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NEW ZEALAND LAW SOCIETY
NZLS EST 1869

Law Society Building, 26 Waring Taylor Street, Wellington,
DX SP20202, Wellington or PO Box 5041, Lambton Quay,
Wellington 6145, New Zealand

TEL +64 4 472 7837 • FAX +64 4 473 7909
E inquiries@lawsociety.org.nz
www.lawsociety.org.nz • my.lawsociety.org.nz

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Policy and Strategy
Inland Revenue
PO Box 2198
Wellington

By email: policy.webmaster@ird.govt.nz

Base Erosion and Profit-Shifting (BEPS) – Strengthening our Interest limitation rules

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on *BEPS – Strengthening Our Interest Limitation Rules: A Government discussion document* (discussion document).

2. This submission focuses on the proposed cap on the deduction permitted for interest paid by a New Zealand borrower to a non-resident related-party lender.

Proposed interest deduction cap

3. The Government proposes a cap on the amount of interest deductible by a New Zealand borrower on debt funding from a related non-resident party by reference to the interest rate that the borrower's ultimate parent could borrow at on standard terms.

4. The maximum permitted deduction to the New Zealand borrower would be capped as follows:

   a) where the ultimate parent of the borrower has a credit rating for senior unsecured debt (and the New Zealand borrower does not), the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin (the margin yet to be determined);

   b) where the New Zealand borrower has a credit rating, the lower of:

      (i) the yield derived from appropriate senior unsecured corporate bonds for the parent's credit rating, plus a margin (yet to be determined); and

      (ii) the yield derived from appropriate senior unsecured corporate bonds for the New Zealand group's credit rating;

   c) where the ultimate parent has no credit rating, the interest rate that would apply if the parent raised senior unsecured debt on standard terms, plus a margin (yet to be determined); and

   d) where there is no ultimate parent, the interest rate that would apply if the New Zealand group raised senior unsecured debt on standard terms (with no margin) such rate being priced on an amount of "arm's length debt" or, alternatively, by deeming related party debt to be equity in determining the borrower's creditworthiness.

5. If the term of a loan exceeds five years, the maximum permitted interest deduction would be determined as if the loan had a five year term.

6. The proposed cap on interest deductions claimable by a New Zealand borrower on funding from a related non-resident party is referred to in this submission as the interest deduction cap.

7. This submission addresses:

   - the justifications advanced in the discussion document in support of the interest deduction cap and questions whether those justifications support a departure from the transfer pricing regime for related-party debt arrangements;

   - whether the interest deduction cap involves a departure from the arm's length principle contained in Article 9 of the OECD Model Tax Convention on Income and on Capital (the Model Convention) included in New Zealand's double taxation agreements; and

   - the practical impact of any such departure, being the risk of economic double taxation of multi-national groups advancing debt to New Zealand subsidiaries.

Summary of proposed alternative regime

8. The Law Society submits that the analysis contained in this submission supports a balancing of Inland Revenue concerns and the importance of the arm's length principle through adoption of an approach that incorporates the interest deduction cap as a safe-harbour adopted by taxpayer election.

9. Under this alternative proposal taxpayers could deduct at least an amount of interest up to the interest deduction cap. However, if a taxpayer could establish that the application of the arm's length principle supported a greater level of deductible interest in New Zealand then that level of deduction should be permitted.

10. It is noted in the context of advancing this proposal the changes to the transfer pricing regime proposed in the discussion document "BEPS – Transfer pricing and permanent establishment avoidance" (the Transfer Pricing Discussion Document) should in large measure mitigate the concerns expressed and justifications offered by the Government in support of the interest deduction cap.

The justification for change

11. The Government offers its justification for the interest deduction cap at paragraphs 3.7 – 3.13 of the discussion document by reference to issues identified in connection with the current application of the transfer pricing regime to related-party debt arrangements.

12. The Law Society observes that all of these issues are either one or more of the following:

    (a) not unique to the transfer pricing rules;

    (b) not specific to related-party debt arrangements; or

    (c) mitigated by certain of the proposals in the Transfer Pricing Discussion Document.

13. By way of elaboration of the last category, the following related measures are proposed in the Transfer Pricing Discussion Document:

(a) the requirement to have regard to both the legal and economic substance of relationship between parties and of a tested transaction in determining an arm's length price (paragraphs 5.26 – 5.33);

(b) the non-recognition of commercially unrealistic or irrational transactions (paragraphs 5.34 – 5.40); and

(c) the proposed reference in the rules to "arm's length conditions" to permit testing of the conditions that arm's length parties would be willing to accept (paragraphs 5.41 and 5.42).

14. The Transfer Pricing Discussion Document also proposes certain administrative changes in connection with the regime including the reversal of the burden of proof (paragraph 5.43 – 5.48).

15. The table below repeats the issues raised in the discussion document and comments on why the Law Society does not consider that they form sound justification for the interest deduction cap.

Issue	Comment
The application of the transfer pricing rules is "resource intensive" (paragraphs 3.1 and 3.13)	This is a general criticism of the transfer pricing rules and the arm's length principle. It is not a concern specific to debt arrangements. Transfer pricing analysis of all internal arrangements can be resource intensive requiring the identification and testing of comparable arrangements and the consideration of other fact-specific considerations. In any case, the concern may be mitigated from Inland Revenue's perspective as a result of the administrative proposals in the Transfer Pricing Discussion Document.
"[C]ommercial pressures" will not "drive the borrower to try to obtain as low an interest rate as possible – for example, by providing security on a loan if possible, and by ensuring their credit rating is not adversely affected by the amount being borrowed." (paragraphs 3.8 and 3.9)	The absence of actual commercial pressure or tension is assumed in related party arrangements and gives rise to the need to impose the arm's length standard. The absence of such tension is also not specific to debt arrangements. Commercial pressures will seldom drive the inclusion (or non-inclusion) of terms or conditions in any related party transaction. The issue is addressed by the arm's length principle as strengthened by proposals in the Transfer Pricing Discussion Document to (a) disregard commercially unrealistic/irrational transactions and (b) incorporate the concept of "arm's length conditions".
"A related party interest payment, such as from the New Zealand subsidiary of a multinational to its	The absence of an external cost is a feature of many internal transactions. It is not specific to debt funding

foreign parent, is not a true expense from the perspective of the company's shareholders. Rather, it is a transfer from one group member to another." (Paragraph 3.9).	arrangements. The arm's length principle operates to ensure that the "transfer" from one group member to another is made on arm's length terms. It is also the case that many related party transactions do involve a cost at a group level. A group is likely to have external borrowings. Internal group advances then ensure appropriate allocation of that external cost to group members. Such allocation is entirely appropriate if made in compliance with the arm's length principle. In any case intra-group funding arrangements have very real consequences in terms of international taxation. The interest paid will give rise to income in the lender jurisdiction and withholding tax will be imposed in the borrower jurisdiction.
"Indeed, it can be profitable to increase the interest rate on related-party debt – for example, if the value of the interest deduction is higher than the tax cost on the resulting interest income." (Paragraph 3.9).	This statement is not specific to debt arrangements and is an obvious point justifying the application of the arm's length principle to all cross border related-party transfers.
"[R]elated party transactions are fundamentally different to third-party transactions. Factors that increase the riskiness of a loan between unrelated-parties (such as whether the debt can be converted into shares, or the total indebtedness of the borrower) are less relevant in a related-party context." (Paragraph 3.10).	The transfer pricing rules recognise that related party transactions are fundamentally different because of the assumed absence of commercial tension. This is what gives rise to the arm's length standard to ensure appropriate tax outcomes are recognised under such arrangements. The absence of commercial pressure and group context will lead to an indifference to a range of factors, terms and connected arrangements that could impact on the stand-alone "riskiness" of a loan transaction or any other arrangement. This consideration is not limited to funding arrangements. Further, the issue is addressed by the arm's length principle as strengthened by proposals in the Transfer Pricing Discussion Document to (a) disregard commercially unrealistic/irrational transactions and (b) incorporate the concept of "arm's length conditions".
"Some related-party loans feature unnecessary and uncommercial terms (such as being repayable on demand or having extremely long terms) that are used to justify a high interest rate. Simply making the related party debt subordinated or subject to optionality may also be used as justifications for a high interest rate. In other cases, a very high level of	As above noting in particular the utility of the proposed changes in the Transfer Pricing Discussion Document to mitigate those concerns. Individual conditions on which funding is advanced could be tested against the proposed "arm's length conditions" test. If the terms of an arrangement become commerciality unrealistic or irrational such

related party debt may be loaded into a New Zealand subsidiary to depress the subsidiary's credit rating, which also is used to justify a higher interest rate." (paragraph 3.11)	that an arrangement would not be entered into on those terms between third parties, the arrangement could be disregarded.
"It can be difficult to challenge such arrangements under the transfer pricing rules as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and a similarly high interest rate…. However, we are concerned that they may still provide scope for taxpayers to choose to borrow from related parties using higher-priced forms of debt than they would typically choose when borrowing from third parties." (Paragraph 3.12)	If it is difficult for Inland Revenue to challenge the arrangement because the arrangement is arm's length that suggests that the tax effect of the arrangement should be allowed to stand. If the comment is intending to suggest that in some cases comparables referenced by the taxpayer are not appropriate comparables, then the proposed administrative changes to the transfer pricing regime should allow that to be properly tested.
"[T]he highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply…. [C]omplying with the transfer pricing rules [is] a resource-intensive exercise which can have high compliance costs and risks of errors." (Paragraph 3.13)	This concern is not specific to debt arrangements. It is suggested that greater complexity and uncertainty could be expected to arise in cases involving integrated production of highly specialised goods, unique intangibles or in the provision of highly specialised services. The uncertainty involved in the application of the arm's length principle is recognised and tolerated by the OECD. Difficulties in the comparability analysis led to recognition in the OECD Guidelines that "*transfer pricing is not an exact science but does require the exercise of judgement on the part of both tax administration and taxpayer*." (1.13). And later at 2.0: "*Tax administrators should hesitate from making minor or marginal adjustments. In general, the parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and the preference for higher degrees of comparability and a more direct and closer relationship to the transaction.*"
"Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue." (Paragraph 3.13 and see paragraph 3.17)).	This issue is not unique to transfer pricing matters.

16. The Law Society also notes the inconsistency in the justification for the interest deduction cap based on the resource intensive and complex nature of compliance with the transfer pricing regime and comments made in the discussion document about the likely cost and complexity involved in compliance with the proposed cap. In addressing the proposed de minimis threshold for loans with a principal value of NZ$10m or less, the discussion document comments at paragraphs 3.46 and 3.47:

"Applying this interest rate cap will likely require the engagement of financial analysts or other subject matter experts, who have access to bond yield data and are able to perform the required calculations. This is no different to the situation at present – firms borrowing from related-parties should be involving subject matter experts to perform comparability analysis and ensure that the interest rate (and the other terms and conditions) of the related-party loan is reasonable.

We therefore believe this proposal will not result in increased compliance costs; indeed compliance costs may reduce in some circumstances."

17. Any justification for the interest deduction cap based on the (relative) cost or complexity of compliance with transfer pricing is ill-founded if the counterfactual under the proposed cap is net neutral (or at best the belief that in some cases compliance costs might reduce).

18. The Law Society submits that no sound justification has been advanced for the proposed departure from the transfer pricing regime.

Inconsistency with the arm's length principle

19. The Government comments in general terms in the discussion document that the interest rate cap would 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 (paragraphs 3.17 and 3.21).

20. Later at paragraphs 3.57 and 3.58 the Government comments that the interest deduction cap is consistent with the existing thin capitalisation rules which are non-arm's length based but:

    "…are consistent with the arm's length principle insofar as their effect is to assimilate the overall profits of the borrower with those which would have occurred in arm's length situations. This is on the basis that, while a thin capitalisation regime does not expressly refer to arm's length amounts, it aims to approximate a similar overall level of interest expense for a taxpayer as would arise in arm's length situations."

21. Government reasons further at 3.58 that:

    "…independent lenders take the credit rating of the group into account when determining the interest rate payable by a New Zealand subsidiary, even without an explicit parent guarantee. Therefore, the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Consequently it should also be consistent with the arm's length principle."

22. The assimilation of the interest deduction cap to the existing thin capitalisation regime as a means to describe the outcome under the cap as consistent with the arm's length principle involves incorrect logic.

23. A thin capitalisation regime will only produce results consistent with the arm's length principle if it produces results that are consistent with an application of the arm's length principle. If the application of the rule produces an outcome inconsistent with the arm's length principle, then it is inconsistent with the arm's length principle. The assimilation of the interest deduction cap to internationally tolerated thin capitalisation regimes based on the amount of the debt not the price of the debt advanced has no bearing on the consistency of the results produced by the application of the rule with the arm's length principle. Consistency with the principle is best served by adherence to it.

24. A thin capitalisation regime is a base protection measurement mechanism applying safe harbours and tolerances set by reference to hard debt to asset percentages selected at a level to protect against the over-allocation of deductible expenditure to New Zealand without discouraging investment in New Zealand relative to our main competition for investment. It does not have at its heart an embedded arm's length principle in relation to the amount or price of debt.

25. Further, the statement that lenders take into account the credit rating of the group without explicit parental support involves significant overstatement. As Inland Revenue is aware, expert views differ on the appropriateness of a creditworthiness upgrading or uplift on the basis of implicit parent support absent contractual guarantees. It is a contentious issue on which we expect more considered guidance will become available in due course.

26. Even if some notching on account of implicit parental support is appropriate the extent of the upgrading is a fact-specific exercise taking into account the importance of the subsidiary to the group having regard to a number of factors including inter alia the subsidiary's contribution to global revenue, reputational/brand considerations and group perceptions of the strategic importance and potential of the market and industry in which the subsidiary operates.

27. There are other dangers in taking a parent's credit rating as a proxy for that applicable to a subsidiary. A parent group and New Zealand subsidiary might be exposed to very different risks. An operating subsidiary in New Zealand exposed to one market and industry could have a very different risk profile to a group holding company with risk spread across multiple investments in multiple jurisdictions.

28. If notching was considered to be appropriate in a given case then it is a fair question to ask whether the upgrading should be reflected in a deemed charge from borrower to parent similar in nature to a guarantee fee which would be expected to be paid to a party that permits its balance sheet to secure cheaper funding for a borrower.

29. The Law Society submits that whether an upgrading in creditworthiness on account of implicit parental support is appropriate in any given case is best tested under an individual transfer pricing analysis.

Significance of the departure from the arm's length principle

30. The departure from the arm's length principle is of real practical significance.

31. The arm's length principle as it is understood by our treaty partners is articulated in Article 9 paragraph 1 of the OECD Model Tax Convention on Income and on Capital (the Model Convention). That article provides:

> *"[Where] conditions are made or imposed between two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

32. Adjustments made in one jurisdiction as a result of the application of the arm's length principle could give rise to economic double taxation without a corresponding adjustment in the counterparty jurisdiction. Key to the elimination of economic double taxation is paragraph 2 of Article 9 of the Model Convention. It provides that:

> *"Where a Contracting State includes the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits."*

33. The obligation imposed on a counterparty State to make a corresponding adjustment as a result of a transfer pricing adjustment made by the first State appears to be conditional on the first adjustment having been made in accordance with the arm's length principle in paragraph 1. Adjustments made under a regime that does not explicitly utilise the principle in informing the adjustment, like the proposed interest deduction cap, may not trigger the counterparty State obligation to make the corresponding adjustment.

34. This gives rise to the potential for economic double taxation of multinational groups. If a New Zealand subsidiary's deductions are limited under the interest deduction cap without a corresponding reduction in the amount of income taxed in the lender's jurisdiction, double taxation will result.

35. It is also difficult to see how that double taxation might be resolved between two States under the Article 25 Mutual Agreement Procedure when (presumably) the level of interest income recognised in the lender jurisdiction is based on traditional arm's length pricing principles and the permitted deduction to the borrower in New Zealand is not so based. New Zealand could not expect the lender jurisdiction to depart from the well tested and internationally normative arm's length principle. The cause of the double taxation will be New Zealand's internationally non-normative interest deduction cap.

Summary and alternative proposal

36. An analysis of the justifications advanced in the discussion document in support of the interest deduction cap suggests to the Law Society that there is no sound basis to depart from the transfer pricing regime for related-party debt arrangements.

37. The Law Society submits that the interest deduction cap cannot be expected to produce outcomes that correspond to outcomes produced following application of traditional arm's length pricing principles.

38. The practical result of the departure from the arm's length principle will be the economic double taxation of multi-national groups advancing debt to New Zealand subsidiaries.

39. The Law Society submits that a balancing of Inland Revenue concerns and the importance of the arm's length principle could be achieved through adoption of an approach that incorporates the interest deduction cap as a safe-harbour adopted by election of taxpayers. Taxpayers would be permitted to deduct at least an amount of interest up to the proposed cap. However, if a taxpayer could establish that the application of the arm's length principle supported a greater level of deductible interest in New Zealand then that level of deduction should be permitted.

40. It is noted in the context of advancing this proposal the changes to the transfer pricing regime proposed in the Transfer Pricing Discussion Document should in large measure mitigate the concerns expressed by the Government in support of the interest deduction cap.

Conclusion

41. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

Kathryn Beck
President