



Inland Revenue
Te Tari Taake

POLICY AND STRATEGY



THE TREASURY
Kaitohutohu Kaupapa Rawa

RECEIVED

6 JUL 2017

MINISTERIAL SERVICES UNIT

Tax policy report: BEPS – interest limitation submissions and policy decisions

Date:	22 June 2017	Priority:	Medium
Security level:	In Confidence	Report no:	T2017/1576 IR2017/325

Action sought

	Action sought	Deadline
Minister of Finance	Agree to the recommendations	29 June 2017
Minister of Revenue	Agree to the recommendations	29 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Hamish Slack	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Steve Mack	Principal Advisor, The Treasury	
Carmel Peters	Policy Manager, Inland Revenue	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS – interest limitation submissions and policy decisions

Executive summary

1. In March this year the Government released the discussion document *BEPS – strengthening our interest limitation rules*. This report advises on the main issues relevant to the policy decisions to be made by Cabinet in July. Following this decision, we will design the detail of the proposals, on which we propose further consultation.

2. The use of debt is one of the simplest ways of shifting profits out of New Zealand. Robust rules limiting the use of debt (and limiting interest payments on that debt) are therefore important base protection measures. Accordingly, the discussion document proposed two key changes to these rules:

- a new method for limiting the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower (referred to as the interest rate cap), which we estimated would increase tax revenues by \$40 million per year; and
- a change to how allowable debt levels are calculated under our thin capitalisation rules (referred to as an adjustment for non-debt liabilities), which we estimated would increase tax revenues by \$50 million per year.

3. We received 27 submissions on the proposals. A full list of submitters is included in the appendix to this report. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals. In general, submitters acknowledged the need to respond to BEPS concerns. However, many submitters did not support the specific proposals put forward.

4. In summary, we are recommending several modifications to the original proposals put forward. We estimate these modifications will not affect the revenue estimate for the proposals (which was \$90 million per annum from the 2018/19 year). However, as discussed below, we are proposing to consult further on the details of one of the proposals (to exclude deferred tax from the non-debt liability adjustment), the outcome of which could have a fiscal consequence. If deferred tax were to be entirely omitted from the proposal, the revenue forecast would reduce by \$10 million per year.

Interest rate cap

5. The discussion document proposed replacing transfer pricing rules with a rule to cap the interest rate deduction allowed on related-party loans from a non-resident to a New Zealand borrower (“inbound related-party loans”) based on the credit rating of the parent company - with a one-notch reduction for the New Zealand subsidiary. We viewed this interest rate cap proposal as a straight-forward, simple and non-manipulable way of pricing related-party debt. We considered that the cap was largely consistent with an arm’s length approach under transfer pricing principles – albeit we accept that this would not be true in every case.

6. As a starting point, many submitters argued that no specific rule for limiting interest rates on related-party debt was necessary. Submitters noted that the Government has proposed to strengthen those rules generally (in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*). They thought that these strengthened rules should be sufficient to address any concerns about interest rates on related-party loans.

7. Submitters were concerned that the rule was novel and untested. They were concerned that New Zealand would stand out on its own and that this would deter FDI.

8. Another concern raised by submitters is that the cap would frequently result in double taxation because the foreign revenue authority would require a higher return on the debt and impose tax on that basis. (As explained in the body of our report, our view is that it is unlikely that our treaty partners will challenge this approach under our treaties.)

9. Some submissions highlighted the consequences of adopting a blunt rule in the nature of the cap. These include concerns that:

- the cap is not a good proxy for an arm’s length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand’s largest foreign-owned businesses are owned by companies with no credit rating);
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

10. Following consultation and further analysis, we consider that if the Government pursued the interest rate cap, adjustments would be needed to the original proposal which would make it more complex. For example, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

11. The difficulty is, however, that simply relying on transfer pricing, as suggested by submitters, will not achieve the desired policy outcomes. It is clear that the international

consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. Commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions. Professor Richard Vann from Sydney University has said “transfer pricing has not proved up to the task of dealing with interest rates”.

12. Accordingly, we recommend that the discussion document proposal be replaced by a *restricted transfer pricing* methodology. We consider this methodology is a better way of achieving the interest rate cap’s objective and would have the same revenue impact. Like the cap, this approach will generally result in the interest rate on the related-party debt being in line with that facing the foreign parent. This is because, under the rule, debt will generally be required to be priced on the basis that it is “vanilla” (that is, without any features or terms that could push up the interest rate) and on the basis that the borrower could be expected to be supported by its foreign parent in the event of a default.

13. Implementing these restrictions in legislation will address the problem that the transfer pricing guidelines, in so far as they apply to related party debt, are open to interpretation, subjective, and fact intensive in their application.

14. We would recommend that the interest rate cap as initially proposed be available as a safe harbour. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable. We believe this would be an attractive option to many companies as it is both simple and provides certainty.

15. We also intend that access to the Mutual Agreement Procedure (MAP) under our Double Tax Agreements be available to taxpayers who consider that taxation under the new rule is inconsistent with the relevant treaty. This will address submitters’ concerns about double taxation. We do not, however, expect many MAP cases will eventuate because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

16. We note that the Australian Taxation Office recently released draft guidelines, which are designed to incentivise Australian subsidiaries to structure their related-party loans into ordinary “vanilla” loans at interest rates similar to that facing their foreign parents. This will produce a similar result to the restricted transfer pricing approach we are recommending. However, the Australian guidelines are administrative measures – taxpayers are able to dispute them if they so choose.

Non-debt liability adjustment

17. The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand (“deductible debt”). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer’s assets as reported in its financial accounts (generally, debt up to 60 percent of the taxpayer’s assets is allowable).

18. The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

19. This proposal was accepted by some submitters but opposed by others, who argued for example that the proposal amounts to a substantial reduction in the amount of deductible debt allowable under the thin capitalisation rules. Overall, this proposal was much less contentious than the interest rate cap.

20. We consider this non-debt liability proposal should proceed. This is because the core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a taxpayer is limited to a commercial level of debt. A third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities. Moreover, the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. We note that Australia requires this same adjustment for non-debt liabilities.

21. A near-universal comment from submitters was that certain non-debt liabilities – most significantly *deferred tax liabilities* – should be carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept – accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. Submitters argued that this is often not the case – that deferred tax liabilities frequently are technical accounting entries and do not reflect future tax obligations. Submitters also pointed to the rules in Australia, which do include a carve-out for deferred tax liabilities and assets.

22. While many deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future, given the concerns raised by submitters, we recommend that we consult further on this matter. We could explore, for example, whether particular deferred tax liabilities that will not result in future tax payments could be identified and carved out from any adjustment. Note that the deferred tax balances of some taxpayers are significant – if a deferred tax exemption were provided, we estimate that this would reduce the fiscal impact of the non-debt liability proposal by up to \$10m per year (from \$50 million per year to \$40 million per year).

Other proposals

23. Finally, the discussion document proposed several minor changes to the thin capitalisation rules. One of these proposals, which was generally welcomed, is a special rule for project finance. This proposal will allow full interest on third party debt to be deductible even if the debt levels exceed the thin capitalisation limit if the debt is non-recourse with interest funded solely from project income. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously. However, some technical issues have been raised which we will consult further on.

24. The other minor changes to the rules are summarised in the table below. Some of these were supported by submitters while others were opposed. Where they were opposed, we are recommending changes to the proposals that, in general, will address submitters' concerns.

Proposal in discussion document	Recommended approach
That the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of \$1 million or less, be made available also to foreign-controlled taxpayers provided they have no owned-linked debt.	Submitters generally supported this proposal. We recommend that the proposal proceed without modification.
That when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.	Few substantive comments were received on this proposal. We recommend that the proposal proceed without modification.
Removing the ability for a company to use a value for an asset for thin capitalisation purposes that is different from what is used for financial reporting purposes, provided the valuation would be allowable under GAAP.	Submitters did not support this change, arguing it would result in high compliance costs. We recommend modifying this proposal to allow taxpayers to retain the ability to use asset values for thin capitalisation that differ from those reported in their financial accounts, but that clearer legislative requirements be developed for when this is option is utilised.
Removing the ability for a taxpayer to use their year-end debt and asset values for thin capitalisation purposes, so that debt and assets can only be valued for thin capitalisation based on average values at the end of every quarter or day.	Submitters did not support this change, arguing it would result in high compliance costs. We recommend that the proposal in the discussion document should not proceed, and instead we recommend inserting an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year.
A remedial amendment to section FE 18(3B) (regarding financial arrangements and trusts) to ensure it operates clearly.	Few substantive comments were received on this proposal. We recommend that this proposal proceed without modification.

Recommended action

We recommend that you:

- (a) **Agree** that ordinary transfer pricing should not be used to price inbound related-party loans.

Agreed/Not agreed

Agreed/Not agreed

- (b) **Agree** that the original proposal for limiting the interest rate on inbound related-party loans – the interest rate cap – should not proceed at this time.

Agreed/Not agreed

Agreed/Not agreed

- (c) **Agree** that the interest rate on inbound related-party loans should be set using a *restricted transfer pricing* approach, whereby the interest rate is set under transfer pricing but ignoring all surrounding circumstances, terms, and conditions that could result in an excessive interest rate unless similar terms apply to significant amounts of third-party debt, and with the presumption that the borrower would be supported by its foreign parent in the event of default.

Agreed/Not agreed

Agreed/Not agreed

- (d) **Note** that officials consider that, in general, this restricted transfer pricing approach would have a similar result to the interest rate cap that was originally proposed, and that therefore the original estimated forecast revenue of \$40m per year from the 2018/19 year remains unchanged.

Noted

Noted

- (e) **Agree** that the precise design of this restricted transfer pricing approach should be subject to further consultation with submitters.

Agreed/Not agreed

Agreed/Not agreed

- (f) **Agree** that the proposed non-debt liability adjustment should proceed, so that a taxpayer's allowable debt level in the thin capitalisation rules is set with reference to its assets less its non-debt liabilities.

Agreed/Not agreed

Agreed/Not agreed

- (g) **Agree** that officials consult further on issues relating to deferred tax.

Agreed/Not agreed

Agreed/Not agreed

- (h) **Note** that if all deferred tax amounts were not included in the non-debt liability proposal, the revenue forecast from the proposal would be \$10 million per year lower.
Noted Noted.
- (i) **Agree** that other technical exclusions to the non-debt liability adjustment be subject to further consultation with submitters.
Agreed/Not agreed Agreed/Not agreed
- (j) **Agree** that the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of \$1 million or less, be made available also to foreign-controlled taxpayers provided they have no owner-linked debt.
Agreed/Not agreed Agreed/Not agreed
- (k) **Agree** in principle to an exemption from the thin capitalisation rules for certain infrastructure projects funded entirely with third-party limited recourse loans.
Agreed/Not agreed Agreed/Not agreed
- (l) **Agree** that the detailed design of this infrastructure exemption be subject to further consultation with submitters.
Agreed/Not agreed Agreed/Not agreed
- (m) **Agree** that, when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.
Agreed/Not agreed Agreed/Not agreed
- (n) **Agree** that existing arrangements affected by the change in (m) be grandfathered.
Agreed/Not agreed Agreed/Not agreed
- (o) **Agree** that taxpayers should continue to be able to use asset values for thin capitalisation that differ from those reported in their financial accounts, but that clearer legislative requirements be developed for when this option is utilised.
Agreed/Not agreed Agreed/Not agreed
- (p) **Agree** that the proposed removal of the ability for a taxpayer to use their year-end debt and asset values for thin capitalisation purposes not proceed, and instead insert an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year.
Agreed/Not agreed Agreed/Not agreed

- (q) **Agree** that the minor remedial, relating to how section FE 18(3B) applies in relation to trusts, proceeds – that is, specifying that in order for a financial arrangement to be treated as owner-linked debt in relation to a trust, the owner must have made 5 percent or more (by value) of the settlements on the trust.

Agreed/Not agreed

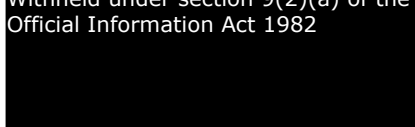
Agreed/Not agreed

- (r) **Agree** that advance pricing agreements (APAs) existing prior to the application date of these changes be grandfathered.

Agreed/Not agreed

Agreed/Not agreed

Withheld under section 9(2)(a) of the Official Information Act 1982



Steve Mack
Principal Advisor
The Treasury

Handwritten signature of Carmel Peters in blue ink.

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Handwritten signature of Hon Judith Collins in blue ink.

Hon Judith Collins
Minister of Revenue

Background

25. In March the Government released the discussion document *BEPS – strengthening our interest limitation rules*. This report provides advice on the 27 submissions the Government received on the discussion document. It also seeks policy decisions on the proposals, including a number of suggested modifications to address issues raised by submitters.

26. We have met with many of the submitters (CA ANZ, CTG, PwC, KPMG, EY, NZBA) to discuss their submissions and explain the proposals. A full list of submitters is included in the appendix to this report.

27. This report advises on the important issues relevant to the policy decisions to be made by Cabinet in July. Following this decision, we will design the detail of the proposals, on which there will be further consultation.

General comments on the proposals

Submitters support interest limitation but not the particular proposals

28. Submitters acknowledged that it was important to address BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, as detailed below, submitters did not agree with many of the proposed changes put forward in the discussion document.

Submission: wider economic concerns

29. Many submitters argued that the proposals have the potential to significantly impact the flow of capital to New Zealand and the willingness of non-residents to establish business in New Zealand. Submitters argued that many of the proposals contained in the discussion document could make New Zealand a less-attractive investment destination and, on this basis, should not be implemented (CTG, CA ANZ, Olivershaw).

Response

30. We disagree with submitters on this matter. The majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that deliberately attempt to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

Submitters do not support an EBITDA-based approach for New Zealand

31. Most submitters were strongly against adopting an EBITDA-based rule as recommended by the OECD. Only one submitter (SKYCITY) discussed the merits of New Zealand adopting this approach – namely that it is advantageous for firms with assets that generate revenue but that cannot be recognised under accounting standards (such as casino licenses).

32. A key reason the other submitters did not support an EBITDA-based approach is that earnings can be volatile. A taxpayer that has interest deductions within the allowable limits one year could breach those limits the next if its revenues fall – even if that is because of factors outside their control (such as poor global economic conditions). Other reasons given by submitters were that:

- some industries have particularly volatile earnings, and these would be especially impacted by an EBITDA-based rule;
- such a rule may disadvantage groups that are heavily capitalised and have tangible fixed assets with long depreciation periods; and
- such a rule is not appropriate for commodity-based economies such as New Zealand.

33. We find the first of these arguments (volatility of earnings) particularly compelling. Provided a reasonable rule for limiting the interest rates of related-party debt can be developed (as discussed below), we do not see merit in adopting an EBITDA-based rule.

34. We note that Craig Elliffe, a professor of tax at Auckland University, reaches this same conclusion in a forthcoming academic article. He writes “... contrary to the strong recommendation in the OECD’s report, there is no compelling case for change to an earnings-based EBITDA method from an assets-based regime”.¹

Concerns about horizontal inequity

35. Some submitters raised concerns that the proposals will result in horizontal inequity between businesses owned or controlled by offshore investors as compared with those in New Zealand. This is because the proposals predominately affect foreign-owned businesses.

36. We do not share these concerns. Foreign-owned businesses are able to reduce their New Zealand tax payments through the use of interest deductions in a way that domestically-owned firms cannot. Indeed, we consider the proposals will increase horizontal equity between foreign-owned and domestically-owned businesses.

Application to outbound investment

37. While the primary focus of the BEPS reforms is on foreign-owned businesses, similar base protection considerations can arise where New Zealand-owned businesses have offshore operations. For this reason, New Zealand’s international base protection measures (such as the

¹ Craig Elliffe, *Interest deductibility: evaluating the advantage of earnings stripping regimes in preventing thin capitalisation*, forthcoming in the New Zealand Law Review (number two).

thin capitalisation rules and the transfer pricing rules) apply to both foreign-owned and domestically-owned businesses.

38. Consistent with this approach, the discussion document proposed that any changes ultimately adopted would apply to both foreign- and domestically-owned businesses.²

39. Three submitters disagreed with this approach, suggesting instead that the proposals should initially apply only to foreign-owned businesses. In particular, they were concerned that New Zealand-owned businesses with foreign-operations could be negatively impacted by the non-debt liabilities proposal.

40. We consider that the proposals should apply to outbound investment as originally proposed – as above, base protection concerns can arise with domestically-owned firms.

41. However, one submitter in particular (SKYCITY) has raised concerns with how the thin capitalisation rules operate for domestically-owned firms – in particular, that fact the rules do not take into account the value of some of its assets when determining its allowable level of debt causes them particular problems. We think this issue should be a subject of further consultation.

Submission: application date

42. The planned application date for these measures is income years starting on or after 1 July 2018. At the time the discussion documents were released, this application date was not publicly known.³ However, many submitters anticipated the Government would seek an early application date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary (PwC, CTG, EY, CA ANZ).

43. Several submitters (including PwC and Powerco) submitted that the application date for these proposals should be no earlier than 1 April 2019.

44. A number of submissions on the interest limitation discussion document also argued that transitional rules should be provided for existing investments for up to five years post enactment.

Response

45. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

46. We note that, in relation to the changes to the thin capitalisation rules (such as the non-debt liability adjustment), taxpayers would have until 30 June 2019 to adjust their balance

² Note that the proposal relating to the interest rate on related party debt applies to both foreign- and domestically-owned taxpayers, but applies only to inbound loans. We are not aware of any concerns regarding the pricing of outbound related-party loans.

³ The discussion document proposed that the measures would apply from income years beginning on or after the date that the new legislation was enacted.

sheets as taxpayers have the ability to determine their thin capitalisation ratio based on their year-end asset and liability values.

Submission: grandparenting APAs

47. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. A large number of submitters expressed concern that APAs would be invalidated when the new legislation comes into effect. These submitters suggested that all existing APAs affected by the proposals in the discussion document should be preserved under transitional rules for the term of the APA.

48. Without grandparenting of existing APAs, taxpayers may be disincentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.

Response

49. We agree that APAs existing prior to the application date of these proposals should be grandparented. There is a high cost and a rigorous process involved in obtaining an APA and it would be unfair if the new proposals rescinded APAs issued before the 1 July 2018 application date – especially considering APAs only run for five years.

Submissions on the proposed interest rate cap

Summary of proposed rule

50. When borrowing from a third-party, commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

51. The discussion document proposed moving away from a transfer pricing approach, and instead limiting the interest rates on related-party loans from a non-resident to a New Zealand borrower (“inbound related-party loans”) – one for when a company has a foreign parent and one where it does not:

- An *interest rate cap*, which would apply when a New Zealand company has a foreign parent (for example, it is a subsidiary of a multinational company). Under the interest rate cap, the allowable interest rate on related-party debt would be set with reference to the interest rate the parent company could borrow at.
- A *restricted transfer pricing rule* when a New Zealand company has no foreign parent (for example, it is owned by a group of non-residents acting together). Under the modified transfer pricing approach, the allowable interest rate on related-party

debt would be determined using transfer pricing, but with a presumed set of conditions (including that the debt is senior unsecured debt issued on standard terms).

52. The purpose of these proposed rules was to ensure that the interest rate on related-party debt is roughly in line with what the borrower would actually agree to if they were borrowing from a third party.

General reaction

53. This proposal – in particular the *interest rate cap* – was the focus of most submissions. Several submitters agreed that the rules for limiting the interest rate on related-party loans need strengthening, but only two submitters agreed with the proposed approach (Oxfam and the CTU).

54. The general view of submitters was that the proposed interest rate cap should not be adopted at all, or if it is adopted, that it should only be a safe harbour, meaning that an interest rate higher than that provided for under the cap would be allowed if it can be justified under transfer pricing.

55. The proposal has also attracted positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.⁴

56. Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – “transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules”.⁵

Submission: transfer pricing changes should be sufficient

57. A recurring theme in the submissions is that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Response

58. Relying on transfer pricing, as suggested by submitters, will not achieve the desired policy outcomes.

59. The international consensus is moving away from using ordinary transfer pricing to limit interest expenses in relation to related-party debt. Concerns over highly-priced related-party debt were part of what was behind the OECD’s recommended interest limitation rule based on EBITDA. Interest denial could result under an EBITDA rule even if the interest expense is appropriate as determined by the arm’s length standard.

⁴ *Government plan to target tax avoidance cops criticism*, National Business Review, May 12 2017.

⁵ Hoke, William, *Australian Court Rejects Chevron’s Transfer Pricing Appeal*, Tax Notes International, May 1 2017.

60. The detail of the transfer pricing rules are “soft law”. They are contained in the OECD transfer pricing guidelines to support the application of tax treaties. Most countries rely on them to solve transfer pricing issues even in the absence of a treaty. The transfer pricing guidelines take the form of guidance rather than set rules. We consider that, once amended as proposed in the *BEPS – transfer pricing and permanent establishment avoidance* discussion document, the transfer pricing rules will work well for non-debt items. However, because of the significant BEPS risks associated with related-party interest payments, we consider that the rule for such payments needs to be stronger, less subjective, and less open to interpretation.” We note, for example, the Australian Taxation Office has stated that the recent Chevron case in Australia had cost them \$10 million in external experts (not taking into account the cost of their own staff) even though it involved related-party interest payments that were, in our view, plainly excessive.⁶

61. In addition, transfer pricing does not adequately take account of the fact that related-party debt financing is fundamentally different to third-party debt financing. For example, subordinated debt⁷ is less likely to be repaid compared to senior debt, and so carries a higher interest rate. This is appropriate in a third-party context: the higher interest rate compensates for the higher risk. However, in a related-party context, debt and equity are highly substitutable. The riskiness of a parent’s investment in a subsidiary does not change whether it invests through equity (which would generate no deduction) or debt. We do not consider that related-party debt being subordinate to other debt should justify a higher interest rate.

Submission: various concerns with interest rate cap

62. Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm’s length standard so would result in double taxation
- will increase compliance costs
- will apply to firms with a low BEPS risk
- has no international precedent.

Inconsistency with arm’s length standard

63. Many submitters argued that the proposal is not consistent with the arm’s length standard (the approach that underpins how countries apply the transfer pricing rules). They argued that it will result in double taxation: the lender jurisdiction will price the loan under traditional transfer pricing, which will produce a higher interest rate than what would be allowable under the rate cap. For example, suppose for a loan between Canada and New Zealand, the Canadian Revenue Authority expects the loan to produce interest income at 7% but the proposed cap would allow deductions only of 5%. In this example, double taxation of the 2% difference would result.

⁶ *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62. The case involved a company owned by Chevron Australia borrowing in the USA at interest rates of about 1.2 percent in USD and on-lending the money to Chevron Australia at an interest rate of about 9 percent in AUD.

⁷ Subordinated debt is a loan that ranks below other loans. In the case of borrower default, subordinated debt is repaid only once higher-ranked debt has been fully repaid.

64. As a more technical matter, submitters were concerned that if double taxation did arise, they would be denied the treaty resolution process if the interest rate cap was incorporated in the thin capitalisation regime rather than the transfer pricing rules.

65. Supporting the double taxation argument, submitters wrote that the New Zealand subsidiary of a multinational will generally have a higher credit risk than the parent. A traditional transfer pricing exercise would therefore result in a higher interest rate. Similarly, submitters saw the proposal as implicitly assuming that the New Zealand subsidiary would have the same credit risk as its foreign parent, and stated that this is not the case and does not represent commercial reality.

66. More generally, submitters were concerned that the interest rate cap would be inconsistent with our Double Tax Agreement (DTA) obligations. DTAs require arrangements (such as a loan) between a New Zealand company and a treaty-partner company to be treated for tax purposes as if it were entered into on arm's length terms – something submitters argued the cap would not do, since they submitted it would allow deductions for less than an arm's length amount of interest.

Compliance costs

67. Many submitters indicated that the proposed interest rate cap would increase compliance costs, even for firms with low gearing levels. They argued that the foreign jurisdiction in a cross-border loan transaction will still require a transfer pricing analysis of the loan for their own purposes (to ensure the interest rate on the loan is not too low), even if the same transaction was also priced using the interest rate cap in New Zealand.

68. Some submitters also wrote that the cap would be harder to apply when the foreign parent does not have a credit rating⁸, as a credit scoring exercise for the foreign parent would have to be carried out (in contrast to when the parent had a credit rating – where the credit rating could simply be used).

Rule applies to firms at low risk of BEPS

69. Submitters were concerned that the interest rate cap would apply even if a firm had a very low level of debt. Submitters argued that this was inappropriate for two reasons:

- If a firm is concerned about the application of the interest rate cap (for example because of double taxation), there is no action the firm can take other than completely eliminating all related-party debt. Submitters contrasted this with the EBITDA rule as proposed by the OECD, which can also result in double taxation but firms are able to reduce the risk of this by reducing the amount of debt they hold.
- Firms with low debt levels, and therefore presenting a low risk of profit shifting using interest, could nevertheless suffer interest denial under the proposal (or alternatively incur costs in restructuring any related-party lending to ensure interest denial does not arise).

⁸ Where the parent does not have a credit rating the application of the interest rate cap is not as straight forward. It is therefore not as appropriate as a safe harbour. About half of New Zealand's 300 largest foreign-owned companies have parents with credit ratings.

Rule has no international precedent

70. Some submitters were concerned that the proposed cap is novel and would not be well understood by foreign jurisdictions. Submitters argued that the proposed rules are not a co-operative approach to international tax policy and will be inconsistent with the OECD and all other countries.

Response

71. We do not agree with all the concerns raised but there were some valid issues to consider. Taking all the submissions, consultation, and subsequent analysis into account, we now recommend that the original proposal be replaced with a restricted transfer pricing approach. This alternative will still use, as a key component in the analysis, the cost of funds of the foreign parent; however, it will incorporate some limited flexibility, which we consider will address many of submitters' concerns. This alternative approach is discussed more below – following our analysis of key submissions which are still relevant to this alternative approach.

72. We do not agree with the argument that the interest rate cap is systematically inconsistent with the arm's length standard. On the contrary, we consider the cap will generally be consistent with the standard because of the transfer pricing concept of "implicit parental support". "Implicit parental support" is the notion that a foreign parent will stand behind a New Zealand subsidiary in the event of a default. That is, multinational groups generally do not let their local subsidiaries go under. "Implicit parental support" is a significant factor in transfer pricing analysis because it hypothesises that, as a commercial matter, it would affect what rate a third party lender would charge the New Zealand subsidiary and what that subsidiary would be prepared to pay. Accordingly, the credit rating of the foreign parent is a strong element in determining the credit rating of the New Zealand subsidiary.

73. Inland Revenue administers transfer pricing having regard to the concept of implicit parental support but some taxpayers do dispute it. Submissions on this were mixed. At one end of the spectrum, CTG said "An assumption of implicit parental support is not valid. A rational commercial lender would never rely on implicit support..." In general, the other submitters agreed that implicit support was a factor to be taken into account in applying the arm's length test. However, views varied on how important a factor it is.

74. We acknowledge that there would be cases when the interest rate cap would not produce an arm's length interest rate because, for instance, the New Zealand subsidiary is in a completely different line of business from the rest of the multinational group and has a different risk profile. Nevertheless, we do not accept that in these cases the interest rate cap would frequently result in double taxation. This is partly because the cap is not arbitrary (unlike EBITDA). Moreover, in our view, the shift in the international consensus makes it less clear that our treaty partners (especially Australia, given their guidance discussed below) would dispute the result of the cap under a treaty.

75. We agree that, as originally proposed, the interest rate cap would have produced some arguably inappropriate results. In particular, we agree with submitters' concerns that the cap would have applied regardless of a taxpayer's debt level in New Zealand. Yet if a firm has low levels of debt in New Zealand, it is unlikely that the structure of their loans (including their interest rates) has been driven by tax. Were the cap to proceed, we would recommend that it would apply more generously to taxpayers with lower debt levels.

76. We also acknowledge that applying the cap for New Zealand subsidiaries with foreign parents that do not have credit ratings might not be straight forward. Where the foreign parent has a credit rating, the allowable interest rate under the cap would be derived from that rating. However, where the parent has no credit rating, the credit worthiness of the parent would first have to be determined by a third party expert before the rate allowed by the cap could be calculated. While the advice we have is that this is not a difficult exercise in the scheme of things, it does result in more compliance costs for some taxpayers compared to others and may give rise to integrity issues.

77. Finally, we note that 16 of foreign-owned firms covered by Inland Revenue's International Questionnaire⁹ were owned by consortiums of non-residents (and therefore have no identifiable foreign parent). Because there is no identifiable parent, the interest rate cap cannot apply to these businesses. The discussion document proposal was to apply a restricted transfer pricing approach to determine the rate on their shareholder debt funding. But we acknowledge the argument that having two sets of rules (a cap and a restricted transfer pricing approach) is a sub-optimal feature of the original proposal given the problem of excessive interest rates can arise regardless of whether there is a foreign parent.

78. Overall, if the Government were to pursue the interest rate cap proposal, we would recommend some adjustments which would add significant complexity. For instance, as above we would recommend adjusting its application for New Zealand subsidiaries with low levels of debt. This would mean that the cap applied differently to taxpayers depending on their circumstances. These differences create perceptions of unfairness. In addition, boundaries can be difficult to administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange matters so that they fall within certain boundaries.

Modified approach

79. We recommend that the discussion document proposal – whereby the foreign parent's credit rating is the *sole* determining factor of the New Zealand interest rate for related party debt, be replaced by a *restricted transfer pricing* methodology. Like the cap, this approach involves a strong presumption that the interest rate on the related-party debt would be in line with that facing the foreign parent. However, unlike the cap, a taxpayer would be able to deviate from this if they can show that it would be appropriate.¹⁰ In addition, all the circumstances, terms and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer (or its foreign parent) can demonstrate that they have third party debt that features those terms or conditions.

⁹ Based on the International Questionnaire for the 2015 income year, which covered New Zealand's 314 largest foreign owned businesses (excluding banks and insurers).

¹⁰ For example, if the New Zealand subsidiary is not wholly-owned by the parent, or if it operates in a substantially different industry to the parent.

80. We consider that this approach would, in general, achieve the same result as the interest rate cap but expect that it would be more acceptable to submitters. This is because it would only impact firms that do not have “vanilla” related-party debt. It also provides a limited amount of flexibility by allowing additional factors to be taken into account in addition to the foreign parent’s credit rating when determining an appropriate interest rate in legitimate cases. This approach also has the advantage that it would apply consistently across taxpayers to the greatest extent possible.

81. Under this restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is strong presumption that the New Zealand subsidiary would be supported by its foreign parent in the event of default;
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
 - That the loan has no exotic terms that are generally not seen with third-party lending¹¹
 - That the loan is not subordinated
 - That the loan duration is not excessive
 - That the debt level of the borrower is not excessive.

82. The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower’s foreign parent.

83. If a taxpayer is able to demonstrate that it (or its parent) has substantial third-party loans with a particular feature, then that feature will not be required to be completely ignored. Instead, that feature will be an allowable factor in the pricing of the loan to the extent the taxpayer’s third-party debt has that feature.

84. For example under this rule, an inbound related-party loan would generally be priced for tax purposes on the basis that it is not subordinated. However, if a taxpayer actually issues subordinated debt to third parties, then some amount of its related-party debt could also be priced as if it were subordinated. Similarly, a loan would generally be priced for tax as if its duration were not excessive, but if the taxpayer has third-party debt with a very long duration, its related-party debt could be priced as if it had a similarly long duration.

85. We consider that this approach would be effective in achieving the overarching objective of this project – which is to ensure that interest rates on related-party debt are

¹¹ The ATO’s draft guidelines on related-party debt include a list of what could be considered an exotic term – including convertibility into equity, that the loan is repayable on demand, and contingencies (that is, interest is only repaid under certain conditions).

broadly similar to the interest rates that the borrower would actually agree to with third-party debt. The rule requires related-party debt to be priced as if it is an ordinary senior loan; however, if taxpayers can demonstrate that they raise debt from third-parties on other terms which result in higher interest rates, this can be taken into account.

86. We recommend that you agree in principle to the adoption of this restricted transfer pricing approach to determining the interest rate for related-party cross border loans. Its precise detail (for example, the wording of the required modifications, and what constitutes “excessive”) would then be considered as part of further consultation.

87. This approach takes account of more factors than the interest rate cap, which focused solely on the foreign parent’s cost of funds. However, this means the rule may be more costly for taxpayers to apply than the cap (particularly for subsidiaries of large multinationals that have credit ratings).

88. We recommend that the interest rate cap as initially proposed be available as a safe harbour. We believe this would be an attractive option to many companies as it is both simple and provides certainty.

89. This safe harbour could be provided either legislatively or administratively. We consider it likely that an administrative safe harbour is the best approach as it provides more flexibility. Nevertheless, we consider that would be a useful matter to consult on further.

90. We note that this rule would still apply in place of our standard transfer pricing rules. It could therefore be considered inconsistent with the arm’s length principle, much like the interest rate cap. However, unlike the cap as originally proposed, we note that:

- if a taxpayer with a conservative level of debt borrows from its parent with a “vanilla” loan, there is no difference between this restricted transfer pricing approach and standard transfer pricing.
- lenders in countries that have a double tax agreement with New Zealand will be able to use the Mutual Agreement Procedure to alleviate any double taxation that may result because of this rule; however, as above, we do not consider this situation likely.

Australian guidelines

91. Since the release of the discussion document the Australian Tax Office released draft guidelines for the interest rates of cross-border related-party loans.¹² These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary “vanilla” loans. Overall, just like the restricted transfer pricing rule above, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent’s cost of funds:

“Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible ‘all-in’ cost to the borrower. The

¹² ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions, PCG 2017/D4.

ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong.”

92. However, unlike what we have recommended, the Australian guidelines are administrative measures – taxpayers are able to dispute them if they so choose. Nevertheless, we think it appropriate to proceed with a law change as we are recommending. Given the manipulability of the general transfer pricing rules, we consider more robust measures are necessary to ensure related-party debt is appropriately priced.

Application of rule to banks

93. The discussion document did not propose exempting any particular industries from the interest rate cap.

Submissions

94. Following a discussion with the New Zealand Bankers Association (NZBA), we received submissions from NZBA and most of the large banks. These submitters argued that New Zealand banking groups should be excluded from the interest rate cap. The main arguments contained in these submissions are:

- Banks are subject to prudential regulation in both New Zealand (RBNZ) and Australia (APRA), which requires related-party loans to be priced on arms-length terms. These regulations also put restrictions on the type of debt that can be issued and the permitted level of support the Australian banks can provide to their New Zealand subsidiaries.
- Unlike most foreign-owned companies operating here, New Zealand's foreign-owned banks issue large amounts of third party debt. This makes transfer pricing exercises more straight-forward as there are clear comparable interest rates.
- Because banks are financial intermediaries (that is, in the business of borrowing from capital markets and then lending out that money), they will be most affected of all firms by a rule that limits the allowable interest rates on related-party debts.

Response

95. We agree that banks would have been disproportionately impacted by the interest rate cap as originally recommended. This is because banks, more than most businesses, rely on debt to fund their businesses, and because they regularly issue non-standard types of debt to third parties (such as debt that converts to equity in certain events). In addition, unlike most foreign-owned companies operating in New Zealand, New Zealand's foreign-owned banks regularly borrow significant amounts from third-parties. This means, when pricing a related-party loan between a New Zealand bank and its foreign parent, there are generally third-party comparables that can be used to ensure the interest rate on the related-party loan is not excessive.

96. We would have therefore recommended that registered banks be carved out from the interest rate cap. However, it is less clear that a carve-out from the approach we now recommend – the restricted transfer pricing approach – would be necessary. Under this method non-standard terms on related-party debt (such as convertibility into equity) would be allowable if the taxpayer can demonstrate that it (or its foreign parent) issues debt with those non-standard features. We consider that this is likely to be the case with the banks, as they (and their Australian parents) do regularly issue third-party debt with non-standard terms, for example.

97. Nevertheless, to ensure this rule would have no unintended consequences, we consider that the issue of whether banks should be subject to the restricted transfer pricing approach should be considered as part of the further consultation. We note that the original revenue forecast of \$40m per year from the interest rate cap did not take into account any impact it might have on the banks; whether or not the restricted transfer pricing rule applies to them will have no impact on this revenue forecast.

Submissions on the treatment of non-debt liabilities

Summary of the proposal

98. The thin capitalisation rules limit the amount of deductible debt a taxpayer can have in New Zealand. Currently, the maximum amount of debt is set with reference to the value of the taxpayer's assets (generally, debt up to 60 percent of the taxpayer's assets is allowable).

99. The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts).¹³ This is because the core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a taxpayer is limited to a commercial level of debt. We consider that a third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

100. Moreover, we are concerned that the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in a company by its shareholders. For example, at present if a company purchases some inventory on deferred payment terms, its allowable debt level under the thin capitalisation rules will increase (because its assets have increased but its interest bearing debts have not). We do not consider that this is an appropriate outcome.

General reaction

101. Several submitters (including CA ANZ, EY and KPMG) indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

¹³ Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

102. A number of other submitters (including CTG, PwC and several submissions representing the infrastructure industry) argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

103. Some submitters also argued that the existing 60 percent thin capitalisation safe harbour is already too low for infrastructure businesses – which are by nature highly geared and capital intensive – and so this proposal would disproportionately affect this industry's ability to stay within the 60 percent safe harbour.

104. Similarly, some submitters suggested introducing an additional arms-length test to allow taxpayers to gear at higher levels than the 60 percent safe harbour where that can be supported as a commercial level of debt. Submitters used the infrastructure industry as an example, where they argued that it is normal for third party debt to be secured on economic terms in excess of the 60 percent safe harbour ratio. Submitters suggested that an arms-length test would also address industry-specific concerns as noted above.

Response

105. At present, the thin capitalisation rules ignore non-debt liabilities. This means that companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment also means that companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

106. With regard to the specific points raised by submitters:

- we agree that in some cases the non-debt liability adjustment will increase volatility in thin capitalisation ratios; however, in other cases the adjustment will reduce volatility (such as when both assets and non-debt liabilities increase).
- We do not agree that the proposal amounts to a significant adjustment in the thin capitalisation safe harbour. This change only impacts taxpayers that have large non-debt liability balances. A taxpayer with only small non-debt liabilities will see very little change in its thin capitalisation ratio. In addition, this change will have no impact on a taxpayer if their thin capitalisation ratio remains below the 60 percent safe harbour (for example, even if the change results in a large increase in a taxpayer's ratio – say from 30 percent to 40 percent – the taxpayer will have no additional tax to pay as its ratio is still within the 60 percent safe harbour).

107. Overall, we do not consider that any of the points raised by submitters provide a reason not to proceed with the non-debt liability adjustment (subject to the modifications discussed below).

108. We agree with submitters that the 60 percent safe harbour will not always be appropriate, but consider that the thin capitalisation rules already adequately deal with these

situations. For example, a New Zealand company's debt level can exceed the safe harbour if it is still in line with the debt level of the company's multinational group (under what is known as the worldwide group debt test). We acknowledge that the use of the worldwide group debt test is rare; in our discussions with submitters we mentioned that we would be happy to look at changes to that rule if there are particular problems with its application in practice. No submissions were received on this.

109. With regards to implementing an arm's length debt test, we note that this was considered by the OECD as part of its work on best-practice interest limitation rules. The OECD recommended against such a rule, concluding that it is not an effective method for preventing profit shifting using debt. We do not recommend an arm's length debt test.

Submission: deferred tax should be ignored

110. To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

111. All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, these deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

112. Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity;
- that deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them;

113. Many submitters referred to the removal of building depreciation in Budget 2010 in making their arguments. The 2010 changes meant that companies that owned previously depreciable buildings needed to record a (sometimes significant) deferred tax liability, which will never result in a future tax payment.

Response

114. We have considered these submissions carefully, including discussing them with the agency in charge of setting accounting standards in New Zealand (the External Reporting Board or XRB) and the Australian Treasury.

115. Accounting standards require the recognition of deferred tax liabilities because a taxpayer may recognise a profit for accounting purpose that will not be taxable until a later period – the deferred tax liability represents that latent tax liability. However, we acknowledge in some cases deferred tax liabilities on a taxpayer’s balance sheet will not accurately represent future tax payments the taxpayer will be required to make.

116. Our contact at the XRB made a similar remark, commenting that:

“In many cases deferred tax balances are simply a timing difference between when income tax is expensed in the financial statements and when income tax becomes payable to the IRD; and in other cases, deferred tax balances recognised in the financial statements may have no impact on the current or future amount of income tax payable to the IRD.

Many users of general purpose financial statements, which include significant deferred tax balances, consider the deferred tax balances and movements to be accounting entries that should be ignored when evaluating the financial performance and financial position of an entity. [...] The recognition of deferred tax adds a level of complexity and volatility to the financial performance reported, which many CFO’s feel are unnecessary and result in deferred movements which are difficult to explain to shareholders.”

117. Nevertheless, the fact remains that accounting standards require the deferred tax to be recognised – suggesting that they do often represent something real. Moreover, while some deferred tax liabilities will not result in future tax payments, not carving out deferred tax is consistent with the general policy taken in the thin capitalisation rules of following accounting principles.

118. The Australian Treasury commented that a key reason they carved out deferred tax from their non-debt liability adjustment is because of volatility concerns (mirroring comments made by submitters above). We agree that not carving out deferred tax could increase volatility of a taxpayer’s thin capitalisation ratio in some instances, though consider that in many other situations it would also reduce it.

119. We recommend that we consult further on issues relating to deferred tax and the non-debt liability proposal. We could explore, for example, whether particular deferred tax liabilities that will not result in future tax payments could be identified and carved-out from any adjustment.

120. Deferred tax balances of some taxpayers are significant. If there was a carve-out for deferred tax, we estimate that this would reduce the fiscal impact of the non-debt liability proposal by up to \$10 million per year (from \$50 million per year to \$40 million per year).

Submission: other technical adjustments

121. Submitters also wrote that it would be appropriate to make other exclusions from the non-debt liability adjustment, for example certain types of derivatives and redeemable preference shares. This was because, for example:

- they are more akin to equity;
- they are not used to fund a taxpayer's balance sheet; or
- that not excluding them would mean that taxpayers' thin capitalisation ratios would become inappropriately volatile.

Response

122. We consider that these other minor exclusions be considered as part of further consultation.

Submissions on other matters

De minimis for inbound thin capitalisation rules

Proposal

123. Many countries provide an exemption for companies with little interest expense, on the basis that they present a low BEPS risk. New Zealand has a de minimis in its outbound rules (of \$1 million of interest deductions), but it does not currently have a de minimis in its inbound thin capitalisation. The discussion document proposed extending the existing de minimis so that it applies to inbound entities as well, provided none of the entity's debt is owner-linked debt (that is, debt from the owner, or that has been guaranteed by the owner).

Submissions

124. Submitters generally supported a de minimis rule on compliance cost saving grounds but wrote that limiting the proposed de minimis to firms with no owner-linked debt would make the de minimis very limited in application. CTG suggested that consideration should be given to adopting Australia's flat de minimis of \$2 million which applies regardless of whether any lending is from related parties. Further to this, CA ANZ submitted that the outbound de minimis rule should be extended to \$2 million as in Australia.

Response

125. If a firm has owner-linked debt, they present a higher BEPS risk than a firm with only third-party debt. On this basis, we consider that the proposed de minimis for inbound entities strikes the right balance between reducing compliance costs and BEPS risk.

126. Submitters did not provide any evidence that the current de minimis threshold in the outbound rules is too low. We do not consider it necessary to increase the current threshold from \$1 million to \$2 million as some submitters suggested.

Infrastructure projects

Summary of the proposal

127. The discussion document proposed adopting a rule presented in the OECD's final report on best-practice interest limitation rules, which would exempt certain infrastructure projects

funded entirely with third-party limited recourse loans from interest limitation rules. This exemption recognises that such funding presents little risk of BEPS.

Submissions

128. Submitters strongly supported this proposal. They wrote that it would make New Zealand a more attractive place for Public Private Partnership (PPP) investment and provide more flexibility in how such investments can be structured.

129. Submitters did make several technical submissions, primarily with a focus on ensuring the exemption works with the various commercial structures adopted by PPPs. We are currently working through these submissions. We note that further consultation with submitters may be necessary.

Response

130. We recommend that you seek Cabinet approval to this proposal in principle.

Non-resident owning body change

Proposal

131. At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level is the greater of:

- 60 percent; and
- 110 percent of its third-party debt.

132. We were concerned that allowing a company to have total debt of 110% of its third-party debt would allow entities to be funded through inappropriately high levels of debt. For example, a project funded 90 percent with third-party debt could have 9 percent shareholder debt and only 1 percent equity.

133. Accordingly, the discussion document proposed changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. The discussion document proposed grandparenting existing arrangements.

Submissions

134. This proposal was not a focus of many submissions. The main comments received were:

- That the proposed grandparenting of existing arrangements was appropriate; and
- That the way the proposal was worded implied it was unnecessarily restrictive.

Response

135. We recommend that this proposal proceed.

Asset valuations

Proposal

136. In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative to its financial statement value, provided that would be allowable under generally accepted accounting principles.

137. The discussion document proposed removing the net current valuation method from the list of available asset valuation methods for the purposes of the thin capitalisation rules. This change would mean that a company would only be able to use values as reported in its financial statements.

138. We proposed this change because we considered that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets. In addition, financial reporting valuations are subject to a higher level of scrutiny than asset valuations adopted solely for thin capitalisation purposes.

Submissions

139. No submissions on this proposal supported the removal of the net current valuation method. Many submitters argued that the flexibility to adopt an alternative valuation method is appropriate. They noted adopting a current valuation approach for financial reporting purposes means that the asset needs to be independently valued every year - an expensive exercise. In contrast, the current approach (where taxpayers can value assets at historic cost for financial reporting but based on current values for thin capitalisation) means taxpayers need to incur the costs of a valuation only when necessary (that is, when relying on an asset's financial value would mean the company would breach the thin capitalisation safe harbour).

140. Most submitters on this proposal suggested explicitly requiring revaluation of assets by an independent expert valuer, which is a feature of Australia's rules¹⁴). One submitter (CTG) also suggested that taxpayers should be required to disclose on their returns if the net current valuation method has been used. This would allow Inland Revenue to better target its resources while ensuring that taxpayers using the net current valuation method for genuine reasons are not unfairly penalised.

141. A few submitters suggested that the thin capitalisation rules should include all measurable assets, including intangible assets. This is consistent with Australia's approach. One submitter with significant intangible assets indicated that lenders look at the earning potential of intangibles and with sufficient rigour imposed on the process, there is no reason for intangible assets to be excluded from the thin capitalisation calculation.

Response

142. We are concerned about the robustness of the current rules (such as the risk that taxpayers are valuing assets without seeking an independent valuation) and the change

¹⁴ The legislation at present currently prescribes no such requirement, though we understand from submitters that it is standard practice to get an independent valuation.

proposed in the discussion document is aimed at ensuring asset values used by taxpayers for thin capitalisation purposes are robust. However, we understand that removing the net current valuation method could increase compliance costs for a number of firms.

143. On this basis, we recommend modifying this proposal to allow firms that meet certain conditions to use the net current valuation method. This modified approach would also be subject to robust legislative requirement (such as requiring revaluation of assets by an independent expert valuer as suggested by submitters, and ensuring a consistent valuation method is used year-to-year) to ensure asset valuations that are being used are robust.

144. We do not support the proposal of including intangible assets in thin capitalisation calculations. These assets – for example, internally-generated intellectual property – are very difficult to value, which is why they are not recognised as assets under New Zealand’s accounting standards. We have discussed this suggestion with the Australian Treasury – they have informed us that the Australian Taxation Office has significant difficulty determining the value of intangible assets, and that they are seeing taxpayers increase their reported values for these assets in response to the recent tightening of their rules (thereby diminishing the impact of the tightening).

145. We note that the safe harbour rule that submitters are referring to is only one option available to taxpayers in the thin capitalisation rules. The worldwide group debt test can alternatively be used by those taxpayers concerned about breaching the 60 percent safe harbour due to the exclusion of intangible assets.

Measurement date for assets and liabilities

Proposal

146. Taxpayers can currently choose to value their assets and liabilities on the last day of the income year, or use an average of their values at the end of each quarter, or each day, in the income year.

147. The first of these methods, valuing assets and liabilities on the last day of the income year, is the simplest and most widely-used approach. However, there is the potential for a taxpayer to use this method to breach the thin capitalisation debt limits for up to one year without facing any interest denial, by partly repaying a loan or converting it to equity on or before their balance date.

148. The discussion document proposed removing the first of these asset valuation methods so that assets can only be valued for thin capitalisation based on the average values at the end of every quarter or at the end of every day. This would ensure that the thin capitalisation rules apply effectively to a loan that was substantially repaid just before the end of the year.

Submissions

149. No submissions on this proposal supported the removal of the year-end valuation option. In particular, submitters were concerned that requiring valuations on a quarterly or daily basis would impose significant and unnecessary compliance costs for the majority of

taxpayers subject to the thin capitalisation rules. Submissions indicated that the year-end valuation option is almost always used and that removing this option would require taxpayers to prepare audited financial statements solely for tax purposes at points in the year when they are not required for financial reporting purposes.

150. Submitters presented two alternative approaches:

- Calculating an average of the opening and closing values of assets and liabilities each income year. This approach features in Australia's rules.
- Implementing an anti-abuse rule in the thin capitalisation regime to tackle this type of tax-driven behaviour.

Response

151. We accept the submission that the proposal to require quarterly or daily valuation would impose significant compliance costs on the majority of corporate taxpayers. We note that both alternative approaches proposed by submitters have advantages and disadvantages. In particular, adopting the Australian approach would require most corporate taxpayers to change their measurement method, whereas a strengthened anti-abuse rule is far more targeted at taxpayers that present a higher BEPS risk.

152. We agree with submitters that the proposal in the discussion document should not proceed. Instead, we recommend adopting the suggestion by submitters to implement an anti-abuse rule that targets situations when a taxpayer substantially repays a loan just before the end of the year. This approach most directly targets the behaviour of concern.

Minor remedial

153. Finally, the discussion document proposed a minor remedial to how section FE 18(3B) applies in relation to trusts. Very few submitters commented on this proposal – the few that did (for example, CA ANZ) supported it.

154. We recommend that the proposal proceed without amendment.

Other issues not progressed

Finance companies

155. One submitter suggested that special rules for non-resident owned finance companies should be developed. For technical reasons, the thin capitalisation rules are not currently very effective for these companies.

156. We agree that special rule for finance companies (similar to the special regime currently in place for registered banks) is necessary to ensure the thin capitalisation rules apply effectively to them. However, such rules would be complex to develop. Furthermore, a review of Inland Revenue data indicated that foreign-owned finance companies do not present much BEPS risk at present. Accordingly, in developing the proposals for the discussion document

we focused on other, more pressing areas of reform. We recommend the development of a special rule for foreign-owned finance companies be considered for a later time.

Non-residents acting together with New Zealand residents

157. Broadly, the inbound thin capitalisation rules apply only to companies where 50% or more of the ownership interests are held by:

- a single non-resident; or
- a group of non-residents acting together.

158. This means that the thin capitalisation rules do not necessarily apply if a company is owned by a group of residents and non-residents acting together, even though similar profit shifting risks can arise. Two submitters questioned this result.

159. We agree that it would be desirable to review whether the situations when the thin capitalisation rules apply should be broadened further. However, this matter was not discussed in the original discussion document. Submitters have had no opportunity to comment on the appropriateness or otherwise of such a broadening. As such, we consider that a change at this time would not be appropriate.

160. We recommend that this be considered in any subsequent review of the rules.

Link to recent NRWT reforms

161. The Government recently bolstered the withholding tax rules on interest payments to non-residents, ensuring they cannot easily be structured around. Four submitters suggested that this means the proposals put forward in the discussion document are unnecessary.

162. We do not agree. NRWT on interest payments is taxed at either 10 or 15 percent (depending on whether the payment is to a jurisdiction New Zealand has a DTA with). This rate is much lower than the company rate of 28 percent. It is therefore important for New Zealand to have robust rules to ensure that excessive interest deductions are not taken in New Zealand, as this still substantially reduces the overall tax take in New Zealand.

Appendix: List of submitters

Abbreviation	Full name	Description	TP ¹⁵
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓
AMP (Aus)	AMP Capital Investors Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	
AMP (NZ)	AMP Capital Investors (New Zealand) Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓
ANZ	ANZ Bank New Zealand Limited	ANZ is a major bank in New Zealand and Australia.	
BNZ	Bank of New Zealand	BNZ is a major bank in New Zealand and Australia (NAB).	
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓
First Gas	First Gas Limited	First Gas is one of NZ's largest gas networks.	
First State	First State Investments	First State Investments (FSI) is the investment management business of the Commonwealth Bank of Australia.	
InfraRed	InfraRed Capital Partners Limited	InfraRed is an active equity investor in the New Zealand PPP sector, currently holding interests in the Auckland South Correctional Facility and Transmission Gully Motorway projects.	

¹⁵ Submission also received on BEPS – transfer pricing and permanent establishment avoidance.

Abbreviation	Full name	Description	TP
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓
Methanex	Methanex New Zealand Limited	Methanex produces and sells methanol globally. Methanex NZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China	
NZBA	New Zealand Bankers Association	NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks.	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCTU is made up of 30 unions and has 320,000 members.	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓
Olivershaw	Olivershaw Limited	Olivershaw provides tax advisory services for corporate clients, corporate boards, high net worth individuals and accounting firms.	
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty. Oxfam NZ is the New Zealand arm of the global organisation.	✓
Plenary	Plenary Origination Pty Ltd	Plenary Group is an independent long-term investor, developer and manager of public infrastructure in Australia.	
Powerco	Powerco Limited	Powerco is New Zealand's largest electricity distributor. It also has the second largest gas distribution network.	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓
QIC	QIC Private Capital Pty Limited	QIC is an investor in global infrastructure markets and manages a 58% interest in Powerco NZ Holdings Limited.	
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓

Abbreviation	Full name	Description	TP
SKYCITY	SKYCITY Entertainment Group Limited	SKYCITY is an entertainment and gaming business owning and operating casinos in New Zealand (Auckland, Hamilton and Queenstown) and Australia (Adelaide and Darwin).	
TPEQ	TP Equilibrium AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓
Westpac	Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch	Westpac is a major bank in New Zealand and Australia.	