDIX FIVE: COMPARISON OF NEW ZEALAND AND AUSTRALIAN THIN CAPITALISATION RULES

	New Zealand	Australia
Ratio	60% of assets	60% of net Australian investments
Debt	Debt is limited to financial arrangements that provide money and give rise to deductions under the financial arrangement rules (does not include non-interest bearing debt).	Debt capital of the entity that gives rise to a debt deduction for an income year.
Assets	Assets means the aggregate of all the taxpayer's assets or the assets of another group member. Broadly the taxpayer may elect to measure total assets by: - Value of the assets shown in the financial statements of the entity's NZ group; or - The net current value of the assets; or Proposal to remove the net current value option.	Base rule is to value as permitted in relevant accounting standards (from AIFRS).[16] Measurement based on an independent valuation is also permitted. The ATO has the discretion to substitute values where it believes that the taxpayer has overvalued its assets or undervalued its liabilities.[17] Some deviations permitted as below. 1. Deferred tax assets are excluded. 2. Defined (employment) benefit plans - Amounts related to defined benefit superannuation plans are not recognised as assets/liabilities. 3. Intangible assets[18] - Internally generated intangible assets can be recognised for thin capitalisation purposes even if not recognised under AASB 138 if: o The reason that the standard does not recognise them is because it is impossible to distinguish between the cost of acquiring that item and of developing the entity's business as a whole; and

[16] ITAA 1997, Div. 820-680(1)
[17] ITAA 1997, Div. 820-690.
[18] ITAA 1997, Div. 820-684(1) and (2).

		o that item otherwise meets the criteria for an internally generated intangible asset under AASB 138. - Intangibles with no active market. Entities can also choose to revalue intangibles with no active market (this would be prevented under AASB 138). [19]
Treatment of non-debt liabilities	Not counted for thin capitalisation purposes. Propose to include all non-debt liabilities except for non-interest bearing shareholder debt.	Non-debt liabilities defined as liabilities other than: - any debt capital of the entity - any equity interest in the entity; - if the entity is a corporate tax entity—a provision for a distribution of profit; - if not a corporate tax entity—a provision for a distribution to the entity's members; - any liability of the entity under a securities loan arrangement if, as at that time, the entity: o has received amounts for the sale of securities (other than any fees associated with the sale) under the arrangement; and o has not repurchased the securities under the arrangement; - a liability of the entity, to the extent that it meets the conditions for being taken into account in working out the borrowed securities amount of the entity as at that time. [20] - Also excludes deferred tax liabilities.
Debt measurement date	At the election of the taxpayer can be calculated either: - Daily; or	Three possible tests:[21] - Opening and closing balance method (i.e. measure on opening

[19] ITAA 1997, Div. 820-684(5).
[20] Div 995 ITAA97
[21] ITAA 1997, Div. 820-635 / Div. 820-640 / Div. 820-645https://www.ato.gov.au/Business/Thin-capitalisation/Understanding-thin-capitalisation/Average-values-for-debt-and-capital-levels/Average-values/

	- Quarterly; or - At the end of the income year.	date and closing date for the year) - 3 measurement days method (i.e. measure on opening date, mid year date and closing date for the year) - Frequent measurement method (i.e. quarterly or more frequently, as desired)
Asset measurement date	At the election of the taxpayer can be calculated either: - Daily; or - Quarterly; or - At the end of the income year.	Three possible tests: - Opening and closing balance method (i.e. measure on opening date and closing date for the year) - 3 measurement days method (i.e. measure on opening date, mid year date and closing date for the year) - Frequent measurement method (i.e. quarterly or more frequently, as desired)