CONSULTATION> OFFICIALS' ISSUE PAPER

# Thin capitalisation settings for infrastructure

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An officials' issue paper

Inland Revenue
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## Making a submission

Inland Revenue invites submissions on the issues raised in this document, including the specific questions asked and any other issues relevant for officials to consider. A complete list of these questions can be found in the Appendix to this issues paper.

Include in your submission a brief summary of the major points and recommendations you have made. Please indicate if officials from Inland Revenue can contact you to discuss the points raised, if required.

The closing date for submissions is **19 June 2025**.

**Submissions can be made:**

- by email to policy.webmaster@ird.govt.nz with "**Thin capitalisation settings for infrastructure**" in the subject line, or
- by post to:

  **Thin capitalisation settings for infrastructure**
  C/- Deputy Commissioner, Policy
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

**Privacy of submissions**

Submissions may be requested under the Official Information Act 1982. Please clearly indicate in your submission if you consider that any information should be withheld on the grounds of privacy, or for any other reason. Contact information such as an address, email, and phone number for submissions from individuals will be withheld. Whether any information is withheld will be determined using the Official Information Act 1982.

# Contents

# Chapter 1 – Introduction

1.1 The purpose of this issues paper is to gain a better understanding of how the current thin capitalisation settings might be discouraging foreign investors from investing in privately owned infrastructure projects in New Zealand, and to explore some possible solutions to address it.

## Background

1.2 New Zealand has an infrastructure deficit. Domestic savings are insufficient to fund the infrastructure investment that New Zealand needs, so New Zealand relies on foreign direct investment (FDI) to help meet the shortfall. As such, the Government is committed to ensuring that New Zealand remains an attractive place for non-residents to invest.

1.3 At the same time, it is important that firms operating in New Zealand pay a fair amount of tax. Base protection measures, such as thin capitalisation rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment. The thin capitalisation rules do this by preventing multinationals from allocating an excessive proportion of their total global debt to New Zealand to reduce the amount of tax paid here.

1.4 On balance, good tax policy in this area should ensure that multinationals operating in New Zealand pay an amount of tax that is fair, but not unduly burdensome.

1.5 Overall, we consider that our rules are serving us well. The rules are well understood and set clear and largely predictable limits on the amount of deductible debt allowable in New Zealand. The limit is broadly set at 60% of the accounting value of the assets of the New Zealand group or 110% of the multinational group's worldwide debt (whichever is higher). However, there is a concern that the thin capitalisation rules may be acting as a deterrent to foreign capital flow, particularly for some investments in infrastructure projects.

1.6 In infrastructure projects, when third-party lenders are willing to lend more than 60% of the value of the assets, the limit may result in interest deductions being denied even though the level of debt is not considered excessive in commercial terms. This is not uncommon in some infrastructure projects, which require significant capital upfront for the construction phase but have secure future cashflows from long-term purchase or service agreements to support the relatively high level of debt. The interest denial increases the effective tax rate for such investments and, therefore, may deter the inflow of capital that New Zealand needs to help resolve its infrastructure deficit.

1.7 The rules were relaxed in 2018 to provide an exemption for public private partnership (PPP) infrastructure projects. The exemption allows PPP projects to take on more debt than the limits imposed by the general rules, provided that the debt is third-party debt (or like third-party debt) with limited recourse (only has recourse to the assets and income that arise from the project). However, this treatment only applies to PPP infrastructure projects with the Crown or a public authority.

1.8 We are interested in better understanding how the current thin capitalisation settings might act as a barrier to FDI in privately owned infrastructure projects that create or significantly upgrade infrastructure assets in New Zealand. Such investments do not qualify for the PPP exemption. The options discussed in this issues paper are intended to remove the potential tax barrier.

1.9 It is hard to say how much changing the thin capitalisation settings will lead to increased investment that helps with New Zealand's infrastructure deficit. This is partly because much of the infrastructure in New Zealand is owned by central or local government, rather than privately owned. There are also many non-tax settings that impact infrastructure investment decisions. In addition, the thin capitalisation rules are just one tax setting that could impact FDI in New Zealand (others include the company tax rate, no capital gains tax and withholding tax rates on distributions to foreign investors).

1.10 However, it is important to ensure that the tax settings do not unduly disincentivise investment in infrastructure compared to other assets.

## Summary of proposals

1.11 This issues paper outlines two potential options aimed at addressing the issue of how the current thin capitalisation settings may unduly deter FDI in privately owned infrastructure projects:

- a targeted rule that applies only to infrastructure projects, and
- a more general rule that applies to third-party debt.

1.12 A targeted rule is our current preference because it focuses on the problem, but we welcome submissions on both options.

## Document outline

| Section | Outline |
|---|---|
| Chapter 2 | outlines the current thin capitalisation settings in New Zealand. |
| Chapter 3 | provides the context of the problem. |
| Chapter 4 | outlines the options contemplated. |
| Chapter 5 | discusses a rule targeted at infrastructure projects. |
| Chapter 6 | discusses a more general rule that applies to third-party debt. |

# Chapter 2 – Current thin capitalisation settings

2.1 Most countries have some form of interest limitation rules to help deal with the risk of base erosion and profit shifting (BEPS), even though the rules can vary considerably from one country to another.

2.2 The OECD's *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (BEPS Action 4: 2015 Final Report)[1] notes that:

> *The use of third party and related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning.*

2.3 New Zealand implemented the thin capitalisation rules in 1996. The rules have undergone a few modifications to ensure that they continue to be fit for purpose. This chapter discusses the thin capitalisation settings that currently apply in New Zealand.

## Purpose of the rule

2.4 Foreign investors can fund their New Zealand investments with equity or debt. The thin capitalisation rules help protect the New Zealand tax base by limiting the amount of debt that they can put into their New Zealand investments before some interest deductions are disallowed. The rules help protect the tax base from the following risks:

- multinational groups allocating an excessive proportion of their worldwide debt (and interest expenses) to New Zealand, and
- multinational groups using intragroup loans to shift profits out of New Zealand through interest payments.

2.5 These risks arise because of the difference in tax treatment between debt and equity. Interest on debt is generally a deductible expense for the payer. Dividends, or other equity returns, on the other hand, are generally not deductible for the payer. This difference in tax treatment has been a longstanding feature of tax systems worldwide.

2.6 For financing from *residents*, the New Zealand tax system is broadly neutral in terms of the incentives to finance a company by debt or equity. Together, the deductible/assessable nature of interest and the imputation system provide that returns on equity and debt are taxed once overall, at the ultimate investor's tax rate.

2.7 When it comes to financing from *non-residents*, the situation can be different. The New Zealand tax system interacts with the tax system in the investor's country of residence to affect the overall return to the investor. When the investment is made from or through a low-tax jurisdiction, investing by debt typically reduces the total tax payable worldwide. This creates a bias for debt investment.

[1] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report | OECD

2.8 Many countries are aware of the revenue risk from allowing their companies to be over-leveraged, and have some form of interest limitation/thin capitalisation rules to address this risk. An effective thin capitalisation regime should limit the ability of non-resident investors to reduce their net New Zealand-sourced income by allocating excessive interest costs to New Zealand. However, it is not intended to disallow high levels of debt that are not driven by this motive.

## Key elements

2.9 There are two broad approaches to the design of an interest limitation rule. The first is the approach that New Zealand has adopted, which is to limit the amount of tax-deductible debt a company can have that will be recognised for tax purposes. This is usually based on its level of assets or its equity. By restricting recognised debt levels, allowable interest deductions are also indirectly restricted. The second approach is to directly limit the interest a company can deduct based on some measure of the company's profits (normally either EBIT or EBITDA).[2]

2.10 The thin capitalisation rules in New Zealand apply only to multinational groups. They do not apply to domestic groups. The underlying policy framework for the general thin capitalisation rules in New Zealand is concerned with the amount of debt apportioned to New Zealand. As such, the test generally applies on a New Zealand group level, as opposed to an entity level.

2.11 There are two key elements to the rules for inbound investment in New Zealand:

- *Worldwide group debt test:* For groups controlled by a single non-resident, the rules generally disallow a portion of the interest deductions if the debt percentage of the New Zealand group exceeds 110% of the worldwide group's debt percentage.[3] This test is concerned with whether the foreign investor has allocated a disproportionate level of their worldwide debt to New Zealand.
- *Safe harbour debt threshold:* The rules include a safe harbour debt threshold of 60% to help with compliance costs. This means that if the debt percentage of the New Zealand group does not exceed 60%, all the interest can be deducted without needing to consider the worldwide group debt test.

2.12 New Zealand's thin capitalisation rules apply to related-party debt as well as third-party debt. Rather than lending to its New Zealand subsidiary, a foreign parent could arrange for the subsidiary to hold a much higher proportion of third-party debt than the parent. This can be a close substitute for direct lending by the foreign parent. The foreign parent could also potentially borrow heavily through its New Zealand entity to help fund its worldwide operations. Finally, rules that apply only to related-party debt could

[2] *Earnings before interest and tax*, and *earnings before interest, tax, depreciation and amortisation*, respectively.
[3] The debt percentage of a group is calculated using the formula in section FE 12 of the Income Tax Act 2007: group debt ÷ (group assets – non-debt liabilities). Section FE 13 provides for the on-lending concession that applies to the calculation.

potentially be avoided using back-to-back loans or third-party debt guaranteed by a related party.[4] Accordingly, the rules respond to concerns about third-party borrowing being done through New Zealand in a manner that erodes the tax base.

2.13 It is worth noting that, when a New Zealand entity is owned by a group of non-residents and none of them have a controlling interest in their own right, the entity is unrestricted in how much third-party debt it can take on, provided the debt is not provided or guaranteed by its owners. However, there is generally less risk of implicit parental support or back-to-back loans in such cases.

2.14 A special thin capitalisation regime applies to registered banks operating in New Zealand. The potential changes discussed in this paper would not apply because they are not relevant to that regime.

## Specific public private partnership rule

2.15 In 2018, New Zealand introduced a specific exemption for public private partnership (PPP) infrastructure projects undertaken with the Crown or a public authority and approved by the Minister of Finance.[5] The rule effectively allows PPPs to take on more debt than the limits imposed by the general rules, provided that the debt is third-party debt (or like third-party debt) that only has recourse to the assets and income arising from the project (limited recourse debt).

2.16 The rule recognises that a PPP can be very highly geared commercially (approximately 85% to 90% debt funded). This is because third-party lenders see a PPP as a safe investment due to the secure cashflow characteristics of the project (long-term cashflows provided by the Crown).

2.17 This measure was intended to improve the competitiveness in the bidding process for PPP infrastructure projects by ensuring that investors are subject to similar levels of thin capitalisation restrictions. For example, as noted above, when a New Zealand entity is owned by a group of non-residents (none of which has a controlling interest in their own right), the entity is unrestricted in how much third-party debt it can take on (provided the debt is not guaranteed by its owners). In contrast, when a New Zealand entity is owned by a single non-resident, it does face restrictions on how much debt (which may just be third-party debt) it can take on.[6]

2.18 The PPP rule is consistent with the BEPS Action 4 Report. This report noted that countries may wish to provide a tightly targeted exemption from interest limitation rules for third-

[4] An example of a back-to-back loan would be when the foreign multinational provides a loan to an unrelated entity which then provides a loan to the New Zealand subsidiary. This could be hard to detect in practice.

[5] Sections FE 4B and 7B of the Income Tax Act 2007.

[6] In general, this restriction is well-placed and prevents multinationals from allocating a disproportionate amount of their worldwide debt in New Zealand.

party limited recourse loans used to fund public benefit infrastructure projects/assets. This is because those loans present little to no risk of BEPS.[7]

**Question for submitters**

Q2.1 Which aspects of the existing public private partnership (PPP) rule, if any, could be improved?

[7] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report | OECD: refer to pages 39 to 41, which include the recommended conditions for an exemption for public benefit infrastructure projects/assets.

# Chapter 3 – Problem definition

3.1 The thin capitalisation rules generally work as intended. The 60% safe harbour threshold is set at a level that means that the vast majority of taxpayers fall below it and do not need to rely on the worldwide group debt test. However, while not common, there is a risk that the current thin capitalisation settings may be discouraging some foreign investment in infrastructure projects by over-taxing some genuine commercial transactions.

3.2 This chapter discusses some of the issues encountered in applying the thin capitalisation rules to infrastructure. As highlighted in Chapter 1, the issues only affect infrastructure projects that do not qualify for the public private partnership (PPP) exemption.

## Issues for infrastructure

3.3 The thin capitalisation rules are just one of several tax settings that may influence investment decisions. However, the rules could affect infrastructure investments more than they affect other sectors.

3.4 Infrastructure projects tend to be capital intensive, particularly during the construction phase, and often need large amounts of debt to meet the funding requirement. Some privately owned infrastructure projects are able to secure debt from third-party lenders that are willing to lend more than 60% of the asset value (though less than the levels seen in PPP infrastructure projects). The thin capitalisation rules may therefore result in interest deductions being denied, even though the level of debt may not be considered excessive in commercial terms. This can result in genuine infrastructure projects being taxed at a higher rate than might otherwise be considered acceptable.

3.5 The borrower can often secure a high level of debt because, as in PPP projects, lenders usually view such investments as relatively safe. The debt is often supported by long-term purchase or service agreements, which provide a degree of certainty regarding the borrower’s ability to service the debt.

3.6 Infrastructure projects tend to be large, so they may be more sensitive to small changes in the expected rate of return. Denying some of the interest deductions under the thin capitalisation rules may mean that some projects do not proceed or, if they do, they would be expected to have a negative impact on project modelling/economics.

3.7 However, infrastructure projects typically generate tax losses in early periods because of the high gearing and the tax depreciation shield from the new assets constructed. This means that the project value might also be less sensitive to interest denial than if the project was paying tax at the outset because the project would not be able to use the interest deductions until much later.

3.8 The worldwide group debt test is intended to help in some situations when the 60% safe harbour is breached. However, the test may not help some infrastructure investments for reasons including the following:

- The worldwide group may have infrastructure projects of differing maturities. More mature projects may have lower debt levels than less mature ones. The average debt level across a portfolio of infrastructure projects may therefore be lower than the commercial debt level of a new project. This is particularly significant for infrastructure, where the projects often span a considerable period.
- A similar issue can arise when the non-resident parent/investor has ownership interests of less than 50% in their investments, including project-financed infrastructure investments. The parent's net equity interest in the investment will be counted as an asset but the investment's debt will not be included in the parent's consolidated accounts. This will push down the worldwide debt to asset percentage. This is particularly the case for some infrastructure investors like pension funds and sovereign wealth funds, which tend to have minimal debt on their balance sheets.
- The non-resident controlling shareholder may invest in a range of industries with different capital structures.
- Under the worldwide group debt test, the decisions of the non-resident majority investor may impact the deductibility of interest in the New Zealand investments. Therefore, the other investors may be unwilling to rely on the worldwide group test, especially because infrastructure projects can be very long term.

3.9 The thin capitalisation rules apply only to foreign-controlled investors and may therefore place some foreign investors or consortia at a disadvantage compared with domestic investors (or foreign investors to whom the rules do not apply). This may reduce competition in bids or investment for projects. The rules might also discourage domestic investors because it may be difficult for them to find foreign investors to take over if they later want to exit from the investment.

3.10 Under the current rules, investors can avoid the interest denial by structuring their investments so that there is no majority shareholder. However, this may not be an attractive option for some investors because the size of their investments might be too small considering the amount of effort required upfront, which might be as much as the effort required for larger investments.

**Questions for submitters**

Q3.1 Do you think New Zealand's thin capitalisation settings are unduly discouraging foreign investment in infrastructure projects? Why or why not?

Q3.2 If the thin capitalisation settings do not restrict the debt level to 60%, what types of non-PPP infrastructure projects do you think are likely to be able to be commercially debt funded by third parties on limited recourse terms at more than 60% of the project/asset value?

Q3.3 What role do you think tax settings play in whether an infrastructure project or investment is made in New Zealand?

Q3.4 To what extent do you think changing the thin capitalisation settings will lead to more infrastructure investment in New Zealand?

Q3.5 Have you seen infrastructure projects, where the debt funding is solely in the form of third-party limited recourse debt, that do not go ahead or where the project economics are significantly impacted because of the thin capitalisation settings?

# Chapter 4 – Options

4.1 The options considered in this issues paper are intended to address the issue of how our thin capitalisation settings may impede investment in projects aimed at creating or significantly upgrading privately owned infrastructure assets in New Zealand that do not qualify for the public private partnership exemption. The options do this by removing a potential disincentive for such investment. The options are not intended as a broader reform of the thin capitalisation regime.

4.2 We have considered two main options:

- a rule targeted at infrastructure projects (discussed in Chapter 5), and
- a more general rule that applies to third-party limited recourse debt (discussed in Chapter 6). Infrastructure projects would be able to use this rule, but it would not be limited to them.

4.3 We have not considered other options, such as increasing the safe harbour threshold. Although this could help encourage more foreign direct investment in infrastructure projects in New Zealand, it would significantly impact the integrity of the thin capitalisation rules. This is because a higher threshold would allow higher levels of related-party debt. This would also potentially provide benefits to many existing projects and to businesses that are not the primary target of the potential policy change.

# Chapter 5 – Rule targeted at infrastructure

5.1 This chapter discusses the option of introducing a targeted rule that applies to infrastructure investment. This option would allow interest on third-party limited recourse debt for eligible infrastructure projects to be fully deductible.

## What targeted rule could look like

5.2 A targeted thin capitalisation rule for infrastructure could draw on elements of the specific rule for public private partnership (PPP) infrastructure projects to allow an entity that would otherwise breach the general thin capitalisation thresholds to fully deduct its interest when the following key requirements are met:

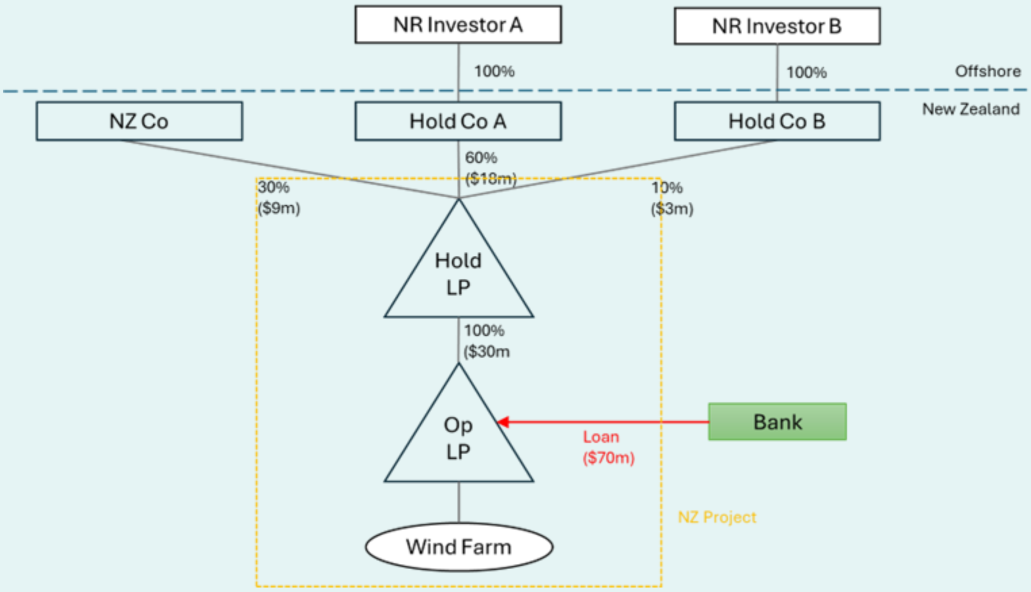
- The debt is applied by the entity to fund (or refinance) an eligible infrastructure project to upgrade or create assets in New Zealand that are expected to have a life of at least 10 years.
- The assets are constructed after a set date (for example, 1 April 2026).
- The debt is from an unrelated third party and only has recourse to the project.
- The debt is not on-lent, except for minor and incidental lending to a third party (such as a bank deposit).
- The interest expense, infrastructure project assets, and the income arising from the project assets must all arise or be incurred in New Zealand.

5.3 If an entity uses this rule, any interest on debt that does not qualify (such as related-party loans from investors) would not be deductible.

5.4 Similar to the existing PPP rule:

- Each infrastructure project could be treated separately. The debt, interest and assets applied under the rule could be excluded from the thin capitalisation calculation of the wider group or another project. Alternatively, the rule could be applied to the financing of a portfolio of new infrastructure projects, provided each project individually qualifies under the rule.
- There could be an optional election to apply the rule to an infrastructure project, which would be available at the time the taxpayer is first able to apply the rule to the project.
- The rule could apply to entities controlled by a single non-resident, partnerships and New Zealand resident entities subject to the outbound thin capitalisation rules. A similar exemption already applies (in effect) when a separate entity is controlled by a group of non-residents.

**Example 1: Application of the targeted rule**




There is a new infrastructure project to develop a wind farm in New Zealand through a dual-limited partnership structure. Operating LP (Op LP) will develop the wind farm and is held by Hold LP. There are three partners in Hold LP: one New Zealand resident company (NZ Co), and two non-resident investors (NR Investor A and NR Investor B), which have set up New Zealand holding companies (Hold Co A and Hold Co B).

The project will cost $100 million. This will be funded by $70 million of bank debt and $30 million of partnership capital. The bank debt is fully secured by the project (being the assets and income streams of the limited partnerships as well as the partnership interests themselves). The bank is willing to extend a relatively high level of debt at the outset because Op LP has a long-term power purchase agreement with a third party for the electricity generated by the wind farm once it is completed.

The $30 million of partnership capital to Op LP will be funded by $9 million from NZ Co, $18 million from NR Investor A via Hold Co A, and $3 million from NZ Investor B via Hold Co B. This will then flow through as partnership capital from Hold LP to Op LP.

The two non-resident investors in the project will be required to calculate their New Zealand group debt percentages for thin capitalisation at Hold Co A and Hold Co B because of the look-through nature of the limited partnership structure for tax purposes.

If we assume that the simplified balance sheet of the dual-limited partnership is $100 million wind farm assets, $70 million debt and $30 million partnership equity, then Hold Co A and Hold Co B will have New Zealand group debt percentages of 70%. This exceeds the 60% safe harbour threshold, and NR Investor A and NR Investor B do not have worldwide group debt percentages that would allow higher levels of deductible interest under the thin capitalisation threshold.

However, Hold Co A and Hold Co B could choose to apply the targeted rule to allow full deductions on the bank debt in New Zealand because:

- the debt is used to fund an eligible infrastructure project (assuming wind farms are on a list of eligible infrastructure projects)
- the wind farm is constructed after the set date (eg, 1 April 2026)
- the debt is from a bank that is an unrelated third party and the debt only has recourse to the project
- the debt is not on-lent, except for minor or incidental lending, to a third party (such as a bank deposit), and
- the interest expense, infrastructure project assets, and the income arising from the project assets all arise or are incurred in New Zealand

5.5 We outline some of the key design considerations below.

## Scope of eligible infrastructure

5.6 One key design consideration is what constitutes an eligible infrastructure project or investment. There are two important questions to consider in this regard.

### New infrastructure vs existing infrastructure

5.7 The first question is whether any change to the thin capitalisation rules for infrastructure should only apply to new infrastructure projects, as proposed above, or whether it should cover existing infrastructure investment as well.

5.8 The Government's broader goal is to help close New Zealand's infrastructure deficit. This goal is best achieved if new infrastructure is created (or existing infrastructure is significantly upgraded). This suggests the rule should be targeted at new infrastructure projects and upgrades. Expanding the rule to existing infrastructure would increase its fiscal cost without necessarily further achieving this goal.

5.9 There is also an analogy with the PPP rule. The PPP rule is primarily targeted at new infrastructure projects where the private sector partners with the government to build a new asset (such as a school, prison or road) that it operates or maintains for a concession period (generally 20–30 years) before responsibility transfers to the government. PPP infrastructure projects require significant capital investment upfront to build the asset and are typically highly geared with debt at the outset, with the debt being repaid throughout the concession period funded by regular payments from the government. The debt is fully repaid by the end of the concession period when responsibility transfers to the government.

5.10 This is similar in some respects to private sector infrastructure projects such as a renewable energy project (like a new wind farm), which also requires significant capital investment upfront to build the asset. These projects can also be highly geared with debt at the outset, often because there is a long-term power purchase or offtake agreement to buy the electricity that the new asset will generate. The debt should reduce over the term of the long-term power purchase agreement. However, because the private sector owns the asset at the end of the agreement (and can potentially sell electricity beyond the term of the agreement), the debt may not have to be fully repaid over its term. The debt would still need to be paid down before the end of the renewable energy project's estimated life.

5.11 Therefore, it would be more natural for any new rule to focus on new infrastructure projects. This increases the level of infrastructure in New Zealand similar to a PPP infrastructure project. New infrastructure projects would typically be greenfield investment projects, but could potentially be brownfield investment projects in some circumstances (such as when an asset is significantly upgraded).

5.12 The PPP rule does cover new investors into a PPP. For example, some private sector PPP investors may sell their interests in a PPP once the asset has been constructed, or partway through the concession period, and move on to their next project or investment. The new investors in a PPP can still apply the PPP rule. This extension of the rule is important to ensure that the original investors can exit their investment. If the rule were limited to original investors, then new investors would be reluctant to buy them out (because they could experience interest denial upon acquisition, which could make the project financially unviable). This would create a barrier to the original investor's exit, which could in turn discourage them from investing in the first place.

5.13 In a similar way, an investor in a wind farm may sell their interest in the company (or special purpose vehicle) that owns the wind farm once it has been constructed, or partway through the term of the long-term power purchase agreement. If there was significant debt in the project vehicle then it may limit the potential pool of investors willing to buy into the wind farm (as foreign investors may face interest denial upon acquisition). In a similar way that the PPP rule covers new investors into a PPP, an extension to other infrastructure projects, like a new wind farm, could also cover new investors into those projects. The boundary could be drawn by restricting eligible infrastructure projects to those with assets constructed after a set date (for example, 1 April 2026).

5.14 Restricting the application of the rule to new infrastructure does mean that longstanding infrastructure businesses could not usually apply the rule. For example, there may be an existing infrastructure business (such as an electricity lines company) that is a regulated business with strong and secure cash flows. These cash flows support the operation of the business and allow the infrastructure to be continually maintained. The business is acquired by a foreign investor, and the strong cash flows may help support higher levels of debt being taken on by the foreign investor that breach the general thin capitalisation thresholds. The high levels of debt mean that some interest deductions will be denied under the general thin capitalisation rules. Since the acquisition would not result in new infrastructure, we consider that the rule should not apply to it. However, such businesses may be able to fall into the rule for particular projects when they create or upgrade eligible infrastructure assets in New Zealand if the other criteria are met.

**Questions for submitters**

Q5.1 Do you think any new rule should be targeted at new infrastructure projects (such as a new wind farm)? Should it apply more broadly to existing infrastructure investment (such as an existing electricity lines company)? Why?

Q5.2 Do you agree that the potential targeted rule should be based on the PPP rule? Is there another approach that would be better?

Q5.3 The description of the key requirements and features in paragraphs 5.2 and 5.4 are targeted at new infrastructure projects. How could they be applied/adapted to existing infrastructure investment if you think that a new rule should cover such investment?

## Defining infrastructure

5.15 The second question is how eligible infrastructure projects or investment should be defined.

5.16 The PPP rule is straightforward in that respect, because the government decides whether it will procure infrastructure investment through a PPP, so anything that is a PPP should qualify for that rule. It is not so straightforward for other infrastructure projects that could be covered by a new rule.

5.17 One approach would be to adopt a relatively traditional definition of infrastructure. For example, infrastructure could be said to refer to the fixed, long-lived structures that facilitate the production of goods and services, including transport, water, energy, social assets, and digital infrastructure such as broadband and mobile networks.[8] This could be supported with a list of what qualifies as eligible infrastructure projects.

5.18 It is important to know what types of infrastructure project or investment (other than PPPs) are likely to be able to be commercially debt-funded by third-party limited recourse debt at more than 60% of the project or asset value (as asked in Chapter 3). For new infrastructure projects, the primary example that we are aware of is renewable energy projects, but we invite submissions on the types of projects (or investments) that should be included on a list of eligible infrastructure projects.

5.19 We have reviewed the approaches adopted in some countries that have targeted exemptions for infrastructure from their thin capitalisation or interest limitation rules. Ireland has adopted a relatively prescriptive list approach. The United Kingdom (UK), by contrast, has focused primarily on infrastructure procured by the public sector and

[8] Infrastructure | The Treasury New Zealand

regulated companies (which is deemed to be public benefit infrastructure), but includes guidance on what is intended to be covered. Both these approaches are largely focused on infrastructure with a clear public benefit (PPPs are covered under both approaches and we have a PPP rule already). Our initial view is that a general definition supported by a list would provide more certainty for investors, but we invite submissions on this point. It may be that a broad definition of infrastructure is reasonable, for example one that extends to projects such as large-scale residential developments (which is included on Ireland's list).

### *Ireland*

5.20 Ireland has a targeted exemption for qualifying long-term public infrastructure projects. The project must be to provide, upgrade, operate or maintain a "large-scale asset" with a minimum expected life span of 10 years. It must also meet the following conditions (note that the "EU Member State" will be Ireland in practice):

- the project operator must be established and tax resident in an EU Member State
- the asset must be situated in a Member State, and
- the income (when it arises) and deductible interest equivalent costs must arise in a Member State.

5.21 Large-scale assets include certain energy, transport, environmental and health care infrastructure, electricity transmission lines, strategic gas infrastructure, railway works, road works, strategic housing developments or large-scale residential developments, an asset constructed pursuant to a PPP, installations generating energy from renewable sources, and an asset specified by the Minister of Finance in regulations made under section 835AAA(1) of the Taxes Consolidation Act 1997 (Ireland). The list is specific and includes by way of example:

- a thermal power station with a total energy output of 300 megawatts or more
- an installation for hydroelectric energy production with an output of 300 megawatts or more, or where the new or extended superficial area of water impounded would be 30 hectares of more, or where there would be a 30% change in the maximum, minimum or mean flows in the main river channel
- a health care facility which, whether or not the facility is intended to form part of another health care facility, shall provide in-patient services and shall have not fewer than 100 beds in order to so provide.[9]

5.22 If a targeted rule in New Zealand followed a list approach, it may not be necessary to adopt as prescriptive a list as Ireland outlining the size/scale of the project, but we welcome submissions on this point.

[9] Revised Acts has the majority of the list of the infrastructure that would qualify as a 'large scale' asset in Ireland. Part 35D-01-01 - Guidance on Interest Limitation Rule has commentary on the rule in Ireland at pages 44 to 46.

5.23 In Ireland, when a relevant entity carries on both a qualifying long-term infrastructure project and other activities, income and expenses are apportioned between the qualifying long-term infrastructure project and the other activities on a just and reasonable basis. However, Ireland has earnings-based (EBITDA) interest limitation rules.

### *United Kingdom*

5.24 The UK has a targeted exemption for taxpayers who elect to be a qualifying infrastructure company (QIC), which is a company that meets the following requirements:

- it must be fully taxed in the UK
- all, or all but an insignificant proportion, of its income and assets must be referable to activities in relation to public infrastructure assets, and
- it must have elected to be a QIC.

This means that PPP companies, infrastructure companies and certain other "public benefit" companies should generally be able to treat third-party limited recourse debt as deductible.

5.25 To be a public infrastructure asset, the asset must meet the "public benefit test". This test is met by a tangible asset that is infrastructure of the UK when it is, or is to be procured:

- by a relevant public body, or
- used in the course of a regulated activity, and
- the asset must have, have had, or be likely to have, an expected economic life of at least 10 years and be recognised on the accounting balance sheet.

5.26 Examples of infrastructure include: water, electricity, gas, telecommunications or sewerage facilities, oil pipelines, oil terminals or oil refineries, railway facilities (including rolling stock), roads or other transport facilities, health or educational facilities, facilities or housing accommodation provided for use by members of the armed forces or of any police force, court or prison facilities, waste processing facilities, and buildings (or parts of buildings) occupied by any relevant public body.[10] This list is not intended to be exhaustive, but illustrative in the UK guidance.

### *Benefits and challenges*

5.27 One key benefit of defining "eligible infrastructure" is that any new rule will be targeted at infrastructure and will not apply beyond infrastructure. The PPP rule was introduced on the basis that the project was of public benefit and presented minimal base erosion and profit shifting (BEPS) risk. This is especially the case for PPPs that are procured by the government. However, there is a reasonable case that extending the treatment to

[10] CFM97130 - Interest restriction: public infrastructure: public infrastructure asset - HMRC internal manual - GOV.UK (www.gov.uk)

other infrastructure projects (and potentially broader infrastructure investment) with a public benefit is the most natural extension of the rule (if it is to be extended).

5.28 One key challenge is determining the appropriate boundary for an eligible infrastructure project or investment. For example, there are varying opinions over whether a data centre or distributed networks (such as charging stations or the distribution of solar panels) is infrastructure with a public benefit (similar to a PPP).[11] This might lead to some potential issues, such as:

- the list or guidance may need to be updated periodically because the scope of what is eligible infrastructure may evolve over time with the advent of new technology, and
- the rule may be more complex to apply if the debt funding is obtained collectively for a mixture of projects, and some of them are not considered eligible infrastructure.

5.29 These risks could be mitigated by taking a relatively broad definition of infrastructure, which could potentially extend to large-scale residential property developments. However, taking a broad definition of infrastructure may open up more of the tax base to BEPS risk.

**Questions for submitters**

Q5.4 What should constitute eligible infrastructure projects or investment? Please include all types of projects that you think should be part of the list of eligible infrastructure projects. This should focus on projects that can be funded at debt levels of 60% or higher from the outset of the project.

Q5.5 Do you agree that a relatively traditional definition of infrastructure could be developed, or supplemented, by a list of eligible infrastructure projects?

Q5.6 Do you think New Zealand should adopt any features from similar rules in Ireland and the UK?

Q5.7 Do you think there is another approach that would be better?

## Third-party debt

5.30 The PPP rule applies to interest on third-party debt. It also applies to debt that is from an investor but is made in the capacity of a third-party lender. This effectively means that investor debt is permitted when the investor debt is not proportional to the equity interests in the project vehicle because the debt would not be a substitute for equity in such circumstances.

[11] Note that whether such businesses are considered eligible infrastructure should only be relevant when such projects would otherwise breach the general thin capitalisation thresholds.

5.31 Our initial view is that, although such a feature may be part of the PPP rule, it would be better for any broader rule for infrastructure to apply only to unrelated third-party debt. If there is any debt from investors (or associates of investors), interest deductions on this debt would not be allowed. This is because related-party debt is riskier from a tax base protection perspective. However, we understand that related-party funding can sometimes be used in new infrastructure projects to allow some returns to investors in the early stage of new infrastructure projects when it is likely to have tax losses such that dividends/profits are unlikely to be paid/distributed. We invite submissions on this point.

**Questions for submitters**

Q5.8 Do you agree that any new rule for infrastructure projects should only apply to third-party debt?

Q5.9 If you think that related-party (investor) debt should be permitted, please outline your reasons why, and in what circumstances it should be allowed.

## Limited recourse debt

5.32 The current PPP rule allows full interest deductibility on third-party debt that has limited recourse to the PPP project. This means that the debt can only have recourse over the project assets, income streams from those assets, and ownership interests in entities that are part of the PPP project. Similar principles could also apply to a potential targeted rule.

5.33 We understand that infrastructure projects may be financed with project portfolio debt. This means that the debt could be advanced on a portfolio basis where it has recourse over a few projects. For example, a business may have completed one wind farm and includes that wind farm as part of the security package when seeking debt finance for its next wind farm. This is not a feature of the current PPP rule and could make a targeted rule more complex.

5.34 In principle, it seems that the debt financing for the second wind farm should be covered by a potential targeted rule, even though the recourse extends to the first wind farm (as an eligible infrastructure project), provided the first and second wind farms would otherwise qualify for the targeted rule. However, if the first wind farm was constructed before the application date of the rule (for example, 1 April 2026), it could not be used as security under this approach. We welcome submissions on this point, particularly on whether this approach would be restrictive in practice.

5.35 There is a question mark over whether the recourse should also extend to cover equity that has been committed by investors but not yet put into the project entity. We understand that it is relatively common in infrastructure projects (including PPPs) for investors to provide equity commitment letters so that the funds can be delayed until needed.

5.36 Our initial view is that it seems reasonable for lenders to have recourse to a predetermined level of equity that investors have committed to for a new infrastructure project (and that will ultimately flow into the project vehicle). However, the third-party debt should not be allowed to be covered by general guarantees by the investors (or their associates). Also, the rule should disallow third-party debt involving back-to-back arrangements with the equity investors, or associates of equity investors.

**Questions for submitters**

Q5.10 Do you think that the debt eligible for full interest deduction under the potential targeted rule should include portfolio debt when the projects/assets within the portfolio would have individually qualified for the rule? Do you have any concerns with this approach?

Q5.11 Do you consider that limited recourse should extend to cover equity that has been committed by investors to an infrastructure project (or investment)? Why?

Q5.12 Is there anything else that limited recourse should be extended to cover?

## Length of concession

5.37 The PPP rule has a natural end when the concession period ends, and responsibility for the asset is returned to the government. This does not apply in the same way to private infrastructure investment, where the assets are held by the private sector, with the third-party debt being repaid before the expected life of the assets. We are interested in submissions on whether it is appropriate that any new rule for private sector infrastructure investment should have no fixed end date.

**Questions for submitters**

Q5.13 Do you consider that any new rule should or should not have a fixed end date? Why?

## Project level

5.38 The current PPP rule allows an investor who has an interest in more than one PPP project to treat each project separately. This means that terms under the PPP rule such as “public project debt” are excluded from other PPP projects and the general thin capitalisation calculations, which apply based on a thin capitalisation group. We think this approach could be followed for a potential new rule targeted at other infrastructure projects. If the debt was borrowed for a portfolio of qualifying projects, the treatment could potentially apply to the whole portfolio.

**Questions for submitters**

Q5.14 Do you think any new rule should apply at the thin capitalisation group level or the project/entity level? Why?

## Optional election

5.39 The current PPP rule has an optional election to apply the PPP rule made when the taxpayer can first apply it to the infrastructure project debt associated with the PPP. This could be followed for any new rule that applies to other infrastructure projects. At this stage, our preference is for an irrevocable election, but we are interested in submissions on this point.

**Questions for submitters**

Q5.15 Do you agree that taxpayers should have an optional election, when the taxpayer could first apply the targeted rule to the infrastructure project, to apply the rule to the project?

Q5.16 Should there be an opportunity to switch the election?

# Chapter 6 – General rule

6.1 This chapter discusses a more general rule that is not restricted in its application to infrastructure projects. However, the rule should still address the issue of how the current thin capitalisation settings may discourage foreign direct investment (FDI) in privately owned projects that are aimed at creating or significantly upgrading infrastructure assets in New Zealand, although at a greater fiscal cost/risk.

## What general rule could look like

6.2 The more general rule would primarily be limited in application, not by the sector that it would apply to, but by the type of debt arrangement. Such a rule could share some similarities to the third-party debt test that has been introduced in Australia recently.[12] Under the rule, the interest expense on a debt would be fully deductible only if:

- the debt is issued to an unrelated third party (an entity that is not an equity investor or an associated person[13] of an equity investor)
- the lenders can only have recourse to the New Zealand assets of the borrowing entity or its New Zealand group (including membership interests in the entities within the New Zealand group)
- the debt is fully used to fund commercial/business activities in connection with New Zealand, and
- the borrower is a New Zealand resident entity.

6.3 The rule would effectively become an alternative test to the worldwide group debt test and the safe harbour debt threshold. This means that a multinational group operating in New Zealand could choose to rely on either the 60% safe harbour threshold, the 110% worldwide group debt test, or the new test to determine if its New Zealand group could claim a full deduction for its interest expense. The group would be allowed to rely on a different test in the following financial year.

6.4 The new test would apply only to inbound investments because the work is targeted at removing factors that could deter inbound investments in infrastructure. Like the 60% safe harbour threshold and the 110% worldwide group debt test, the new test would apply on a New Zealand group level rather than on entity or project level. This means that entities in the same New Zealand group could not apply a different thin capitalisation test.

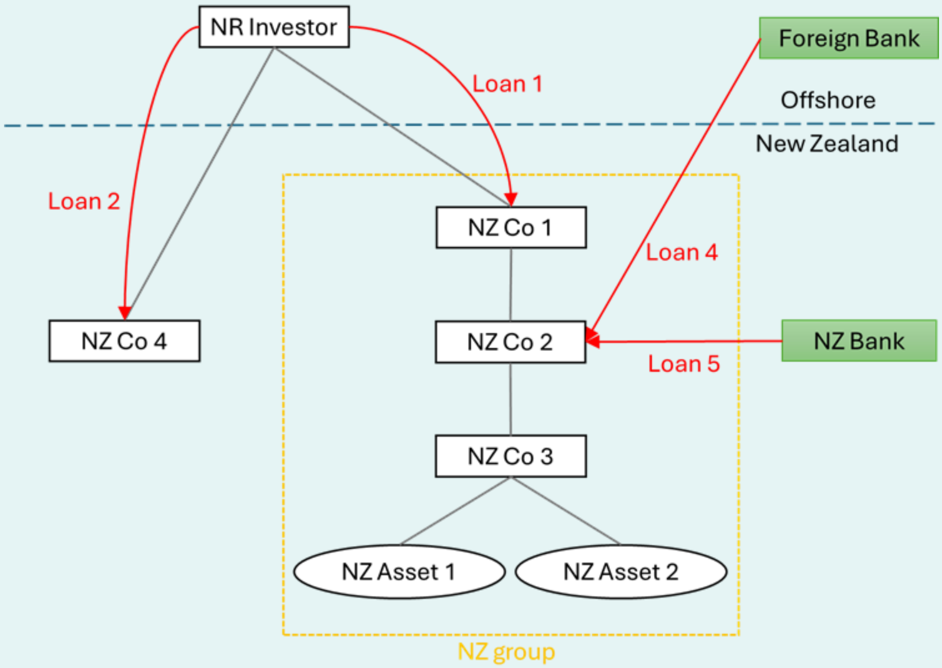
6.5 For a group that chooses to apply the new test, the interest expense would be non-deductible on debt that does not fulfil the above requirements, such as related-party

[12] The third party debt test in Australia has replaced the arm's length debt test that was previously part of its interest limitation rules. This is part of a broader change to the interest limitation rules in Australia to adopt earnings-based (EBITDA) interest limitation tests. Third party debt test | Australian Taxation Office has information on the rule.
[13] *Associated person* is defined in subpart YB of the Income Tax Act 2007.

debt, debt that provides recourse to overseas assets, debt guaranteed by a foreign parent, or debt where the funding is applied directly or indirectly to support commercial activities overseas.

6.6 The following example illustrates the application of the rule.

**Example 2: Application of general rule that applies to third-party debt**




NR Investor directly holds two wholly-owned subsidiaries in New Zealand, namely NZ Co 1 and NZ Co 4. NZ Co 2 is a wholly-owned subsidiary of NZ Co 1 and NZ Co 3 is a wholly-owned subsidiary of NZ Co 2. NZ Co 1, NZ Co 2, NZ Co 3, and NZ Co 4 are New Zealand tax resident entities that operate solely in New Zealand.

Based on the grouping rule under sections FE 25 to FE 30 of the Income Tax Act 2007, NZ Co 1, NZ Co 2, and NZ Co 3 are part of the same New Zealand group, but NZ Co 4 is not (unless NR Investor chooses it to be part of the same New Zealand group under section FE 30). Therefore, NZ Co 4 can apply a different thin capitalisation test to determine if the interest on Loan 2 would be fully deductible.

If the New Zealand group (NZ Co 1, NZ Co 2, and NZ Co 3) chooses to apply the new test, Loan 1 would be considered debt issued to related parties. Therefore, interest expense on that loan would not be deductible.

Loan 4 and Loan 5 would be considered debt issued to unrelated third parties. For the interest expense on those loans to be deductible, the lenders could only have recourse to the assets of NZ Co 1, NZ Co 2, and NZ Co 3 that are New Zealand assets. The loans must also not be guaranteed by either NZ Investor or NZ Co 4, and the proceeds must be used fully to fund economic/business activities in connection with New Zealand.

## General considerations

6.7 This approach is premised on a notion that, regardless of the sector, an amount of debt should not be considered excessive if the debt is extended by third-party lenders with limited recourse to the New Zealand operations and is not used to fund commercial activities in other countries. This is because it takes the viewpoint that a high level of debt should be allowed if it is fully supported by a New Zealand operation.

6.8 One consequence of this option is that it would mean there is no need to determine what constitutes an eligible infrastructure project/investment and the potential boundary issues associated with that, as noted in Chapter 5. This option allows the market to put a limit on the quantum of debt that a group could take on because the market would not extend a level of debt that is not commercially viable. However, it would be harder to target the rule at new infrastructure (or new investment).

6.9 The rule would be sector neutral, but would more likely apply to entities investing in sectors such as infrastructure and potentially property. We understand it is more common for entities in those sectors to be able to secure third-party debt on limited recourse terms above 60% of the value of the assets at a price that is commercially viable. It is unclear if other sectors could also use the rule.

6.10 The application of a general rule might be limited in practice, but would still extend beyond the primary intent of this work, which is to remove the potential impediment to FDI in privately owned projects that are aimed at creating or significantly upgrading infrastructure assets in New Zealand.

6.11 This means that a general rule would be more costly to implement, without that extra cost resulting in more investment in new infrastructure (or even new investment). For example, it might be possible for existing businesses to be acquired and loaded with a higher level of third-party debt (which may include subordinated debt). Debt levels for such investment would generally have been capped at 60% of the value of the assets in the financial statements.

6.12 A rule that applies to all sectors would also effectively sit as a third general test alongside the worldwide group debt test and the safe harbour debt threshold. Therefore, a general rule represents a more fundamental change to the overall thin capitalisation regime. A general rule would move away from the underlying policy framework of the thin capitalisation rules, which is intended to prevent the overallocation of debt to New Zealand, based on the overall worldwide gearing ratio when the safe harbour is breached.

6.13 This option would, therefore, require a more thorough assessment as to how it might impact the overall integrity of the thin capitalisation regime, to ensure that that the rule does not create unintended consequences. As intended, many sectors are not likely to be in a position to apply the rule, but the design of the rule still needs to ensure that entities will not be able to apply the rule inappropriately to over-gear their New Zealand operations.

6.14 Some requirements are common to both options (the targeted rule and the general rule), but the risks tend to be magnified for the general rule because it applies to a greater variety of scenarios. Therefore, some requirements would need to be more detailed/stringent to ensure that the general rule applies appropriately in all circumstances. Also, it may not always be possible to have clear-cut tests that are easy to apply. These consequences would inevitably increase the compliance requirements, even for entities that present little risk and should clearly qualify for the rule from a policy perspective.

**Questions for submitters**

Q6.1 Do you think a general rule that applies to third-party limited recourse debt is a viable solution to the problems identified in Chapter 3?

Q6.2 Do you consider that a general rule is too broad (relative to the problem)?

Q6.3 Do you have concerns about any of the requirements described above?

Q6.4 What other requirements could there be to help protect the New Zealand tax base?

Q6.5 Apart from infrastructure, are there other sectors/investments/projects that can obtain third-party debt funding above 60% on limited recourse terms and without foreign investor guarantees? What are they? Is application of the rule appropriate in such scenarios? Why?

## Third-party debt

6.15 The general rule would require debt to be issued to an unrelated third party. This requirement is intended to prevent a foreign parent or investor from using related-party debt as a replacement for equity to increase interest deduction and reduce the tax paid in New Zealand. As part of this requirement, the debt would not be allowed to be provided by any equity investor, or an associated person of an equity investor, to the borrowing entity at any time, unless the associated person is part of the borrowing entity's New Zealand group.

6.16 Related-party transactions are fundamentally different to third-party transactions. Factors that increase the riskiness of a loan between unrelated parties are less relevant in a related party context. For example, the more a third party lends to an entity, the more money is at risk if the entity fails. However, the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with related-party debt or equity. Therefore, foreign parents can easily replace equity with related-party debt.

6.17 The risk that related-party debt may be used as a replacement for equity to reduce the tax paid in New Zealand is even greater for debt below the senior debt level, where the lenders may take on some equity risks. Such debt would allow a multinational group to receive a higher return by claiming interest deductions for its New Zealand business without significantly increasing its risk compared to if the parent puts in equity.

6.18 Under the safe harbour threshold and the worldwide group debt test, this risk is more contained because those tests still put an upper limit on the amount of debt that the New Zealand group can take before a portion of the interest deductions is denied. This is not the case for a rule that does not specify an upper limit to the amount of debt that the New Zealand group can take.

6.19 There is also a risk that multinational groups might circumvent this rule by issuing debt to a third party, which in turn issues a back-to-back loan to the foreign parent (which may consist of a few layers to avoid detection). To mitigate this, the rule should explicitly prohibit such arrangements. Nevertheless, it may still be administratively difficult to monitor this in practice, especially if the arrangement is conducted overseas. Although this risk also exists for the targeted option, the risk is magnified for a rule that applies to all sectors and business arrangements.

**Questions for submitters**

Q6.6 Do you think the above requirement is appropriate? If not, what should be the appropriate criteria?

Q6.7 What would be a good measure to prevent avoidance of this requirement?

## Limited recourse debt

6.20 The rule would require the debt to have recourse only to the New Zealand assets of the borrowing entity, or a member of its New Zealand group. This requirement intends to ensure that the rule would only allow a debt level that is commercially justified entirely by the New Zealand operations.

6.21 Generally, the rule would allow lenders to have recourse only to assets that are:

- available to the borrowing entity or a member of its New Zealand group
- held by the entity or a member of its New Zealand group, and
- substantially connected to New Zealand and not substantially connected to other jurisdictions.

6.22 Determining the New Zealand assets that the lender could have recourse to is less straightforward for the more general rule. This is because the rule could potentially apply to a wider variety of commercial activities and arrangements, particularly compared to the targeted rule that only applies to infrastructure projects.

6.23 For real property such as land, buildings and infrastructure, determining if it would qualify as a New Zealand asset is relatively straightforward based on its physical location.

However, this may not be the case for other types of assets. For example, should products that are sold overseas qualify as New Zealand assets? What if they are kept in a storage facility in another country? Should receivables from foreign customers qualify? Although ownership interests in a foreign entity would not qualify, it is less clear for a non-controlling interest in a domestic entity that in turn owns a minor indirect interest in a foreign entity. Determining whether an asset qualifies as a New Zealand asset would therefore depend on the facts and circumstances.

6.24 Given the breadth of the possible scenarios, it might not be possible to have a clear-cut test for this requirement. For example, whether an asset generates or could generate assessable income in New Zealand would not be a good proxy to determine if that asset should qualify as a New Zealand asset. For some real property located in New Zealand, the gain on sale may be a capital gain, which is not assessable income in New Zealand, even though such property should qualify as a New Zealand asset. On the other hand, income from investments in foreign shares could be assessable income in New Zealand, although such assets should not qualify as a New Zealand asset.

6.25 The New Zealand assets that the lenders can have recourse to should include membership interests in the borrowing entity, or a member of its New Zealand group (if the entity or group only has New Zealand assets itself). By extension, this also means that the lenders could have recourse to future income streams of the entity. However, if an entity owns a foreign asset, the membership interest in that entity would not be considered a New Zealand asset for this purpose.

6.26 A more general rule may have to disallow recourse to equity that has been committed by investors but not yet put into the business. Allowing this equity commitment in the context of infrastructure projects is more straightforward when the full amount is still expected to be injected into the project at some point in the future, and the commitment letter simply accounts for the timing. However, an equity commitment in the context of an existing business may be more like a parental guarantee or form of contingent parental support, which should not be allowed. A rule that applies to all sectors and business arrangements should therefore apply the more stringent requirement to ensure that it would not apply inappropriately. Alternatively, the rule could have a specific exception for equity commitment letters for infrastructure project financing, but this would add to its complexity.

6.27 To ensure that the debt is supported by only the New Zealand operations, the requirement would also prohibit credit support that allows the lender to have recourse against an associated person of the borrower that is not also a member of its New Zealand group. If the New Zealand group includes a foreign entity that operates through a permanent establishment in New Zealand, credit support from the foreign entity would not be allowed.

6.28 Despite the above prohibition for credit support, there is a risk that implicit parental/investor support might still allow the quantum of debt to be higher than would otherwise be the case. This is particularly so when there is a single controlling foreign investor, and the failure of the New Zealand operations would significantly impact the global group. This means it may not be possible to ensure that the level of debt is commercially justified solely in relation to the New Zealand operations. Accordingly, there is a risk of allowing excessive interest deductions with this option.

**Questions for submitters**

Q6.8 Do you think the above criteria is set appropriately to ensure that the debt is supported only by the New Zealand business operation of a multinational group? If not, what should be the appropriate criteria?

Q6.9 Do you agree that whether an asset generates or could generate assessable income in New Zealand is not a good proxy to determine if that asset should qualify as a New Zealand asset?

## Use of debt funding

6.29 The rule is intended to allow interest deductions on third-party debt funding that supports a New Zealand business operation. Therefore, the rule includes a requirement that the debt funding is fully used for commercial/business activities in connection with New Zealand. This is to prevent multinational groups from incurring interest expense deductions in New Zealand to fund commercial activities that generate income overseas, which would effectively provide a tax subsidy to other countries.

6.30 This requirement should accommodate investments in projects aimed at creating or significantly upgrading infrastructure assets in New Zealand. Particularly in an infrastructure project financing context, it is easier to determine if the use of the debt funding is confined to a New Zealand operation.

6.31 For a general business operation, complying with the rule may be more challenging because ensuring that the funding is not used for a commercial activity in another country can be less straightforward, given the fungibility of money. Entities would have to demonstrate that the proceeds from issuing the debt are fully used to fund commercial activities in connection with New Zealand to comply with the requirement.

**Questions for submitters**

Q6.10 Do you think the above criteria is effective in ensuring that the debt funding is only used for a New Zealand business operation? If not, what should be the appropriate criteria?

## Tax residence of borrower entity

6.32 The requirement that the borrowing entity must be a New Zealand tax resident is intended to ensure that the debt is supported by only the New Zealand business operation.

6.33 This would mean that a New Zealand group would not qualify to apply the rule if the group is borrowing through a branch/permanent establishment of a non-resident entity that is part of the New Zealand group. This is because, in such a case, the non-resident entity would still legally be the borrowing entity that is responsible to satisfy the debt obligations.

**Questions for submitters**

Q6.11 Do you think this requirement is appropriate? If not, why?

## Group level

6.34 A general rule that applies to all third-party debt with limited recourse to New Zealand operations should apply on a New Zealand group level rather than on entity level. This is similar to the worldwide group debt test and the safe harbour debt threshold test. This approach would ensure consistency with the way the other thin capitalisation tests are applied.

6.35 This requirement is necessary to ensure that entities within the same New Zealand group would not each apply different tests to get the benefit of each test. This would undermine the overall integrity of the thin capitalisation regime. For example, multinational groups may obtain a high level of third-party debt through one entity and apply the rule discussed in this chapter, while applying the 60% safe harbour test for the other entities within the group and advancing related-party debt to these entities. This differs from the more targeted rule, which is based on the public private partnership (PPP) thin capitalisation rule, and would allow the calculation to be done at a project/entity level.

**Questions for submitters**

Q6.12 Do you think a new general rule that applies to all third-party debt with limited recourse to the New Zealand operation of a multinational group should apply on a group level or entity level? Why?

Q6.13 If the rule were to apply on entity level, what mechanism would be appropriate to ensure that entities within the same New Zealand group would not be able to apply different tests to get the benefit of each test and undermine the overall integrity of the thin capitalisation regime?

## Optional election

6.36 The new test would sit as a third general test alongside the 60% safe harbour debt threshold and the 110% worldwide group debt test. However, the new test would only benefit groups with eligible third-party debt above the limit set by the other two tests. So, groups with debt below the limits set by the safe harbour debt threshold or the worldwide group debt test would not need to rely on the new test.

6.37 The funding structures of most entities are unlikely to change drastically from year to year. As such, we expect most entities would stick with the same test. However, there seems to be little risk of tax mischief from applying a different thin capitalisation test from one year to the next. Therefore, our initial view is that there should be no restriction for entities from applying a different thin capitalisation test in the following year.

**Questions for submitters**

Q6.14 Should entities be allowed to change their thin capitalisation test from one year to another? If not, why?

## Outbound entities

6.38 The more general rule discussed in this chapter could be applied only to inbound investments, since this work is intended to consider the issue of how the thin capitalisation rules may deter inbound investments in infrastructure.

6.39 Even if the application of the rule is not restricted to inbound investments, the rule is not likely to apply to outbound entities. This is because the restrictions are designed to prevent the debt from being used to fund commercial activities in other jurisdictions. Also, a higher safe harbour threshold of 75% already applies to outbound entities, and an earnings-based alternative test is also already available to outbound entities.

**Questions for submitters**

Q6.15 Should the rule only apply to inbound entities? If not, why?

# Appendix - Discussion questions

## Chapter 2 - Current thin capitalisation settings

**Specific public private partnership rule**

Q2.1 Which aspects of the existing public private partnership (PPP) rule, if any, could be improved?

## Chapter 3 - Problem definition

**Issues for infrastructure**

Q3.1 Do you think New Zealand's thin capitalisation settings are unduly discouraging foreign investment in infrastructure projects? Why or why not?

Q3.2 If the thin capitalisation settings do not restrict the debt level to 60%, what types of non-PPP infrastructure projects do you think are likely to be able to be commercially debt funded by third parties on limited recourse terms at more than 60% of the project/asset value?

Q3.3 What role do you think tax settings play in whether an infrastructure project or investment is made in New Zealand?

Q3.4 To what extent do you think changing the thin capitalisation settings will lead to more infrastructure investment in New Zealand?

Q3.5 Have you seen infrastructure projects, where the debt funding is solely in the form of third-party limited recourse debt, that do not go ahead or where the project economics are significantly impacted because of the thin capitalisation settings?

## Chapter 5 - Rule targeted at infrastructure

**Scope of eligible infrastructure – new infrastructure vs existing infrastructure**

Q5.1 Do you think any new rule should be targeted at new infrastructure projects (such as a new wind farm)? Should it apply more broadly to existing infrastructure investment (such as an existing electricity lines company)? Why?

Q5.2 Do you agree that the potential targeted rule should be based on the PPP rule? Is there another approach that would be better?

Q5.3 The description of the key requirements and features in paragraphs 5.2 and 5.4 are targeted at new infrastructure projects. How could they be applied/adapted to existing infrastructure investment if you think that a new rule should cover such investment?

**Scope of eligible infrastructure – defining infrastructure**

Q5.4 What should constitute eligible infrastructure projects or investment? Please include all types of projects that you think should be part of the list of eligible infrastructure projects.

This should focus on projects that can be funded at debt levels of 60% or higher from the outset of the project.

Q5.5 Do you agree that a relatively traditional definition of infrastructure could be developed, or supplemented, by a list of eligible infrastructure projects?

Q5.6 Do you think New Zealand should adopt any features from similar rules in Ireland and the UK?

Q5.7 Do you think there is another approach that would be better?

**Third-party debt**

Q5.8 Do you agree that any new rule for infrastructure projects should only apply to third-party debt?

Q5.9 If you think that related-party (investor) debt should be permitted, please outline your reasons why, and in what circumstances it should be allowed.

**Limited recourse debt**

Q5.10 Do you think that the debt eligible for full interest deduction under the potential targeted rule should include portfolio debt where the projects/assets within the portfolio would have individually qualified for the rule? Do you have any concerns with this approach?

Q5.11 Do you consider that limited recourse should extend to cover equity that has been committed by investors to an infrastructure project (or investment)? Why?

Q5.12 Is there anything else that limited recourse should be extended to cover?

**Length of concession**

Q5.13 Do you consider that any new rule should or should not have a fixed end date? Why?

**Project level**

Q5.14 Do you think any new rule should apply at the thin capitalisation group level or the project/entity level? Why?

**Optional election**

Q5.15 Do you agree that taxpayers should have an optional election, when the taxpayer could first apply the targeted rule to the infrastructure project, to apply the rule to the project?

Q5.16 Should there be an opportunity to switch the election?

## Chapter 6 - General rule

**General considerations**

Q6.1 Do you think a general rule that applies to third-party limited recourse debt is a viable solution to the problems identified in Chapter 3?

Q6.2 Do you consider that a general rule is too broad (relative to the problem)?

Q6.3 Do you have concerns about any of the requirements described above?

Q6.4 What other requirements could there be to help protect the New Zealand tax base?

Q6.5 Apart from infrastructure, are there other sectors/investments/projects that can obtain third-party debt funding above 60% on limited recourse terms and without foreign investor guarantees? What are they? Is application of the rule appropriate in such scenarios? Why?

**Third-party debt**

Q6.6 Do you think the above requirement is appropriate? If not, what should be the appropriate criteria?

Q6.7 What would be a good measure to prevent avoidance of this requirement?

**Limited recourse debt**

Q6.8 Do you think the above criteria is set appropriately to ensure that the debt is supported only by the New Zealand business operation of a multinational group? If not, what should be the appropriate criteria?

Q6.9 Do you agree that whether an asset generates or could generate assessable income in New Zealand is not a good proxy to determine if that asset should qualify as a New Zealand asset?

**Use of debt funding**

Q6.10 Do you think the above criteria is effective in ensuring that the debt funding is only used for a New Zealand business operation? If not, what should be the appropriate criteria?

**Tax residence of borrower entity**

Q6.11 Do you think this requirement is appropriate? If not, why?

**Group level**

Q6.12 Do you think a new general rule that applies to all third-party debt with limited recourse to the New Zealand operation of a multinational group should apply on a group level or entity level? Why?

Q6.13 If the rule were to apply on entity level, what mechanism would be appropriate to ensure that entities within the same New Zealand group would not be able to apply different tests to get the benefit of each test and undermine the overall integrity of the thin capitalisation regime?

**Optional election**

Q6.14 Should entities be allowed to change their thin capitalisation test from one year to another? If not, why?

**Outbound entities**

Q6.15 Should the rule only apply to inbound entities? If not, why?