

14 February 2018

Taxation (Neutralising Base Erosion and Profit Shifting) Bill: Drafting error in restricted transfer pricing rule

Introduction and summary

1. This letter concerns the new rule to limit the rate of deductible interest on related party cross border debt (the restricted transfer pricing rule) in the Taxation (Neutralising Base Erosion and Profit Shifting) Bill (the BEPS Bill). Officials have become aware that as the Bill is drafted, the use of the general transfer pricing ownership threshold means this rule does not apply as widely as was intended. Officials will be recommending to the Finance and Expenditure Committee that in line with the stated policy intention, the ownership threshold is changed to align with that in the thin capitalisation rules, which also deal with the issue of interest deductibility.

2. In short, as the Bill is drafted, the restricted transfer pricing rule applies where a person or group holds 50% or more of the voting interests in a New Zealand company. Voting interests are the average percentage a person holds of four shareholder decision-making rights in a company. Officials intend to recommend that where a foreign shareholder has varying decision-making rights on their shares in a New Zealand company it will be the highest, rather than the average, of the four rights that determines whether that person or group has a 50% or greater interest in the New Zealand borrower.

3. This change will have no impact in the usual case where shareholders do not have varying rights.

4. The Finance and Expenditure Committee expects to hear from submitters on the Bill on 28 February and 2 March. The Committee has been briefed on this issue and submitters will be able to make submissions on it at the hearing if they choose to do so. The Committee will also accept written submissions provided by 2 March.

Analysis

5. There are four shareholder decision-making rights that may be carried by a share in a company. These are the right to participate in decision-making concerning:

- a) a dividend or other distribution to be paid or made by the company; or
- b) the constitution of the company; or
- c) a variation in the capital of the company; or
- d) the appointment of a director of the company.

6. These rights are not necessarily held equally by all classes of share so that a shareholder may have different decision-making rights under each of the four tests. Section YC 2(2) of the Income Tax Act 2007 calculates a person's voting interest in a company by averaging the differing percentages. In general, this is a sensible rule, since it gives equal weight to each right, and ensures that the ownership percentages in a company do not total more or less than 100%.

7. However, there are two cases in the international context where the averaging approach is not used. In these cases, the threshold looks at the highest percentage a person has of each of the four rights in the company, so that the base protection aim of these rules applies more broadly. These cases are the CFC and thin capitalisation regimes, the latter of which is particularly relevant here.

8. From a policy perspective, the restricted transfer pricing rule is closely related to the thin capitalisation rule. Both rules deal with the very significant BEPS issue of interest deductions on cross border related party debt. In an EBITDA rule, as recommended by the OECD in BEPS Action 4, thin capitalisation and transfer pricing are effectively combined, and thus necessarily subject to the same ownership threshold. What has now been developed as the restricted transfer pricing rule was initially seen by officials as sitting appropriately in the thin capitalisation subpart of the Act. In particular:

- Paragraph 3.17 of the March 2017 Government discussion document *BEPS – Strengthening our interest limitation rules* stated:

We propose amending the thin capitalisation rules to limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower.

- This position was reiterated in the 8 September 2017 note provided to external submitters. Paragraph 34 included the following passage:

We propose that a financial arrangement will be subject to the restricted transfer pricing rule if:

- *the borrower is an entity that is subject to the thin capitalisation rules (the inbound rules, the outbound rules, and the banking rules); and*

9. However, it was decided the restricted transfer pricing rule should sit within the transfer pricing rules than the thin capitalisation rules. This was because:

- the restricted transfer pricing rule restricts certain terms and features of related-party debt but still relies on the general transfer pricing rules to determine the final price of that debt;
- embedding the restricted transfer pricing rule in the general transfer pricing rules allows certain related adjustments to be made, e.g. the adjustment for the payee in section GC 11.

10. An unintended consequence of locating the restricted transfer pricing rules outside the thin capitalisation rules is that the ownership test in the thin capitalisation rules (in particular the direct control interest test in section FE 39) does not automatically apply. As the restricted transfer pricing rule, as included in the BEPS Bill, does not include a provision to test voting interests based on the highest decision-making right rather than the average decision-making rights, the restricted transfer pricing rule will not apply as widely as was intended.

11. Given the close policy connection between the thin capitalisation rules and the restricted transfer pricing rule, it would make no sense at all for the two to have different ownership thresholds.

12. In conclusion, officials will recommend to the Committee that the restricted transfer pricing rules be amended so that they will also apply to a New Zealand person borrowing from a non-resident person or group if the lender and borrower would be associated if their voting interests were determined based on their highest shareholder decision-making right rather than their average shareholder decision-making rights.

Circulation

13. This letter is being sent to everyone who made a submission to the Finance and Expenditure Committee on the Bill, and will also be published on the Tax Policy website.

Yours sincerely

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