SUBMISSIONS

BEPS – Strengthening our interest limitation rules

Submissions received for the Government's discussion document *BEPS – Strengthening our interest limitation rules* (March 2017).

Number	Submitter
001	SKYCITY Entertainment Group Limited
002	Oxfam New Zealand
003	Olivershaw Limited
004	First Gas Limited
005	First State Investments
006	New Zealand Council of Trade Unions Te Kauae Kaimahi
007	TP EQuilibrium | AustralAsia
008	QIC Private Capital Pty Limited
009	AMP Capital Investors Limited
010	Powerco Limited
011	KPMG
012	Plenary Origination Pty Ltd
013	Chartered Accountants Australia and New Zealand
014	Ernst & Young Limited
015	PricewaterhouseCoopers
016	AMP Capital Investors (New Zealand) Limited
017	Russell McVeagh
018	Deloitte
019	ANZ Bank New Zealand Limited
020	Bank of New Zealand
021	Methanex New Zealand Limited
022	New Zealand Bankers Association
023	American Chamber of Commerce in New Zealand Inc.
024	Westpac
025	Corporate Taxpayers Group
026	New Zealand Law Society
027	InfraRed

#001

SKYCITY ENTERTAINMENT GROUP

30 March 2017

SKYCITY Entertainment Group Limited
Federal House 86 Federal Street
PO Box 6443 Wellesley Street
Auckland New Zealand
Telephone +64 (0)9 363 6141
Facsimile +64 (0)9 363 6140
www.skycitygroup.co.nz

BEPS –Interest limitation rules
c/o Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
WELLINGTON 6140.

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

Dear Madam

The following brief submission has been prepared by SKYCITY Entertainment Group Limited on the discussion document released by officials titled "BEPS – Strengthening our interest limitation rules".

SKYCITY Entertainment Group Limited is a member of the Corporate Taxpayers Group. SKYCITY supports the objective to ensure New Zealand collects its fair share of tax from investments made by foreigners in New Zealand. SKYCITY is listed in both New Zealand and Australia and its share register shows approximately 66% foreign shareholders. Its largest shareholders are primarily custodial holdings.

In addition, SKYCITY has substantial investments in Australia and operates casinos in both Adelaide and Darwin. The operators of the two casinos are Australian resident companies.

The discussion document proposes that the current thin capitalisation ratios of 60% for inbound investment and 75% for outbound investment are retained but the way the ratio is calculated will be narrowed by including non-debt liabilities and by removing the current provision that allows the revaluation of assets for the purpose of the thin capitalisation calculation when that revaluation is not included in the entity's financial statements.

The effect of these two changes is likely to have a significant impact on the interest deductibility of entities subject to either or both the inbound or outbound thin capitalisation rules. If an entity breaches the outbound thin capitalisation rules in New Zealand, having borrowed to invest or loan funds cross border, it may then breach the inbound thin capitalisation rules in the country into which it is investing, and would be subject to the denial of interest deductions in both countries for the same investment.

It appears from the discussion document New Zealand is moving to align its thin capitalisation rules with those of Australia. However, there are significant differences in the approach proposed under this discussion document and the Australian legislation, in particular with regard to revaluation of assets and including intangible assets in the thin capitalisation calculation.

The Australian legislation provides that as a general rule an entity must comply with the accounting standards when revaluing its assets for the purpose of calculating its thin capitalisation liability. However, an entity can choose to revalue an asset, including an intangible asset for these purposes as long as it meets stringent requirements. The valuation must be in writing and must be made before the due date for lodging the relevant income tax return. If the revaluation is included in the financial statements, an external expert is not required to undertake the revaluation, but if the revaluation is not included in the financial statements, the assets must be revalued by a person who is an expert in valuing such assets and whose pecuniary and other interests could not reasonably be regarded as being capable of affecting the person's ability to give an unbiased opinion in relation to the revaluation. We have attached a copy of the relevant Australian legislation.

SKYCITY submits that if New Zealand is not going to follow the best practice as set out by the OECD and limit interest deductions by way of an EBITDA ratio, and is going to tighten its current thin capitalisation rules in line with the Australian legislation, it should adopt the same position as Australia on revaluation of assets and include intangibles in the asset calculation and not exclude this aspect of the legislation. An entity that does not wish to include the revaluation of an asset in its financial statements but wishes to include the current value in its thin capitalisation calculation could be required to have the assets valued by a member of the New Zealand Institute of Valuers. In SKTCITY's opinion, a revaluation of assets by an independent professional firm for the purposes of the thin capitalisation regime would result in a greater level of scrutiny than may be the case if the assets were not revalued by an expert but were instead revalued by the company directors or employees.

In some cases the accounting standards may preclude the recognition of an intangible asset from being included in the financial statements. An example of this in New Zealand is the SKYCITY Casino licences. Banks lend on the value and earning potential of intangibles such as a licence and, with sufficient rigour imposed on the process, there should be no reason for such assets to be excluded from the thin capitalisation calculation.

There can be many reasons entities do not include revaluations in their balance sheets, and entities taking this conservative approach should not be penalised by the removal of the net current valuation method from the list of available valuation methods for thin capitalisation.

The discussion document states that the objective of the thin capitalisation rules is to prevent companies from shifting profits out of New Zealand through excessive interest deductions. Does a thin capitalisation regime that focuses on debt, equity and assets and not actual earnings or profits achieve this goal? If the regime is to be based on debt, equity and assets, then the calculation should include all measurable assets, including intangible assets, at current net value.

As noted in the discussion document, New Zealand relies heavily on foreign direct investment to fund domestic investment. If the majority of countries from which New Zealand sources investment adopt the recommendations set out in the OECD report then the EBITDA ratio method will be more widely understood than a method based on a ratio of debt to equity. The OECD proposals are designed to ensure that profits are taxed where the underlying economic activity occurs and where value is created. It is not clear that a regime which focuses on debt, equity and assets rather than actual earnings achieves this result.

SKYCITY submits that the aspects of the Australian thin capitalisation regime relating to the revaluation of assets by an independent expert should be included in the New Zealand legislation. If this does not occur, the "best practice" approach provided in the OECD's final report on BEPS, (Action 4 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), of an EBITDA based ratio should be adopted.

I agree to Inland Revenue contacting me to discuss the above brief submission if required.

Yours faithfully

Richard Smyth
Deputy Chief Financial Officer

Australian Government
Australian Taxation Office

Revaluing assets

Assets can be revalued for thin capitalisation purposes, provided the revaluation is done in accordance with accounting standards, even if they are not also revalued for accounting purposes.

Once an asset is revalued, the asset must continue to be revalued in accordance with the frequency set out in the accounting standards. If the entity does not continue to revalue in accordance with the accounting standards, then it cannot use the original revaluation for the period that it fails to comply with the accounting standards in this regard. It must use the value specified in its financial statements.

If the revaluation is done for the purposes of calculating the entity's thin capitalisation position and is reflected in its financial statements that it is required by Australian law to prepare, the revaluation does not need to be done by either an external expert or an internal expert. However, if either the entity is not required to prepare financial statements or it is required to but the revaluation is not reflected in those statements, the revaluation must be done by either an external expert or by an internal expert.

External expert

An independent expert is a person:

- who is an expert in relation to valuations of that class of assets, and
- whose pecuniary or other interests could not reasonably be regarded as being capable of affecting that person's ability to give an unbiased opinion in relation to that valuation.

Internal expert

An internal expert must be a person who is an expert in valuing such assets, and

- whose pecuniary or other interests could reasonably be regarded as affecting the person's ability to give an unbiased opinion but only because the person would be one of the following
  - performing duties as an employee of the entity
  - providing services to the entity under an arrangement with the entity that is substantially similar to a contract of employment.

To be an acceptable value, the internal expert must make the revaluation in accordance with a methodology that has been reviewed and accepted as suitable by an external expert – see criteria above. The review of the methodology by the external expert must include the validity of any assumptions made, and the accuracy and reliability of the data and other information to be used.

Revaluing an asset in a class of assets

The values used for thin capitalisation purposes are the values calculated under the accounting standards. If the accounting standards require an asset to be revalued at certain intervals, the entity must comply with this for thin capitalisation purposes as well.

A strict adherence to this would require that once an asset in a class is revalued, all the assets in that class must be revalued. The thin capitalisation rules will allow an entity to revalue one or more assets in the class only, provided that no asset in the class of assets has fallen in value.

Example 8: Revaluing assets

Two assets in the same class – asset A and B – have a carrying value of $1,000 and $2,000 respectively. The entity wants to revalue asset A but not asset B. In the relevant income year, asset A has increased in value to $1,200 and the value of asset B has remained the same.

Because, as a class, no asset has fallen in value, asset A can be revalued without having to also revalue asset B. However, if the value of asset B had fallen to $800, asset A could not be revalued without asset B also being revalued.

See also:

- section 820-680 (/law/view/document?docid=PAC/19970038/820-680) of the ITAA 1997.

Revaluation records

An entity must keep records in relation to the revaluation containing details about all of the following:

- the methodology used in making the revaluation, including any assumptions that may have been made
- how the methodology was applied, including information used
- who made the revaluation, their qualifications and their experience as an expert in valuing assets of the relevant kind
- the remuneration and expenses paid to that person.

Where the revaluation was made by the internal expert, the records must **also** include the following details:

- who the external expert was that reviewed the methodology for the valuation
- the external expert's qualifications and experience as an expert in valuing assets of the relevant kind
- the remuneration and expenses paid to the external expert
- the external expert's review of the methodology and their agreement that the methodology is suitable.

All records must be prepared by the time the entity must lodge its tax return for the income year for which the revaluation is made.

However records need not be kept where the asset was revalued subject to subsection 820-680(2A) of the ITAA 1997.

See also:

- section 820-985 (/law/view/document?docid=pac/19970038/820-985) of the ITAA 1997.

Last modified: 09 Mar 2016 QC 48208

Our commitment to you

We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

Some of the information on this website applies to a specific financial year. This is clearly marked. Make sure you have the information for the right year before making decisions based on that information.

If you feel that our information does not fully cover your circumstances, or you are unsure how it applies to you, contact us or seek professional advice.

820-680(1)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(1)&db=HISTFT&stylesheet=HIST)

For the purposes of this Division, an entity must comply with the *accounting standards in determining what are its assets and liabilities and in calculating:

(a) the value of its assets (including revaluing its assets for the purposes of that calculation); and

(b) the value of its liabilities (including its *debt capital); and

(c) the value of its *equity capital.

Note:

This requirement to comply with the accounting standards is modified in certain cases (see sections 820-310 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-310#PAC/19970038/820-310) , 820-682 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-682#PAC/19970038/820-682) , 820-683 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-683#PAC/19970038/820-683) and 820-684 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-684#PAC/19970038/820-684)).

View history note

820-680(1A)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(1A)&db=HISTFT&stylesheet=HIST)

In particular, for the purposes of this Division, the entity has an asset or liability at a particular time if, and only if, according to the *accounting standards, the asset or liability can or must be recognised at that time.

Note:

This application of the accounting standards is modified in certain cases (see sections 820-682 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-682#PAC/19970038/820-682) and 820-683 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-683#PAC/19970038/820-683)).

View history note

Requirements for revaluation of assets

820-680(2)

A revaluation of assets mentioned in paragraph (1)(a) must be made by a person:

(a) who is an expert in valuing such assets; and

(b) whose pecuniary or other interests could not reasonably be regarded as being capable of affecting the person ' s ability to give an unbiased opinion in relation to that revaluation.

Note 1:

The entity must also keep records in accordance with section 820-985 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-985#PAC/19970038/820-985) about the revaluation, unless the exception in subsection (2A) of this section applies.

Note 2:

This subsection also applies to some revaluations that are not allowed by the accounting standards (see subsection 820-684(5) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-684(5)#PAC/19970038/820-684(5))).

View history note

Revaluation reflected in statutory financial statements for the same period

820-680(2A)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2A)&db=HISTFT&stylesheet=HIST)

A revaluation of an asset need not comply with subsection (2) if:

(a) the revaluation is for the purpose of the entity calculating the value of its assets for the purposes of this Division as applying to the entity for a particular period; and

(b) the entity is required by an Australian law to prepare financial statements for a period that is or includes all or part of that period; and

(c) those financial statements reflect the revaluation.

View history note

External validation of a revaluation made internally

820-680(2B)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2B)&db=HISTFT&stylesheet=HIST)

A revaluation of assets mentioned in paragraph (1)(a) may be made by a person (the ***internal expert***) if:

(a) apart from this subsection, paragraph (2)(b) would prevent the internal expert from making the revaluation, but only because, in making it, he or she would be:

(i) performing duties as an employee of the entity; or

(ii) providing services under an *arrangement with the entity that is substantially similar to a contract of employment; and

(b) another person (the ***external expert***):

(i) is not prevented by subsection (2) from making the revaluation; and

(ii) has reviewed the methodology for making it (including the validity of any assumptions to be made, and the accuracy and reliability of the data and other information to be used); and

(iii) has agreed that that methodology is suitable for making it; and

(c) the internal expert makes the revaluation in accordance with that methodology.

Note:

This subsection also applies to some revaluations that are not allowed by the accounting standards (see subsection 820-684(5) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-684(5)#PAC/19970038/820-684(5))).

View history note

Revaluation of individual assets

820-680(2C)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2C)&db=HISTFT&stylesheet=HIST)

Subsection (1) does not prevent the entity from revaluing one or more assets in a class of assets (as distinct from revaluing all the assets in the class) if the value of no asset in that class has fallen since the entity last calculated the total value of all the assets in that class in accordance with the *accounting standards.

View history note

When further revaluation of assets required

820-680(2D)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2D)&db=HISTFT&stylesheet=HIST)

If:

(a) the entity revalues one or more assets (whether constituting a class of assets or not) for the purpose of calculating the value of its assets for the purposes of this Division as applying to the entity for a particular period (the ***first period***); and

(b) the revaluation is *not* required by the *accounting standards; and

(c) if the revaluation *had* been required by the accounting standards, the entity could have relied on it in preparing financial statements that the entity is required by an Australian law to prepare for a period (the ***later period***) that ends *after* the first period;

the entity may also rely on the revaluation in calculating the value of its assets for the purposes of this Division as applying to the entity for a period that is or includes all or part of the later period.

View history note

820-680(2E)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2E)&db=HISTFT&stylesheet=HIST)

If subsection (2D) does *not* permit the entity to rely on the revaluation in calculating the value of its assets for the purposes of this Division as applying to the entity for a period that is later than the first period, the revaluation is disregarded in determining whether subsection (1) requires the entity to revalue the one or more assets in calculating the value of its assets for those purposes.

> **Note:**
>
> As a result, the entity may not be required to make a further revaluation of the one or more assets. However, if the entity does not, it must use the value of the one or more assets that is reflected in financial statements for the relevant period that comply with the accounting standards.

View history note

Accounting standards need not otherwise apply to the entity

820-680(3)

Subsection (1) has effect whether the *accounting standard would otherwise apply to the entity or not.

View history note

SECTION 820-682 Recognition of assets and liabilities - modifying application of accounting standards

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-682&db=HISTFT&stylesheet=HIST)

Deferred tax assets and deferred tax liabilities

820-682(1)
Despite subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) , an entity must not recognise:

(a) a deferred tax liability (within the meaning of the *accounting standards) as a liability for the purposes of this Division; or

(b) a deferred tax asset (within the meaning of the accounting standards) as an asset for the purposes of this Division.

Note:

Subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) require compliance with accounting standards.

Surpluses and deficits in defined benefit superannuation plans

820-682(2)
Despite subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) , an entity must not recognise an amount relating to a defined benefit plan (within the meaning of the *accounting standards) as:

(a) a liability for the purposes of this Division; or

(b) an asset for the purposes of this Division.

Note:

Subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) require compliance with accounting standards.

Australian Government
Australian Taxation Office

INCOME TAX ASSESSMENT ACT 1997

CHAPTER 4 - INTERNATIONAL ASPECTS OF INCOME TAX

View history reference (/law/view/document?LocID=PAC%2F19970038%2FCh4&db=HISTFT&stylesheet=HIST)

View history note

PART 4-5 - GENERAL

View history reference (/law/view/document?LocID=PAC%2F19970038%2FPt4-5&db=HISTFT&stylesheet=HIST)

View history note

Division 820 - Thin capitalisation rules

View history reference (/law/view/document?LocID=PAC%2F19970038%2FDiv820&db=HISTFT&stylesheet=HIST)

View history note

Subdivision 820-G - Calculating the average values

View history note

Special rules about values and valuation

SECTION 820-683 Recognition of internally generated intangible items - modifying application of accounting standards

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-683&db=HISTFT&stylesheet=HIST)

Accounting standards prevent recognition of some items

820-683(1)

Subsection (2) applies in relation to an item, other than internally generated goodwill (within the meaning of *accounting standard AASB 138), if:

(a) the item cannot be recognised under that standard as an internally generated intangible asset (within the meaning of that standard) because that standard determines that the cost of the item cannot be distinguished from the cost of developing the entity's business as a whole; and

(b) the item would otherwise meet criteria under that standard for recognition as such an asset.

Note 1:

As a general rule, an entity must comply with the accounting standards when recognising its assets for the purposes of this Division (see subsections 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22) and (1A) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1A)%22)).

Note 2:

This section does not apply to ADIs (see subsection (6)).

Entity may choose to recognise the item as an intangible asset

820-683(2)
Despite subsections 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22) and (1A) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1A)%22), the entity may choose to recognise the item as such an asset for a period for the purposes of this Division (other than section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22)).

Note:

Section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22) is about records for Australian permanent establishments.

820-683(3)
A choice under subsection (2):

(a) must be in writing and may cover more than one item; and

(b) must be made before the due day for lodging the entity's *income tax return for the income year that is, or that includes, the period; and

(c) subject to subsection (4), has effect, for the entity and the item, for the period and each later period.

820-683(4)

The entity may, in writing, revoke a choice under subsection (2). The revocation has effect:

(a) for each period in the income year for which the entity is next required to lodge an *income tax return; and

(b) for each later period.

820-683(5)

When:

(a) recognising an item as an asset under this section; and

(b) calculating the value of the asset (including revaluing the asset);

the entity must, to the maximum extent possible, comply with the *accounting standards as if the recognition were allowed by those standards. This subsection has effect subject to section 820-684 (/law/view/document?LocID=%22PAC%2F19970038%2F820-684%22).

> **Note:**
>
> Section 820-684 (/law/view/document?LocID=%22PAC%2F19970038%2F820-684%22) will allow the entity to revalue the asset even if accounting standard AASB 138 would prevent this because of the absence of an active market.

Choice not available to ADIs

820-683(6)

An entity cannot make a choice under subsection (2) for a period if, for the period, the entity is an *outward investing entity (ADI) or an *inward investing entity (ADI).

View history note

Disclaimer and notice of copyright applicable to materials provided by CCH Australia Limited

Australian Government
Australian Taxation Office

INCOME TAX ASSESSMENT ACT 1997

CHAPTER 4 - INTERNATIONAL ASPECTS OF INCOME TAX

View history reference (/law/view/document?LocID=PAC%2F19970038%2FCh4&db=HISTFT&stylesheet=HIST)

View history note

PART 4-5 - GENERAL

View history reference (/law/view/document?LocID=PAC%2F19970038%2FPt4-5&db=HISTFT&stylesheet=HIST)

View history note

Division 820 - Thin capitalisation rules

View history reference (/law/view/document?LocID=PAC%2F19970038%2FDiv820&db=HISTFT&stylesheet=HIST)

View history note

Subdivision 820-G - Calculating the average values

View history note

Special rules about values and valuation

SECTION 820-684 Valuation of intangible assets if no active market - modifying application of accounting standards

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-684&db=HISTFT&stylesheet=HIST)

Accounting standards prevent revaluation of some assets

820-684(1)

Subsection (2) applies if complying with *accounting standard AASB 138 would prevent an entity from revaluing an intangible asset (within the meaning of that standard) because of the absence of an active market (within the meaning of that standard).

Note 1:

As a general rule, an entity must comply with the accounting standards when revaluing its assets for the purposes of this Division (see subsection 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22)).

Note 2:

This section does not apply to ADIs (see subsection (7)).

Entity may choose to revalue the asset

820-684(2)

Despite subsection 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22), the entity may choose to revalue the asset for a period for the purposes of this Division (other than section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22)).

Note:

Section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22) is about records for Australian permanent establishments.

820-684(3)

A choice under subsection (2):

(a) must be in writing and may cover more than one asset; and

(b) must be made before the due day for lodging the entity's *income tax return for the income year that is, or that includes, the period; and

(c) subject to subsection (4), has effect, for the entity and the item, for the period and each later period.

820-684(4)

The entity may, in writing, revoke a choice under subsection (2). The revocation has effect:

(a) for each period in the income year for which the entity is next required to lodge an *income tax return; and

(b) for each later period. **Requirements for such revaluations**

820-684(5)

Subsections 820-680(2) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2)%22) and (2B) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2B)%22) apply in relation to a revaluation under subsection (2) in a corresponding way to the way they apply in relation to a revaluation mentioned in paragraph 820-680(1)(a) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22).

Note 1:

Subsections 820-680(2) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2)%22) and (2B) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2B)%22) set out requirements and other matters in relation to revaluations under subsection 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22).

Note 2:

The entity must also keep records in accordance with section 820-985 (/law/view/document?LocID=%22PAC%2F19970038%2F820-985%22) about the revaluation.

820-684(6)

When revaluing an asset under subsection (2), the entity must, to the maximum extent possible, comply with the *accounting standards as if the revaluation were allowed by those standards. **Choice not available to ADIs**

820-684(7)

An entity cannot make a choice under subsection (2) for a period if, for the period, the entity is an *outward investing entity (ADI) or an *inward investing entity (ADI).

⊞ View history note

Disclaimer and notice of copyright applicable to materials provided by CCH Australia Limited

OXFAM
New Zealand

Deputy Commissioner Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

Taxation of Multinationals - Discussion Documents

Dear Madam,

Oxfam welcomes positive steps by this Government to address the unfair situation where the world's richest and most powerful companies and people are avoiding paying their fair share of tax. Tax is key to making sure everyone has vital public services. It is an essential tool to ending extreme inequality, and could help lift millions of people out of poverty. It is estimated that poor countries are losing at least $170 billion every year because of tax avoidance - this is more than the total amount that these same countries are receiving in aid. When taxation works fairly, the majority benefit.

New Zealand could be missing out on up to $500 million a year in tax from multinational companies - money that could be spent on health, education and housing. On a broad level we support the proposals in the documents however we are concerned that **they do not go far enough;**

- in ensuring that New Zealand receives its fair share of tax from multinationals operating in New Zealand
- in committing New Zealand to collaborate on issues of greater transparency around tax practices globally.

Our comments on proposed rules and recommendations are below.

BEPS - Transfer Pricing and Permanent Establishment Avoidance

Oxfam has long been concerned about multinationals not paying tax in the countries they operate in and trade with as it deprives the host countries of tax revenues to spend on desperately needed social services for the local populations.

Diverted profits tax

To that end Oxfam has been supportive of and has called for a Diverted Profits Tax to counter such behaviour. We are supportive of the government's moves to bring in an equivalent measure. We note however that the tests suggested include a consideration of whether the structure is contrary to the purpose of the respective double tax agreement.

Recommendation: Oxfam recommends that the proposed diverted profits tax equivalent does not reference any double tax agreement but focus simply on the other objective tests.

- a non-resident supplies goods or services to a person in New Zealand;
- a related entity (either associated or commercially dependant) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about;
- some or all of the sales income is not attributed to a New Zealand permanent establishment of the non-resident;

Recommendation: Oxfam recommends that New Zealand's double tax agreements are reviewed to ensure New Zealand can receive its fair share of tax revenue from multinationals and if favourable renegotiation is not possible then the double tax agreements should be rescinded.

BEPS - Interest Limitation Rules

Interest deductions

Oxfam notes that the government has chosen not to implement the earnings stripping rules recommended by the OECD. We are comfortable with this only if the government can assure the people of New Zealand that what it is proposing is equally effective.

On that basis we support the proposals in this document as interest deductions are a very straightforward way of reducing profit by multinationals. For this reason we particularly support:

- The removal of non-debt liabilities from the assets component of the debt to assets test. Such a move will level the playing field between multinationals that would commercially use debt to fund fixed assets and those that wouldn't. For this reason Oxfam strongly supports this move.

- The other proposal we particularly support is the removal of the 10% related party debt allowance for conglomerates including Public Private Partnerships (PPP). Currently PPPs are allowed to deduct all unrelated party debt plus 10% of their related party debt. As related party debt is a "profit stripping" device Oxfam does not see the logic of this and we are pleased to see the proposal to remove it.

Excessive interest rates

Oxfam is aware of the current loophole where high levels of debt can feed into a high interest rate for transfer pricing purposes. We therefore support the intent of the proposals to eliminate this. We note that the proposals are to:

- apply the credit rating of senior unsecured debt for multinationals with an identifiable parent;

- assess the level of arms-length debt and then the applicable interest rate when there is not an identifiable parent.

It is the second option that causes us concern. Multinationals without an identifiable parent include Private Equity (who are known to take a tax aggressive approach to investment). To find a comparable level of arms-length debt our understanding is that you need to find the debt level of a comparable New Zealand owned firm. Given the high levels of foreign ownership in all our major industries, Oxfam would question whether identifying such a comparable firm was possible. We note that even iconic New Zealand firms such as Spark and Fletcher Building have significant levels of foreign ownership. Even in industries that still have some level of New Zealand ownership such a move will incentivise full foreign ownership so that high levels of interest deduction can become the norm.

Recommendation: It is not our first preference to require all related party interest to be disallowed but if these are the only options available, they have to be taken to ensure entities such as Private Equity pay their fair share of tax. We suggest that if related party interest disallowance is considered excessive; earning stripping rules must be reconsidered for this group.

Omissions on current proposed rules

Global collaboration on tax

Oxfam is an international development agency and our mission is to eliminate poverty globally. We see progressive tax systems (spent progressively) as one of the levers to be able to achieve this goal. While there is a lot that governments can and are doing on their own to improve the progressiveness of their tax systems, such as this consultation on tax policy in New Zealand, there is a limit to what countries can do unilaterally.

Earlier this year, Oxfam released a report that revealed that 8 men own the same wealth as 3.6 billion people who make up the poorest half of humanity. Tax havens are part of this problem. In order to end poverty and inequality; we have to end tax avoidance globally.

Recommendation: Oxfam is calling on all countries to allow for greater collaboration on taxation. A fair and level playing field on corporate tax requires transparency measures, including full public country by country reporting, transparency on beneficial owners and transparency by governments on the tax incentives they grant and in particular on tax rulings.

Non-resident finance companies

Another omission is any move to apply specific interest limitation rules to non-resident finance companies. The issue is they currently only have the on-lending concession apply to them meaning they can have unlimited and unconstrained interest deductions (as was the case with the Australian banks before the specific bank rules were implemented).

OXFAM NEW ZEALAND
PO BOX 68357, NEWTON, AUCKLAND 1145 LEVEL 1, 14 WEST STREET, NEWTON, AUCKLAND
P +64 9 355 6500 P 0800 400 666

oxfam.org.nz

We understand that there is currently not a high level of non-resident finance companies operating in New Zealand. Oxfam accepts that this may be currently the case but this can change very quickly (as was the situation with the banks).

Recommendation: While all the other measures are correcting issues that have been in place for some time, we suggest that it would be preferable to fix identified issues before they become a 'significant drag' on the tax base thereby affecting the government's ability to provide social services.

Oxfam welcomes these consultation documents and we recognise that this a positive first step to ensure multinational companies pay their fair share of tax from profits earned in New Zealand. As stated above we do strongly recommend the inclusion of policies that promote greater collaboration on tax globally to tackle the growing issue of inequality.

Oxfam wishes to acknowledge the significant assistance provided by Andrea Black, adviser to Oxfam, in the research and analysis of the Tax Consultation Documents. Oxfam also greatly appreciates the access to your officials and the open and insightful discussions they had with Andrea Black.

We would be happy to discuss any of these points in more detail. Please contact Paula Feehan- Advocacy and Campaigns Director at paula.feehan@oxfam.org.nz.

Yours sincerely,

Rachael Le Mesurier
Executive Director
Oxfam New Zealand

OXFAM NEW ZEALAND
PO BOX 68357, NEWTON, AUCKLAND 1145 LEVEL 1, 14 WEST STREET, NEWTON, AUCKLAND
P +64 9 355 6500 P 0800 400 666

oxfam.org.nz

OLIVERSHAW LTD
TAX SPECIALISTS

Olivershaw Limited
Level 1, Aviation House
12 Johnston Street
WELLINGTON
PO Box 30 504
Lower Hutt 5040
Phone: 04 577 2700
Fax: 04 577 2701

Contacts: Robin Oliver Ph 04 568 0685
Mob 021 0353380
Mike Shaw Ph 04 568 0684
Mob 0275227763

18 April 2017

Deputy Commissioner (Policy and Strategy)
Inland Revenue Department
PO Box 2198
Wellington 6140

policy.webmaster@ird.govt.nz - "BEPS – Interest limitation rules"

Dear Cath

BEPS – Interest Limitation Rules - Proposals to the Interest Rate on Related Party Loans

We are intending to submit on the proposals in Chapter 3 of the Discussion Document March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document).

The date for a submission is 18th April but we seek an extension until 28th April along the lines of this summary of the submission.

Our central submission is that given the development of transfer pricing since it was introduced into New Zealand law and given the recent changes to the rules and guidelines that New Zealand has separately proposed to adopt, the problem of excessive interest rates identified by the Discussion Document should be addressed through the normal application of transfer pricing methodology. There are clear inconsistencies in the outcomes from the Discussion Document proposal and the outcomes that would result from applying transfer pricing rules – applying an arm's length test for the terms and conditions of related party loans.

We consider that the proposed interest rate cap would not be consistent with our double tax agreements, contrary to the view advanced in the Discussion Document.

Perhaps of even greater importance, New Zealand's economic growth strategy requires considerable foreign investment to grow our wealth and incomes. For that reason for many years our international tax policy has recognised the need to balance potential revenue collection from foreign investors with the need to do so in a way that is not overly adverse in attracting such investment and that would not flow through to a general increase in the economy's cost of capital. The appropriate policy balance seems best achieved by continuing to apply the internationally accepted arm's length principle to deductible interest (based also on loan terms and conditions that are arm's length and a capital structure that is arm's length.)

As we interpret it, the essence of the OECD BEPS project is for countries to co-ordinate approaches to the risks and problems identified with the taxation of international capital flows. The proposed formulaic interest rate cap approach is the direct opposite of such a co-operative approach to international tax policy. In effect it seems to abandon the long-standing internationally accepted arm's length approach with a formulaic approach unique to New Zealand that would be inconsistent in many cases with an arm's length approach.

Failure by New Zealand to keep within the ambit of the arm's length principle with respect to deductible interest costs would mean that foreign investors into New Zealand would not have the protection that compliance with the arm's length principle has in terms of settling disputes between New Zealand and an overseas jurisdiction (mutual agreement by competent authorities - including advanced pricing agreements, and, if provided for, arbitration of disputes between jurisdictions, - and corresponding pricing adjustments). Since most other countries would require interest to be set by the lender on an arm's length basis, which is likely in many cases to be higher than the rate set by the proposed formulaic approach, the result must inevitably be widespread double taxation of New Zealand investments. Thus by moving outside the arm's length framework, New Zealand would introduce tax rules that would impose higher capital costs and risks to investors. There could also be wider reputational risks to New Zealand with any such attempt to jettison the accepted international approach to levying taxation.

There would seem to be a need for a very strong policy reason for New Zealand adopting a policy which unilaterally withdraws New Zealand from these rules for settling jurisdictional disputes. We submit that the Discussion Document does not provide such a justification.

We also disagree with the suggestion in the Discussion Document that loans for a term exceeding 5 years are inherently uncommercial and not to be considered to be issued on arm's length terms. What is an arm's length term of a loan will vary depending on the circumstances of the business and the loan.

Given the complexities for taxpayers and IRD of applying transfer pricing rules we submit that there should be safe harbour rules where the terms and conditions of related party loans should be legislatively accepted as meeting an arm's length test. The government should be confident that the revenue base is not at risk where commercial constraints operate as to require loan terms and conditions to be arm's length.

In that regard if a taxpayer is within the existing thin capitalisation thresholds (60% assets, 110% worldwide gearing) the interest rate should be accepted. It seems unlikely that related party debt could be "deeply subordinated" so as to enable dividends to be disguised as interest by increasing the level of debt and then deeply subordinating related party debt at such levels of gearing.

It is also submitted that there should be a safe harbour rule from transfer pricing where a New Zealand entities total debt is not materially held proportionately by shareholders and debt instruments with the same terms and conditions are not materially held in proportion to share ownership

We further submit that there should be a further safe harbour form the application of transfer pricing to related party debt where the interest rate is set at no more than the cost of the related party's cost of funds measured as the cost of senior unsecured debt on standard terms plus a margin as outlined in the Discussion Document. This would, however, be only a safe harbour and taxpayers would be free instead to use another safe harbour (as above) or full transfer pricing methodology.

Finally, we submit that if an interest rate cap is introduced that overrules the arm's length test for related party loans, existing investments funded by such loans should not be subject to such a cap. That is because investments have been made on the commercial basis that New Zealand would accept loans with arm's length terms and conditions. That is a reasonable expectation for investor's to make. To now impose new rules contrary to such expectations would adversely and retrospectively affect investment decisions. That would be contrary to long-standing policy adopted in New Zealand with respect to tax changes with retrospective effect.

Yours faithfully

Yours faithfully
Olivershaw Limited

Robin Oliver MNZM
Director
robin@olivershaw.co.nz

Mike Shaw
Director
mike@olivershaw.co.nz

#003B

OLIVERSHAW LTD
TAX SPECIALISTS

Olivershaw Limited
Level 1, Aviation House
12 Johnston Street
WELLINGTON
PO Box 30 504
Lower Hutt 5040
Phone: 04 577 2700
Fax: 04 577 2701

Contacts: Robin Oliver Ph 04 568 0685
Mob 021 0353380
Mike Shaw Ph 04 568 0684
Mob 0275227763

28 April 2017

Deputy Commissioner (Policy and Strategy)

Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath

BEPS – Interest Limitation Rules - Proposals to the Interest Rate on Related Party Loans

This submission is with respect to the proposals in Chapter 3 of the Discussion Document March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document).

We would welcome the opportunity to discuss this submission.

Executive Summary

We have reviewed the proposed limit on the interest rate on related party loans based on an interest rate cap set at the interest rate that the borrower's ultimate parent could borrow on standard terms (defined as the parent's credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin).

Our conclusion and central submission is that given the development of transfer pricing since it was introduced into New Zealand law, and given the recent changes to the rules and guidelines that New Zealand has separately proposed to adopt, the problem of excessive interest rates identified by the

Discussion Document should be addressed through the normal application of transfer pricing methodology. The Discussion Document proposals would produce clear inconsistencies in outcomes from the result that would arise from applying transfer pricing rules. The Discussion Document proposals are, in our view, inconsistent with the originally stated policy objective of thin capitalisation rules which was stated to be "to accurately determine interest expense properly attributable to New Zealand without interfering with normal commercial behaviour, at minimal compliance cost, within the self-assessment system."

The key question is - how can New Zealand justify adjusting an interest rate if the taxpayer can demonstrate that the interest rate is an arm's length price based on an arm's length gearing and with debt issued on arm's length terms and conditions? Disallowing interest deductibility for an arm's length transaction at an arm's length price would:

- Make New Zealand inconsistent with the rest of the world, especially Australia.
- Poorly target interest adjustments beyond the problem identified in the Discussion Document.
- Undermine the ability of high risk/ potentially high return New Zealand investments (especially innovative and new technology enterprises with global potential) to access capital.
- Seem to be contrary to New Zealand's commitments under double tax agreements to apply transfer pricing methodology.
- Raise the prospect of international double taxation.
- Unfairly penalise some firms in an arbitrary manner.

We also consider that there are a number of detailed problems with the Discussion Document proposal. For example, the Discussion Document states that "most firms subject to the thin capitalisation rules are controlled by a single non-resident" parent and then attributes that parent's financing costs to the New Zealand entity. However, many firms with related party cross border lending are not are not controlled by a single parent. Even if our other problems with the proposal did not apply, the only funding cost that could conceivably be relevant is that of a parent that wholly owns the New Zealand entity. Outside that scenario there seem to be substantial practical problems with the Discussion Document proposal.

As we interpret the Discussion Document the policy issue is the perceived need to buttress our existing thin capitalisation rules. We note that this is different from the OECD's recommended EBITDA approach for limiting interest deductibility. The OECD EBITDA approach's stated objective is to reduce what the OECD claims to be a tax preference for debt over equity. In the main we view that as a tax penalty on equity resulting largely from the classical double taxation of company income. The EBITDA can be seen as trying to level the international playing field by trying to impose a tax penalty on an element of interest.

These considerations are not relevant in the New Zealand environment where debt and equity have more equal tax treatment as a result of imputation. Instead the New Zealand focus should be purely on ensuring that our thin capitalisation rules do not allow New Zealand corporate income to be extracted as low-taxed interest in a manner contrary to the intent of our policy settings. We submit that this is best achieved through transfer pricing methodology with safe harbours to reduce compliance and administrative costs where the tax base risk is low.

In summary, our submission is:

- It is not appropriate to set any interest rate cap on the basis of the interest rate paid by the "borrower's ultimate parent" on its senior unsecured debt. The borrowing costs of the non-resident investor can only technically be relevant when the parent wholly owns or possibly consolidates with the New Zealand entity for accounting purposes.
- The issue of determining the interest expense properly attributable to New Zealand should be determined by existing thin capitalisation rules buttressed by the arm's length rule for determining deductible interest rates.
- The arm's length test should be subject to safe harbour rules. One such safe harbour rule should be that for determining deductible interest rates the actual terms and conditions of related party loans should be acceptable provided the New Zealand entity has gearing within the thin capitalisation maximum gearing ratios (the focus of concern should be in cases where the 60% debt ratio has been exceeded).

Current Thin Cap Rules- Inbound investment

Very broadly, our inbound thin cap rules restrict the debt level of a non-resident controlled corporate group or taxpayer. If the level of debt exceeds prescribed limits, the interest expense of the excess debt is treated as income offsetting the deduction available on such interest. The effect is that interest on the excess debt is non-deductible. The level of debt is treated as excessive if the:

- New Zealand group debt exceeds 60% of total assets; or

- New Zealand group debt exceeds 110% of the debt percentage of the worldwide group.

A person subject to these thin cap rules can choose the option that is most favourable from its point of view.

The inbound thin cap rules apply to a non-resident or a New Zealand entity that is under the control of a single non-resident or that is controlled by a group of entities (including non-residents and entities controlled by non-residents that act together) - for example a joint venture fund that includes non-residents. A New Zealand entity is under the control of a non-resident or group of entities if that non-resident or group has ownership interests of 50% or more or has control by any other means. Ownership interest is the **highest** of shares, voting rights, or rights to distribution (sections FE2 and FE 39 of the Income Tax Act 2007 ("the Act"). In contrast, for transfer pricing and other purposes, a company is associated with another company if it has 50% or more of **voting interests** or, if applicable a market value interest (sections YB2(1) and (2) of the Act).

Policy Objective of Inbound Thin Cap Rules

The policy objective of inbound thin cap rules was stated in the original 1995 Discussion Document (International Tax – A discussion document) to be to "limit the ability of non-resident investors to artificially reduce their net New Zealand-sourced income by allocating excessive interest costs to New Zealand" (page 53). The policy aim was further stated to be: "to accurately determine interest expense properly attributable to New Zealand without interfering with normal commercial behaviour, at minimal compliance cost, within the self-assessment system" (idem).

In effect, thin cap is an anti-abuse rule. Dividends are non-deductible (so that the New Zealand tax rate on the equity investment by a non-resident in a New Zealand company is the company tax rate of 28% plus NRWT on dividends, if any). Interest is deductible so that the New Zealand tax rate on debt finance is limited to the NRWT (or AIL) on interest. The policy concern that underlies thin cap is that debt is substituted for equity so that what would in the absence of tax be taxed as an equity return (28% plus any NRWT) is instead taxed at the much lower rates on interest. At the extreme, a non-resident could invest $1 of equity and repatriate all profits as interest, effectively paying minimal New Zealand tax on the investment. As the 1995 discussion document made clear, concerns with protecting the New Zealand tax base need to be balanced by having a tax system that is attractive to foreign investors given New Zealand dependence on investment from abroad to generate economic growth. Thin cap rules have therefore always been seen from a policy perspective as targeting situations where it could reasonably be concluded that investment was being undertaken by debt that was in substance equity or would have been by way of equity if based on normal commercial considerations.

Proposal

The thin cap rules that were implemented following the 1995 discussion document set maximum debt/equity ratios as outlined above. (The maximum group debt percentage was reduced from 75% to 66% from 2011/12). The 2017 discussion document raises the concern that New Zealand's thin cap rules set maximum debt/equity ratios (the level of debt) but the policy concern is with the level of profits (prior to financing costs) that a non-resident investor can extract by way of lowly taxed interest. In other words, the concern is with the level of interest expense which is a product of the level of debt (constrained by existing thin cap rules) and cost of debt or interest rate (seen by the Discussion Document as not constrained by existing thin cap rules.)

The example is given of a New Zealand company owned by a foreign parent. The New Zealand subsidiary is funded from loans from the parent. The risk of that debt is increased because of the high level of gearing or by its terms and features – examples given are the loan being highly subordinated, repayable on demand, having extremely long terms, or convertible into shares (paragraphs 3.10 and 3.11). It is argued that while this may increase the risk associated with the debt, and thus be used to try to justify high interest rates, this does not alter the overall risk to the parent of the investment. It simply transfers equity risk into debt risk – with the overall risk borne by the foreign investor unchanged.

The 2017 discussion paper proposes as a response to retain New Zealand's current thin cap rules but supplement them by a cap on the level of deductible interest rates.

It is proposed:

- The cap apply to loans from a non-resident to a New Zealand borrower (3.17)

- The loan must be a related party loan defined (3.43) as being when the lender is:
  - a member of the same worldwide group as the borrower
  - a member of a non-resident owning body (a group of 2 or more non-residents who each hold ownership interests in the company)
  - an associated person of the group or body.

- The basic rule proposed is that the interest rate cap is set at the interest rate that the borrower's ultimate parent (the main operating company in the group where the parent is a holding company) could borrow on standard terms (defined as the parent's credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin. - paragraph 3.23). Where there is no ultimate parent (the New Zealand firm is owned by a non-resident owning body), the interest rate that would apply if the New Zealand group raised senior unsecured debt on standard terms with no margin and in determining the rate on such senior unsecured debt basing this on the level of debt under transfer pricing principles or deem all related party debt to be equity for the purposes of determining the New Zealand group's credit worthiness (3.36)

- A related party loan is proposed to be treated as having a term of 5 years for determining the interest rate cap (3.53).

Comment

We accept that the policy objective of thin cap rules is the level of interest deductions. This is determined by not only the level of debt (constrained by current thin cap rules) but also the price of debt (the interest rate). We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent (and carrying on the same business activity as the parent), increasing the risk associated with parent lending may be used to justify a higher interest rate but does not alter the parent's overall investment risk. We can understand the argument why in such a scenario high interest rates can be viewed as being substituting non-deductible dividends for deductible interest. However, we consider that any policy response should be targeted at situations where there is this close substitutability of interest for dividends and should be reasonable in that context. Any policy response should also be consistent with the international tax framework adopted by our trading partners which is based on arm's length terms and prices being applied to related party transactions.

The example in the discussion document is of a foreign parent that has 100% ownership of a New Zealand subsidiary. The implicit assumption is that the parent and subsidiary are in essence operating the same type of business and therefore lenders have a similar risk when lending to either the parent or the subsidiary. The document argues that if the foreign parent substitutes debt for equity (or introduces features into the debt instrument that increases the debt risk) this does not alter the owner's overall risk in the investment but merely how that risk is allocated between different instruments all of which are owned by the same person. That is an argument for limiting deductible interest rates but only within the scenario where an increase in debt risk is offset by a decrease in equity risk with no change in the actual risk faced by any investor. The discussion document also argues that it makes no difference whether the foreign parent borrows funds and then on-lends them as a related party loan to the subsidiary or whether the subsidiary borrows directly from an unrelated party. This leads to the conclusion that the commercial cost of funds is the parent's interest rate. However, again it is limited to the scenario presented in the discussion document (100% owned subsidiary) and assumes that the parent explicitly or implicitly guarantees the unrelated party debt of the subsidiary.

The discussion document proposals are not well targeted and not reasonable in their context. While we concede that there may be situations outside a 100% commonly owned group, where in substance the same outcome arises, any interest cap based on the parent's cost of borrowing should be limited to situations where, as in the simple example presented in the discussion document, any increase in debt risk can reasonably be viewed as not altering the overall risk assumed by any investor so that the increased interest rate can in substance be viewed as a dividend return on equity.

The issues with the wide ambit of what is proposed in the discussion document can be illustrated by the example of a foreign lender deemed to be a related party lender under the proposals that has only a 51% interest in the New Zealand borrower. The foreign lender is in a different business and has a totally different risk profile to the New Zealand borrower. It may be an institutional investor (a collective investment vehicle) with no gearing itself and a diversified world-wide portfolio of investments of which the New Zealand investment is an immaterial aspect. In the case of a sovereign wealth fund the investor is likely to have an implicit or even explicit government guarantee enabling it to borrow at close to a sovereign risk credit rating. The New Zealand investment may be very high risk – such as petroleum mining or an IT venture. The only related party debt is provided by that foreign lender so that the other (49%) owners of the New Zealand investment do not provide loan finance.

In such a case, it cannot realistically be argued that the correct market interest rate of the New Zealand entity (the interest expense properly attributable to New Zealand without interfering with normal commercial behaviour) is the interest rate the foreign lender would be required to pay on its borrowings. It cannot realistically be argued that the foreign entities debt is substitutable for equity. Finally, it cannot realistically be argued that in providing related party debt the risks assumed by each investor remain the same as if the investment were equity financed. The lender will have a credit rating for senior unsecured debt that reflects its sovereign risk credit rating or at least a very high credit rating given its lack of gearing and diversified investment portfolio. The New Zealand investment entity will have a cost of funds reflecting its much higher risk being a geared undiversified high risk investment. The example may be somewhat of an outlier but illustrates the general point that the discussion document example was a 100% owned subsidiary with the same investment profile as the parent. Outside the parameters of that restricted example, it is clear that the commercial cost of funds of the New Zealand entity will not necessarily reflect the cost of funds of any single overseas investor in that entity.

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

The remaining funding is therefore required to be provided by way of debt. Financial institutions are unlikely to provide such debt funding because of the risk – or if they did so only at very high interest rates. The most obvious source of debt funding is the foreign fund(s). The fund(s) ownership interest means that they have an in-depth and up to date knowledge of the New Zealand investment so that they have a better view than an external financier of the actual debt risk involved. Obviously, however, from a purely commercial perspective the fund(s) will want an interest rate on this related party debt that reflects its actual commercial risk – which is the risk associated with the New Zealand firm which will be considerably higher than the fund(s) cost of debt based on the fund(s) high credit rating. If interest on such related party debt is restricted to the interest rate that the fund(s) could borrow on standard terms (defined as the fund(s)'s credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin), a material part of the commercial interest cost of the New Zealand entity would become non-deductible. Applying the proposals in the discussion document in this way would amount to introducing a tax penalty on high risk/ high growth New Zealand ventures with global potential. That seems clearly contrary to the government's economic growth strategy.

To avoid these economic distortions and to ensure that any limitation of deductible interest is in line with the stated policy objective it is therefore submitted that any such limitation should be consistent with international practice and narrowed to situations closer to the example provided in the discussion document where it is more arguable that related party debt may be viewed as more substitutable for equity and does not affect the investment risk borne by each investor.

The Primary Rule Should be that Interest Rates Should be Governed by Transfer Pricing

Interest is the price paid by the borrower for the use of finance provided by debt funding. The general international rule is that where goods or services are supplied across a border between associated persons, the price for goods or services must be set at an arm's length price being the price that would be agreed upon if the parties to a related party transaction were not associated and acted at arm's length. Since the interest rate is simply a price for the use of money, transfer pricing should apply to cross border interest rates between related parties just as it does for rents for land or machinery between related parties.

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

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

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

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

Even so, since New Zealand's thin capitalisation rules did not override our double tax agreements ("DTAs") where (principally by way of the article 9 – associated person transactions - and article 24 – non-discrimination) DTAs required interest to be deductible if such interest met the arm's length transfer pricing test, it is understood that New Zealand accepted that the arm's length test overruled the thin capitalisation rules.

The policy environment has changed considerably since 1995.

- The Discussion Document's focus is excessive interest rates not the quantum of debt per se. The level of interest rates (price) is squarely within the ambit of transfer pricing rules governed by internationally agreed guidelines as to its technical application.

- The Discussion Document's focus is (correctly) on the interest rate set with respect to related party loans. The 1995 concerns with the level of debt incurred by a New Zealand enterprise with unrelated parties are not relevant in this context.

- Transfer pricing is now well developed internationally and New Zealand taxpayers and IRD have developed considerable expertise in operating transfer pricing rules. For example, the OECD is now clear that article 9 of the Model Convention (the transfer pricing article) "is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital." (2014 Commentary pages 183-184). The rationale is that transfer pricing rules aim to establish a level of profits from a transaction that corresponds to the profits that would have resulted from an arm's length transaction and, to achieve this, the level of debt as well as the interest rate and the terms and conditions attaching to a related party loan needs to be on an arm's length basis. It is now clear that transfer pricing under article 9 specifically allows a tax authority to disallow interest deductions to the extent that a related party loan is not provided on an arm's length basis. In other words, it is not clear that the discussion document objective of limiting the extraction of profits by way of excessive interest costs on related party lending can be met within normal transfer pricing rules applying the arm's length principle.

The Discussion Document is, in our view, correct in reaching the view that the policy issue with related party lending is to determine a commercial (arm's length) quantum of interest which, as the Discussion Document notes, is the product of the level of interest rate and the level of debt. In other words, price (interest rate) and quantity (level of gearing) need to be considered from a commercial perspective in an integrated approach. Transfer pricing rules achieve such an outcome and should be the preferred method of dealing with the issues raised in the Discussion Document.

Unlike the proposed arbitrary cap based on the lender's cost of borrowing, transfer pricing accommodates scenarios outside the simple parent lending to subsidiary scenario where both parent and subsidiary undertake similar business/investment activities because transfer pricing can take into account these material differences in situations. Transfer pricing also provides the advantage of consistency with other comparable tax jurisdictions, especially Australia which uses an arm's length pricing approach to determine acceptable interest rates.

New Zealand's economic growth strategy requires considerable foreign investment to grow our wealth and incomes. For that reason for many years our international tax policy has recognised the need to balance potential revenue collection from foreign investors with the need to do so in a way that is not overly adverse in attracting such investment and that would not flow through to a general increase in the economy's cost of capital. The appropriate policy balance seems best achieved by continuing to apply the internationally accepted arm's length principle to deductible interest (based also on loan terms and conditions that are arm's length and a capital structure that is arm's length.)

As we interpret it, the essence of the OECD BEPS project is for countries to co-ordinate approaches to the risks and problems identified with the taxation of international capital flows. The proposed formulaic interest rate cap approach is the direct opposite of such a co-operative approach to international tax policy. In effect, it seems to abandon the long-standing internationally accepted arm's length approach with a formulaic approach unique to New Zealand that would be inconsistent in many cases with an arm's length approach.

Failure by New Zealand to keep within the ambit of the arm's length principle with respect to deductible interest costs would mean that foreign investors into New Zealand would not have the protection that compliance with the arm's length principle has in terms of settling disputes between New Zealand and an overseas jurisdiction (mutual agreement by competent authorities - including advanced pricing agreements, and, if provided for, arbitration of disputes between jurisdictions, - and corresponding pricing adjustments). Since most other countries would require interest to be set by the lender on an arm's length basis, which is likely in many cases to be higher than the rate set by the proposed formulaic approach, the result must inevitably be widespread double taxation of New

Zealand investments.   Thus, by moving outside the arm's length framework, New Zealand would introduce tax rules that would impose higher capital costs and risks to investors. There could also be wider reputational risks to New Zealand with any such attempt to jettison the accepted international approach to levying taxation.

There would seem to be a need for a very strong policy reason for New Zealand adopting a policy which unilaterally withdraws New Zealand from these rules for settling jurisdictional disputes. We submit that the Discussion Document does not provide such a justification.

The desirability of using transfer pricing as the prime set of rules to protect the tax base is especially strong given the recent revision to the OECD's transfer pricing guidelines as a result of the BEPS project. In a separate Discussion Document (Transfer pricing and permanent establishment avoidance) released at the same time as the interest limitation discussion document, it is proposed that New Zealand's transfer pricing rules be strengthened so that they are aligned with the OECD transfer pricing guidelines and Australia's transfer pricing rules. In particular, the new rules if implemented will clarify that New Zealand transfer pricing rules can be used to:

- Disregard the legal form of a transaction (a related party loan) to the extent the legal form does not reflect the economic substance of the transaction.

- Allow the legal conditions of a transaction to be replaced by arm's length conditions (or allow the transaction to be disregarded) with respect to transactions that independent parties would not have entered into under those conditions.

This seems to provide IRD with the tools to amend (or disregard) related party loans where it can reasonably be argued that, as per the examples in the Discussion Document, interest on the loans is in substance a dividend. Such interest, if re-characterised under transfer pricing rules, would achieve the non-deductible result that is the policy objective as set out in the Discussion Document. The Discussion Document itself seems to accept that transfer pricing proposals would provide tools to meet the policy objective of the Discussion Document. At page 8 it states:

> "the proposed transfer pricing rules would disregard legal form if it does not align with the actual economic substance of the transaction. They would also allow transactions to be reconstructed or disregarded if such arrangements would not be entered into by third parties operating at arm's length."

In any case, it would seem that our DTAs based on the OECD Convention override any disallowance of interest costs for a non-resident enterprise or New Zealand company paying interest to a non-resident.

Article 9 of the Model Convention provides that where an enterprise has related party transactions not on arm's length terms these can be adjusted by tax authorities to produce a profit that would have accrued to the enterprise if transactions were on an arm's length basis and that profit can be made liable to tax by a jurisdiction. As discussed in the OECD's 1986 "Report on Thin Capitalisation" and in the Commentary to article 9, there have been differences of views as to whether article 9 simply allows a jurisdiction to adjust profits to those arising on an arm's length basis (in which case New Zealand would not be restricted to taxing profits in excess of those that would be calculated on an arm's length basis) or whether the article prohibits countries from calculating and taxing profits in excess of those that would be calculated on an arm's length basis (in which case DTAs based on the Convention would overrule any attempt by New Zealand to impose a deductible interest rate cap not in conformity with the arm's length principle). The OECD's conclusion was that the latter of the above alternatives is the correct way to interpret DTAs. This is reflected in the following statement on page 184 of the 2014 Commentary Update:

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

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

Article 24 (3) of the Model Convention states that a permanent establishment of a non-resident cannot be less favourably taxed than a New Zealand company carrying on the same activities. Article 24 (4) states that interest paid by a New Zealand company to a non-resident shall be deductible under the same conditions as if it had been paid to a resident of New Zealand. An exception applies if the transfer pricing article (article 9) applies. It is generally accepted that these provisions override thin capitalisation/restrictions on interest deductibility as proposed in the Discussion Document if such rules are inconsistent with the results under transfer pricing. For example, the OECD Commentary on article 24 states that the article:

> "does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible [with transfer pricing rules]. However, if such treatment results from rules which are not compatible with [transfer pricing rules] and which only apply to non-resident [lenders] (to the exclusion of resident [lenders]), then such treatment is prohibited." (2014 Commentary page 367).

The Discussion Document argues that its proposed cap on interest deductibility where the lender is non-resident would be consistent with our DTAs on the following bases:

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

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

- The Discussion Document argues that the OECD has recommended an EBITDA based interest limitation rule and thus the Discussion Document approach must be consistent with international practice and the OECD's recommendations. Clearly the Discussion Document approach is not consistent with international practice being unique in the world. As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". Whether or not it is seen as equivalent to what OECD recommends is not determinative of whether or not the approach would be overridden by a DTA. In any case the OECD EBITDA approach explicitly does not limit interest deductions to situations where the lender is non-resident. Instead the OECD recommends that the EBITDA approach apply **at a minimum** to all entities that are part of any multinational group but the OECD also suggests it could usefully apply to all entities including stand alone companies with purely domestic operations (OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – 2016 Update page 37). The inconsistency with the provisions of the DTA thus does not arise with the OECD proposal. They do, however, arise with the Discussion Document proposal.

It is submitted that if the arm's length test is our primary rule for limiting the deductibility of related party cross border interest rates because of our DTAs it should, even without the other advantages noted above, be our primary provision under domestic law.

The Discussion Document discusses and rejects the transfer pricing approach because "the highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply" (para 3.13). If compliance costs are a concern it is difficult to reconcile that with the proposed de minimis rule that those with related party loans less than $10 million be required to use "ordinary transfer pricing rules" (para 3.48). Further, this raises the viability of transfer pricing rules more generally. Again we see no basis for this assertion and we believe the transfer pricing rules are robust.

Admittedly transfer pricing rules can in some circumstances be complex but that is not being advanced as a reason not to apply them across all other prices other than interest. The normal response to such complexity is a set of safe harbour rules – which we support. Australia applies transfer pricing to limit related party cross border interest rates and in doing so can adjust such rates in accordance with identified uncommercial terms along the lines set out in the Discussion Document - the loan being highly subordinated, repayable on demand, having extremely long terms, convertible into shares.

The Australian thin capitalisation rules, including using an arm's length approach for setting maximum debt levels, were recently subject to a comprehensive review by the Australian Board of Taxation – Review of the Thin Capitalisation Arm's Length Debt Test December 2014. This concluded that the arm's length test is the "central plank of the thin capitalisation rules" (page 5). It is supported by safe harbour rules which "the vast majority of taxpayers affected by the thin capitalisation rules can operate within" (page 5). This manages the complexity issue raised by our Discussion Document. The review supported retention of the arm's length test noting that "Stakeholders, including the ATO, universally supported retaining [the arm's length test] indicating that the test should be available to all taxpayers" (page 25). Mainly administrative measures were recommended to improve the operation of the rules (largely an improved risk framework for better identifying risks). The Australian experience, and the ATO's endorsement of the use of the arm's length principle, suggests that the Discussion Document's stated concern with the risk to the tax base from using an arm's length approach (para 3.13) is unfounded. Complexity can be managed by adopting appropriate safe harbour rules.

The Discussion Document (at page 10) cites the OECD Report on Interest Limitation Rules as supporting the view that the arm's length test has not proven to be adequate to deal with the issue of profits being extracted at a low rate of tax by way of excessive interest costs. The OECD Report (2016 Update page 24) notes that the arm's length test "requires a consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed" and that this has the advantage in that "it recognises that entities may have different levels of interest expense depending on their circumstances." However, the Report argues that the arm's length test may not be sufficient to deal with all BEPS issues. It notes, for example, "an arm's length test does not prevent an entity from claiming a deduction for interest expenses which is used to fund investments in non-taxable assets or income streams". Instead the Report supports the EBITDA approach (complementing the arm's length test). The EBITDA approach is recommended to apply at a minimum to all MNEs – not just international transactions. That is because, while the stated objective of the Discussion Document is to buttress our existing thin capitalisation rules, the OECD Report has a wider BEPS focus. Since the OECD Report supports the arm's length test as a complement to its wider EBITDA approach, it is not appropriate to consider the OECD Report as evidencing a rejection of the arm's length approach.

Finally, it is noted that adjusting interest deductions within the transfer pricing framework has the very significant advantage of incorporating measures to reduce the risk of double international taxation. For example, New Zealand denies an interest deduction to a parent and in effect treats part of the interest as a non-deductible dividend. The parent company is taxed on interest but not dividends. The parent company jurisdiction still recognises the full payment as taxable interest whereas New Zealand in effect treats part of the payment as a dividend which would be tax exempt under the laws of the parent company jurisdiction. If the New Zealand adjustment to interest deductibility is made under transfer pricing rules then under paragraph 2 of Article 9 of the Model convention a corresponding adjustment is required by the parent company jurisdiction so as to avoid double taxation. No such adjustment seems possible under the approach proposed in the Discussion Document. Nor, outside the arm's length test, are the other OECD convention protections for taxpayers such as the mutual agreement procedure (and possibly arbitration) and Advanced Pricing Agreements with other jurisdictions available.

Transfer Pricing Buttressed by Existing Deemed Dividend Rules

There may be a concern that the ambit of transfer pricing rules may be too narrow to cover all situations in which there could be a base concern. However, it needs to be appreciated that with respect to interest rates paid to shareholder lenders, interest over a commercial rate (excessive interest) is likely to be a dividend under current law (section CD 5). The company provides money to the shareholder/lender (interest) and this exceeds more than the market value of what the shareholder provides because the interest rate exceeds the market rate.

Safe Harbour Rules

As previously noted, the complexity for taxpayers and IRD of applying transfer pricing may justify safe harbour rules. In all cases (except possibly de minimis), all related party interest should be at reasonably arm's length or market rates given the risk profile of the borrower, and the terms and conditions of the actual loan.

Existing thresholds for debt levels

If a taxpayer is within the existing thin capitalisation thresholds (60% assets, 110% worldwide gearing) the interest rate should be accepted. It seems unlikely that related party debt could be "deeply subordinated" so as to enable dividends to be disguised as interest by increasing the level of debt and then deeply subordinating related party debt at such levels of gearing.

There still may be a concern that related party debt can be issued with repayment terms or convertibility that is used to justify an excessive interest rate. Consideration could be given to allow IRD to adjust deductible interest rates to reflect a rate that would apply without such special terms. That could for example be the rate paid on unrelated party debt.

We do, however, disagree with the suggestion in the Discussion Document that loans for a term exceeding 5 years are inherently uncommercial and not to be considered to be issued on arm's length terms. What is an arm's length term of a loan will vary depending on the circumstances of the business and the loan. It seems difficult to argue that arm's length loans should be limited to 5 years when mortgages over land are commonly provided between unrelated parties for terms of 20 or 30 years. It is likely that a long term low risk investment (such as an infrastructure project) would commercially, and on an arm's length basis, have terms exceeding 5 years.

Interest rates based on the related party's costs of funds.

We submit that there could be a further safe harbour form the application of transfer pricing to related party debt where the interest rate is set at no more than the cost of the related party's cost of funds measured as the cost of senior unsecured debt on standard terms plus a margin as outlined in the Discussion Document. This would, however be only a safe harbour and taxpayers would be free instead to use another safe harbour (as above) or full transfer pricing methodology.

It would seem useful to provide such a safe harbour where a related party is lending funds and the interest rate is such that there is no realistic chance of the interest rate being higher than would be the arm's length rate applying full transfer pricing methodology.

Grandparenting

The Discussion Document proposes that once the proposed interest limitation rule is legislated for it should take effect and apply to related party cross border financial arrangements currently under foot.

We submit that if an interest rate cap is introduced that overrules the arm's length test for related party loans, existing investments funded by such loans should not be subject to such a cap. We submit that not grandparenting existing loans in this way would be contrary to stated policy on prospective and retrospective tax law changes and grandparenting.

The policy positon in this area was set out in the October 2003 paper by the then Deputy Commissioner (Policy) – Taking a Fixed Tax Positon in a Changing World. The paper notes that tax changes often impact on decisions and investments made prior to the legislative amendment taking effect. There are economic and justice/fairness benefits in providing taxpayers with certainty as to how tax law impacts on them but this needs to be balanced by the ongoing need to amend the tax legislation. The conclusion reached (at page 13) is:

> "It is legislated changes in expectations that really matter, not just changes in the legal words. Protecting expectations is seen as the best way of balancing the social and economic benefits of legal certainty with the social and economic costs of living with fixed law."

The paper goes on to state (at page 18):

> "As a general rule the government will propose prospective legislation. Such legislation can, however, still affect existing transactions especially if there is no grandparenting provisions. . . . officials will recommend legislation with pre-enactment effect, when this seems to be the best way to maintain the rational and reasonable expectations of the operation of the law."

In effect, the paper concludes that people should expect some forms of tax changes and that such changes will impact (adversely or positively) on past decisions and investments. However, where people have a rational and legitimate expectation that the law will not change – it can objectively be said that a tax law change would surprise a reasonable person – then a person should be protected from tax law changes by way of grandparenting provisions.

As outlined above the arm's length principle is a well established principle for adjusting related party transactions both internationally and by New Zealand. Within the ambit of the arm's length principle people could reasonably expect some aspects of the legislation to change and it might be hard to justify grandparenting. However, if New Zealand legislation were to move outside this principle and tax profits greater than an arm's length profit (the result that in some cases will seem inevitably to arise with the proposed interest cap) this is a surprise. Objectively considered, this is beyond the reasonable or rational and legitimate expectations of international investors.

Investments have been made on the commercial basis that New Zealand would accept loans with arm's length terms and conditions. That is a reasonable expectation for investors to make. To now impose new rules contrary to such expectations would adversely and retrospectively affect investment decisions.

Thus, if New Zealand were to proceed with the interest cap proposal without grandparenting provisions for existing investments, this would be contrary to long-standing policy adopted in New Zealand with respect to tax changes with retrospective effect. In accordance with that long standing policy, and in recognition of the economic and social benefits of certainty of the law, any such change in policy should have a grandparenting provision so that existing related party loans should not be subject to an interest rate cap although such loans might subject to the more orthodox arm's length test.

We would welcome the opportunity to meet with you to discuss this submission.

Yours faithfully
Olivershaw Limited

Robin Oliver MNZM
Director
robin@olivershaw.co.nz

Mike Shaw
Director
mike@olivershaw.co.nz

First Gas Limited
42 Connett Road West, Bell Block
Private Bag 2020, New Plymouth, 4342
New Zealand
P +64 6 755 0861
F +64 6 759 6509

18 April 2017

BEPS – Interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

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

Submission: "BEPS - strengthening our interest limitation rules" discussion document

We outline in this letter our submission on the Government discussion document "BEPS - strengthening our interest limitation rules", which was released on 3 March 2017 (the **discussion document**).

We welcome the opportunity to make this submission, and would be happy to discuss further with officials if that would assist in understanding and appropriately taking into account our key concerns as part of the consultation process.

Introduction – overview of First Gas

First Gas Limited (**First Gas**) owns and operates New Zealand's entire high-pressure natural gas transmission network, as well as more than 4,800 km of gas distribution pipelines across the North Island which, on behalf of gas retailers, deliver gas to more than 60,000 customers.

First Gas, formerly Vector Gas Limited, was acquired in 2016 by a consortium of foreign investors including two wholesale unlisted infrastructure funds managed by First State Investments (**FSI**) group entities, along with a co-investment from two Canadian institutional fund managers. FSI (known as Colonial First State Global Asset Management in Australia) is the investment management business of the Commonwealth Bank of Australia.

First Gas subsequently acquired the Maui gas pipeline from its long term owners, and has recently acquired further gas distribution pipelines in the Bay of Plenty.

Summary of submission

We summarise our key submission points as follows:

- The non-debt liabilities proposal will inequitably penalise infrastructure businesses - which are by nature highly geared and capital intensive - and will result in unjustifiably prejudicial treatment of foreign vs locally owned businesses in that and other highly geared sectors.
- Deferred tax liabilities, which can be disproportionately significant for owners of regulated infrastructure as compared with other taxpayers, are analogous to equity and should not be subtracted from asset values.
- If the non-debt liabilities proposal goes ahead, the availability of different asset valuation methods should be reconsidered, in the interests of most accurately identifying the value of assets that are funded by those liabilities and debt.
- Abolishing asset and liability measurement at the end of the income year imposes significant additional compliance costs: the status quo does not impose an unreasonable burden on

taxpayers in terms of assessing their thin capitalisation position, which in turn encourages compliance.

- The interest rate cap is without international precedent and may cause inequities at the boundary / increase the risk of double taxation: it should not proceed. It appears to be based on an unreasonable assumption that New Zealand entities are implicitly supported by their foreign parent/related parties.

- If the interest rate cap proposal proceeds, this should only be as a safe harbour backstop for existing transfer pricing rules. In addition, the rules concerning the allowable margin should not result in different treatment depending on different ownership structures, and the five year term should be reconsidered because it is not commercially realistic (particularly for infrastructure debt financing: a one-size-fits-all approach, although attractive for its simplicity, does not reflect commercial reality).

- The issue being addressed by the "strengthened" interest limitation rules is best solved through the application of orthodox transfer pricing principles.

- Significant investment decisions with a long-term horizon have been made by FSI and other infrastructure investors based on then current New Zealand tax law. The current tax treatment of existing financing arrangements entered into by FSI and other infrastructure investors should be preserved through appropriate grandparenting measures. This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. First Gas' significant capex needs mean they require ready access to debt and equity funding from the global capital markets. Given the importance of infrastructure to New Zealand's economic growth and productivity in the future, tax settings should be encouraging further foreign direct investment (via both debt and equity) into New Zealand infrastructure assets – not discouraging it.

General comments

First Gas recognises the significance of the OECD's BEPS project and Inland Revenue's work programme in that regard. Clearly it is important that all New Zealand tax resident businesses (including those that are owned or controlled by offshore investors) are subject to an appropriate level of taxation in New Zealand.

However, First Gas is concerned that the discussion document's proposals will result in horizontal inequity between businesses owned/controlled by offshore investors as compared with those in New Zealand ownership. In particular, long term infrastructure businesses with regulated asset bases (such as in the energy industry) are significantly supported by overseas capital and accordingly are likely to be disproportionately impacted by the proposals.

The proposals in their current form do not recognise that infrastructure businesses are invested into on a long-term basis, and by their nature are capital intensive and highly geared. With a relatively low regulatory WACC allowed by the regulator and the need to reinvest capital to maintain and expand the asset, it is inevitable that infrastructure businesses (in particular regulated utilities) will need to borrow significantly to achieve a commercial return demanded from its global financial sponsors: it does not reflect any lack of commerciality in terms of debt levels (but, rather, a sensible investment decision and a norm). If the proposals are enacted in their current form, there is a real and appreciable risk of an adverse impact upon offshore investment decision-making as regards whether to invest in New Zealand-based infrastructure, or elsewhere globally.

Given that New Zealand is heavily reliant on foreign direct investment as a capital importing nation, the proposals warrant serious reconsideration. This is particularly the case given New Zealand's very shallow capital market, and First Gas' (and other regulated infrastructure firms') capex-intensive business models that demand constant and unimpeded access to vitally important investment capital. Any tax policy settings that make New Zealand infrastructure assets an unattractive destination for that capital pose serious risks to the infrastructure sector's economic viability, for New Zealand's energy needs and correspondingly our country's economic growth and prosperity.

If the proposals are enacted in their current form, First Gas has serious concerns regarding the impact on the availability and cost of capital for itself and other New Zealand infrastructure businesses.

Assets net of non-debt liabilities

The discussion document proposes to subtract the value of non-debt liabilities from a firm's asset value for the purposes of the thin capitalisation rules **(thin cap)**. This is based on an international comparison which indicates that a 'gross assets' basis for thin cap is unique to New Zealand.

We do not support this proposal, which materially reduces the long-standing 60% safe harbour threshold. Beyond stating that the proposal seems to make thin cap more consistent with its "core objectives", we are concerned that the discussion document does not set out a properly reasoned case for this change.

Further, the proposal does not recognise that the funding of business assets via non-debt liabilities is a legitimate investment decision. Non-debt liabilities generally (but not always: deferred tax liabilities being one example) reflect the existence of real obligations for taxpayers, which are required to be met by equally real business assets. It is difficult to see why these assets should be effectively excluded from a firm's thin cap calculation.

Conversely, certain non-debt liabilities that would be subtracted in arriving at net assets under the current proposals do not actually fund assets on the balance sheet (for example, an unrealised liability recorded in respect of an out-of-the-money derivative). In these cases we do not consider it is appropriate to arbitrarily exclude a corresponding amount of assets from the thin cap calculation. Such an approach could also encourage firms to make tax-driven decisions in relation to their accounting policies (again, hedging/derivatives is an obvious example), in order to ensure that corresponding assets are reflected in their balance sheet, thereby mitigating or eliminating the impact of a net assets measurement.

As a general observation, we consider that the existing 60% thin cap safe harbour is already too low for the infrastructure industry. Long term infrastructure businesses (particularly regulated utilities) are by their very nature likely to be geared above this level. As explained above, the use of debt is a sensible approach to balancing the need of consumers (e.g. low WACC / tariff setting, proper maintenance and expansion of assets) and the need for acceptable commercial returns of financial sponsors. The high level of gearing is acceptable to lenders due to the stable, long term nature of infrastructure businesses, and given that the ability to service debt is ultimately determined by cash coverage rather than balance sheet type ratios. Given these settings, the industry will therefore be disproportionately penalised as a result of these changes.

Rather than changing the basis for the current 60% safe harbour, we suggest instead an additional arm's length safe harbour test to allow taxpayers to gear at higher levels where this is supportable as being a commercial level of debt. This is a feature of thin cap regimes in a substantial number of jurisdictions. We consider that this would address Officials' concerns regarding industry specific rules noted at paragraph 4.29 of the discussion document. Further, this proposal would be more consistent with Officials' stated goal of ensuring taxpayers (including different types of taxpayers) have commercial levels of debt. It is also consistent with other features of the New Zealand taxation system that require taxpayers to demonstrate qualitative matters such as a "market value" (depreciable property/trading stock rules on disposal and dividend rules), an "arm's length amount" (transfer pricing) or "arm's length terms" (on-lending concession for thin cap purposes).

However, if the non-debt liabilities proposal does proceed, we strongly submit that a more considered approach should be taken to identifying which such liabilities are subtracted from the value of assets. For example, as is the case in Australia, deferred tax liabilities should not be carved out from the total asset value as they are normally not regarded as a 'real liability' by a debt funder and can be classified as equity for debt covenant purposes. Contingent liabilities to pay amounts upon redemption of redeemable shares, related party trade creditors and shareholder current accounts (if not already covered by interest-free loans) are additional examples.

Further, if the proposal is implemented, we submit that other aspects of the thin cap rules should be reconsidered to ensure that taxpayers are able to value their asset base in a commercially realistic manner. In particular, Officials recommend at paragraphs 5.24 to 5.27 of the discussion document that asset valuation should now be restricted to financial statements values only. By contrast, Australia offers a more generous market valuation option for assets in certain circumstances, subject to obtaining appropriate third party valuation support. This should be considered by Officials as a way of ensuring that thin cap measures interest bearing debt against the true value of shareholders' investment.

Measurement date for assets and liabilities

We do not support the proposal to remove the current default (annual) asset valuation measurement date. This will in effect require taxpayers to prepare IFRS-based values on at least a quarterly basis, in most cases solely for tax purposes. Because IFRS requires a number of complex calculations (e.g. impairment testing, fair value and mark to market calculations), it would otherwise be very unusual to prepare these values so frequently. This proposal will therefore impose significant additional compliance costs for taxpayers. By contrast, the status quo represents a sensible approach for taxpayers to assess their thin cap position (i.e. simply based on their annual accounts – with the current value approach as an option as submitted above), which in turn encourages compliance.

The discussion document indicates that Inland Revenue's concern with the year end measurement date arises from perceived shortcomings in the existing anti-avoidance rule in section FE 11 of the Income Tax Act 2007. As these concerns are presumably relevant in only a small number of isolated cases (the discussion document does not cite anecdotal evidence supporting what is otherwise a theoretical concern), it is vastly disproportionate to impose significant additional compliance costs on all taxpayers. We submit that targeted amendments to the anti-avoidance rule would be a more appropriate policy response.

Interest rate cap – assumptions

As a starting point, we consider that the proposed interest rate cap appears to assume the implicit support of New Zealand entities by their foreign related parties. This assumption ignores the separate legal entity principle, as well as business and economic reality. Except where an enforceable guarantee is provided by a foreign owner, it is fundamentally flawed to assume that a multinational parent (and especially a consortium investor such as is the case in relation to First Gas) will always support a New Zealand related party.

Interest rate cap – use of transfer pricing principles

As a result of concerns that 'traditional' thin cap regimes are vulnerable to excessive interest rates on related party loans, the discussion document proposes a cap on the deductibility of such interest. However, as in Australia and numerous other jurisdictions with thin cap regimes, we consider that orthodox transfer pricing rules are adequate to ensure that related-party lending is conducted on arm's length terms.

As a result, we do not support the proposed interest rate cap. We are concerned that the cap is a blunt instrument which will increase horizontal inequity between locally and foreign owned businesses. The proposal is untested and to our knowledge is without international precedent (and in this regard we have identified fundamental/conceptual concerns above, and further specific concerns below). We are also concerned that, particularly when combined with the other proposals, the interest rate cap will introduce a unique level of complexity to New Zealand thin cap relative to other jurisdictions.

The cap also introduces a substantial double taxation risk where the lender's jurisdiction applies transfer pricing principles. Although the same could be true for thin cap interest apportionment to a certain extent, it is relatively straightforward for a taxpayer to manage debt levels within thin cap thresholds. The mutual agreement process has also historically allowed competent authorities to resolve more complex double taxation issues. However, we are concerned that the impact of the interest rate cap, together with the proposed treatment of non-debt liabilities, introduces a more substantial risk of double taxation.

As a way of addressing these deficiencies, we submit that the concerns sought to be addressed by the proposed interest rate cap should be dealt with instead through orthodox transfer pricing rules. We consider that this more closely aligns with, and less invasively gives effect to, the stated policy objective of preventing profit shifting by way of excessive interest deductions.

We note the discussion document's warning that if an interest limitation rule will not achieve its stated objectives, then an EBITDA based rule (as suggested by the OECD) may need to be adopted. We do not agree that an EBITDA based rule is a necessary result of rejecting the interest rate cap. As recognised in the discussion document, such a rule has its own challenges and, as noted above, the policy concern can be adequately addressed via existing transfer pricing rules.

Further, given the recent bolstering of the NRWT rules with respect to related party debt, we consider that New Zealand should be less concerned with base erosion and profit shifting resulting from interest on related party debt. New Zealand's comprehensive application of NRWT to passive income streams (including now where consortia will not be able to access the approved issuer levy regime) can be contrasted with the difficulties of European Union members and some other nations, who are unable to use withholding tax with similar efficacy[1]. Further, in certain related party situations (i.e. involving associated persons) where NRWT is only a minimum tax, investors may nevertheless be subject to a full New Zealand income tax burden on the relevant income stream. As a result, we consider that some of the concerns leading to the recommendation of an EBITDA based measure (or indeed, an interest cap rule) are not relevant in a New Zealand environment.

Finally, if the interest rate cap proposal does proceed, First Gas considers that it should have application only as a 'safe harbour' backstop for the existing transfer pricing rules. Taxpayers who are willing and able to undertake a full transfer pricing analysis to support arm's length pricing for related party debt should not have interest rate deductions limited by an arbitrary cap. The cap should therefore be limited to circumstances where a taxpayer does not undertake full transfer pricing analysis. We consider this would mitigate some of the concerns with the cap detailed above.

Interest rate cap – design matters

If the interest rate cap proposal does proceed, we submit that the proposed five year maximum term (when looking to senior unsecured debt issuance pricing as a base from which to notch) is too short, particularly in industries with stable cash flows and a solid long term asset base. Too short a term is uncommercial and risks giving rise to non-arm's length outcomes.

Particularly from an infrastructure perspective, a five year term is demonstrably too short. In a New Zealand specific context (e.g. PPPs), Officials will be aware of senior debt with terms of seven years or longer. In Australasian markets, ten year infrastructure bonds are not unusual and longer terms up to thirteen years are available in overseas capital markets. Similarly, First Gas understands from FSI (and in First Gas' own experience) that related party loans will normally have a term between five to ten years. Hence a five year term represents an overly restrictive assumption.

Given New Zealand's status as a net capital importer, we consider it would be unwise to restrict taxpayers' interest rate cap calculations from being based on appropriately priced overseas debt financing in the manner proposed by Officials (or, indeed, to restrict access to such financing itself).

As a result, we consider that the appropriate term needs to vary across industries and across credit cycles. As has been the practice with transfer pricing matters, Inland Revenue could provide more tailored guidance on what it considers uncommercial in the context of intercompany debt.

Alternatively, if a hard cap is imposed, this should err on the side of being higher than the proposed five year term to avoid arbitrarily and unduly penalising investors.

The proposed approach for adding a margin also raises horizontal equity issues. In particular, the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating is inequitable. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. This is preferable as a matter of tax policy to minimise the extent to which investment decisions are impacted by tax rules.

Grandparenting for existing arrangements

[1] For further comments in this regard, see for example: OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

The current long-standing tax policy settings have critically informed a number of significant investment decisions, including the FSI-managed consortium's own recent investment in New Zealand.

For any infrastructure investor, the pre and post-tax yields of an investment are significant outputs from the valuation and modelling process that is undertaken prior to making, and in ascertaining the viability of making, that investment. Based on those settings, resulting yields and other factors, FSI made a significant commercial decision to financially sponsor a material investment into New Zealand's energy infrastructure and recommend the investment accordingly to the current consortium members (comprising wholesale infrastructure funds and various institutional/sovereign or quasi-sovereign agency investors).

Uncertainty and risk is of course inherent in any investment, particularly over the extended modelling horizon that is used by long term infrastructure investors. The consortium that has invested into First Gas has already been affected by the changes to availability of the approved issuer levy regime. The impact of the proposals in the discussion document, if enacted in their current form, would further materially affect the post-tax return on the significant investment that the consortium has made in a core feature of New Zealand's infrastructure landscape. As a result, we submit that the proposals, if enacted, should include grandparenting, particularly for arrangements entered into before the release of the discussion document and in particular in the infrastructure sector where long-term investment decisions are made.

This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. As noted above, First Gas' significant capex needs mean require ready access to debt and equity funding from the global capital markets. Given the importance of infrastructure to New Zealand's economic growth and productivity in the future, tax settings should be encouraging further foreign direct investment (via both debt and equity) into New Zealand infrastructure assets – not discouraging it.

The rationale and case for grandparenting for non-PPP infrastructure investment is just as compelling as for the PPP projects referenced at paragraph 5.12ff of the discussion document (except we would submit that owner-linked debt should not be non-deductible as proposed by the discussion document and instead a section FE 31D-style regime should apply as is referenced in paragraph 5.14 of the discussion document: transfer pricing measures can constrain any quality of debt issues). If similar grandparenting is not introduced, then a horizontal inequity will arise as between Government-sponsored and private sector-sponsored key infrastructure investment in New Zealand. To this end First Gas also supports the grandparenting of the operation of section FE 31D in relation to non-resident owning body debt entered into prior to enactment of the proposed reforms. First Gas also submits that for non-grandparented consortia arrangements it is a disproportionate policy response to deny all interest deductions on shareholder debt.

Concluding comments

Thank you again for the opportunity to submit on the discussion document. Should you have any further queries or wish to discuss this submission further, please contact me on (06) 755 0861 or by email at david.smith@firstgas.co.nz.

Yours faithfully

David Smith
Chief Financial Officer
First Gas Limited

#005

First State Investments

Colonial First State
Global Asset Management

Level 4 Tower 1
201 Sussex Street
Sydney NSW 2000
GPO Box 3892
Sydney NSW 2001

18 April 2017

BEPS – Interest limitation rules
c/- Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

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

Submission: "BEPS - strengthening our interest limitation rules" discussion document

We outline in this letter our submission on the Government discussion document "BEPS - strengthening our interest limitation rules", which was released on 3 March 2017 (the **discussion document**).

We welcome the opportunity to make this submission, and would be happy to discuss further with officials if that would assist in understanding and appropriately taking into account our key concerns as part of the consultation process.

Introduction – overview of FSI

First State Investments (FSI) (operating as Colonial First State Global Asset Management in Australia) is the investment management business of the Commonwealth Bank of Australia. We are a global asset manager with established offices across Europe, the US, Middle East, and Asia Pacific regions. FSI has stewardship of over US$147.2 billion in assets managed on behalf of institutional investors, pension funds, wholesale distributors, investment platforms, financial advisers and their clients worldwide.

FSI is one of the pioneer infrastructure investors in Australia, with a 20-plus year track record of investing in infrastructure assets on behalf of over 85 institutional investors. We also have experience in managing 51 infrastructure investments in Europe, Australia and Asia since September 1994 with an infrastructure portfolio valued at approximately US$5.8 billion as at 31 December 2016. We adopt a long-term buy and hold investment approach focused on value creation through continuous investment.

Two wholesale unlisted infrastructure funds managed by FSI, along with a co-investment from two Canadian institutional fund managers, recently made their first (and a significant) investment in New Zealand as part of the consortium which in 2016 acquired both First Gas Limited (formerly Vector Gas Limited) and the Maui gas pipeline (collectively "First Gas"). The First Gas business now operates New Zealand's entire high-pressure natural gas transmission network, as well as more than 4,800 km of gas distribution pipelines across the North Island which, on behalf of gas retailers, deliver gas to more than 60,000 customers.

Summary of submission

We summarise our key submission points as follows:

- The non-debt liabilities proposal will inequitably penalise infrastructure businesses - which are by nature highly geared and capital intensive - and will result in unjustifiably prejudicial treatment of foreign vs locally owned businesses in that and other highly geared sectors.

- Deferred tax liabilities, which can be disproportionately significant for owners of regulated infrastructure as compared with other taxpayers, are analogous to equity and should not be subtracted from asset values.

- If the non-debt liabilities proposal goes ahead, the availability of different asset valuation methods should be reconsidered, in the interests of most accurately identifying the value of assets that are funded by those liabilities and debt.

- Abolishing asset and liability measurement at the end of the income year imposes significant additional compliance costs: the status quo does not impose an unreasonable burden on taxpayers in terms of assessing their thin capitalisation position, which in turn encourages compliance.

- The interest rate cap is without international precedent and may cause inequities at the boundary / increase the risk of double taxation: it should not proceed. It appears to be based on an unreasonable assumption that New Zealand entities are implicitly supported by their foreign parent/related parties.

- If the interest rate cap proposal proceeds, this should only be as a safe harbour backstop for existing transfer pricing rules. In addition, the rules concerning the allowable margin should not result in different treatment depending on different ownership structures, and the five year term should be reconsidered because it is not commercially realistic (particularly for infrastructure debt financing: a one-size-fits-all approach, although attractive for its simplicity, does not reflect commercial reality).

- The issue being addressed by the "strengthened" interest limitation rules is best solved through the application of orthodox transfer pricing principles.

- Significant investment decisions with a long-term horizon have been made by FSI and other infrastructure investors based on then current New Zealand tax law. The current tax treatment of existing financing arrangements entered into by FSI and other infrastructure investors should be preserved through appropriate grandparenting measures. This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future.

General comments

FSI recognises the significance of the OECD's BEPS project and Inland Revenue's work programme in that regard. Clearly it is important that all New Zealand tax resident businesses (including those that are owned or controlled by offshore investors) are subject to an appropriate level of taxation in New Zealand.

However, FSI is concerned that the discussion document's proposals will result in horizontal inequity between businesses owned/controlled by offshore investors as compared with those in New Zealand ownership. In particular, long term infrastructure businesses with regulated asset bases (such as in the energy industry) are significantly supported by overseas capital and accordingly are likely to be disproportionately impacted by the proposals.

The proposals in their current form do not recognise that infrastructure businesses are invested into on a long-term basis, and by their nature are capital intensive and highly geared. With a relatively low regulatory WACC allowed by the regulator and the need to reinvest capital to maintain and expand the asset, it is inevitable that infrastructure businesses (in particular regulated utilities) will need to borrow significantly to achieve a commercial return demanded from its global financial sponsors: it does not reflect any lack of commerciality in terms of debt levels (but, rather, a sensible investment decision and a norm). If the proposals are enacted in their current form, there is a real and appreciable risk of an adverse impact upon offshore investment decision-making as regards whether to invest in New Zealand-based infrastructure, or elsewhere globally. Given New Zealand's need for foreign direct investment as a capital importing nation, the proposals warrant serious reconsideration.

Assets net of non-debt liabilities

The discussion document proposes to subtract the value of non-debt liabilities from a firm's asset value for the purposes of the thin capitalisation rules (**thin cap**). This is based on an international comparison which indicates that a 'gross assets' basis for thin cap is unique to New Zealand.

We do not support this proposal, which materially reduces the long-standing 60% safe harbour threshold. Beyond stating that the proposal seems to make thin cap more consistent with its "core objectives", we are concerned that the discussion document does not set out a properly reasoned case for this change.

Further, the proposal does not recognise that the funding of business assets via non-debt liabilities is a legitimate investment decision. Non-debt liabilities generally (but not always: deferred tax liabilities being one example) reflect the existence of real obligations for taxpayers, which are required to be met by equally real business assets. It is difficult to see why these assets should be effectively excluded from a firm's thin cap calculation.

Conversely, certain non-debt liabilities that would be subtracted in arriving at net assets under the current proposals do not actually fund assets on the balance sheet (for example, an unrealised liability recorded in respect of an out-of-the-money derivative). In these cases we do not consider it is appropriate to arbitrarily exclude a corresponding amount of assets from the thin cap calculation. Such an approach could also encourage firms to make tax-driven decisions in relation to their accounting policies (again, hedging/derivatives is an obvious example), in order to ensure that corresponding assets are reflected in their balance sheet, thereby mitigating or eliminating the impact of a net assets measurement.

As a general observation, we consider that the existing 60% thin cap safe harbour is already too low for the infrastructure industry. In FSI's experience, long term infrastructure businesses (particularly regulated utilities) are by their very nature likely to be geared above this level. As explained above, the use of debt is a sensible approach to balancing the need of consumers (e.g. low WACC / tariff setting, proper maintenance and expansion of assets) and the need for acceptable commercial returns for financial sponsors. The high level of gearing is acceptable to lenders due to the stable, long term nature of infrastructure businesses, and that the ability to servicing debt is ultimately determined by cash coverage rather than balance sheet type ratios. Given the above setting, the industry will therefore be disproportionately penalised as a result of these changes.

Rather than changing the basis for the current 60% safe harbour, we suggest instead an additional arm's length safe harbour test to allow taxpayers to gear at higher levels where this is supportable as being a commercial level of debt. This is a feature of thin cap regimes in a substantial number of jurisdictions. We consider that this would address Officials' concerns regarding industry specific rules noted at paragraph 4.29 of the discussion document. Further, this proposal would be more consistent with Officials' stated goal of ensuring taxpayers (including different types of taxpayers) have commercial levels of debt. It is also consistent with other features of the New Zealand taxation system that require taxpayers to demonstrate qualitative matters such as a "market value" (depreciable property/trading stock rules on disposal and dividend rules), an "arm's length amount" (transfer pricing) or "arm's length terms" (on-lending concession for thin cap purposes).

However, if the non-debt liabilities proposal does proceed, we strongly submit that a more considered approach should be taken to identifying which such liabilities are subtracted from the value of assets. For example, as is the case in Australia, deferred tax liabilities should not be carved out from the total asset value as they are normally not regarded as a 'real liability' by a debt funder and can be classified as equity for debt covenant purposes. Contingent liabilities to pay amounts upon redemption of redeemable shares, related party trade creditors and shareholder current accounts (if not already covered by interest-free loans) are additional examples.

Further, if the proposal is implemented, we submit that other aspects of the thin cap rules should be reconsidered to ensure that taxpayers are able to value their asset base in a commercially realistic manner. In particular, Officials recommend at paragraphs 5.24 to 5.27 of the discussion document that asset valuation should now be restricted to financial statements values only. By contrast, Australia offers a more generous market valuation option for assets in certain circumstances, subject to obtaining appropriate third party valuation support. This should be considered by Officials as a way of ensuring that thin cap measures interest bearing debt against the true value of shareholders' investment.

Measurement date for assets and liabilities

We do not support the proposal to remove the current default (annual) asset valuation measurement date. This will in effect require taxpayers to prepare IFRS-based values on at least a quarterly basis, in most cases solely for tax purposes. Because IFRS requires a number of complex calculations (e.g. impairment testing, fair value and mark to market calculations), it would otherwise be very unusual to prepare these values so frequently. This proposal will therefore impose significant additional compliance costs for taxpayers. By contrast, the status quo represents a sensible approach for taxpayers to assess their thin cap position (i.e. simply based on their annual accounts – with the current value approach as an option as submitted above), which in turn encourages compliance.

The discussion document indicates that Inland Revenue's concern with the year end measurement date arises from perceived shortcomings in the existing anti-avoidance rule in section FE 11 of the Income Tax Act 2007. As these concerns are presumably relevant in only a small number of isolated cases (the discussion document does not cite anecdotal evidence supporting what is otherwise a theoretical concern), it is vastly disproportionate to impose significant additional compliance costs on all taxpayers. We submit that targeted amendments to the anti-avoidance rule would be a more appropriate policy response.

Interest rate cap – assumptions

As a starting point, we consider that the proposed interest rate cap appears to assume the implicit support of New Zealand entities by their foreign related parties. This assumption ignores the separate legal entity principle, as well as business and economic reality. Except where an enforceable guarantee is provided by a foreign owner, it is fundamentally flawed to assume that a multinational parent (and especially a consortium investor such as is the case in relation to First Gas) will always support a New Zealand related party.

Interest rate cap – use of transfer pricing principles

As a result of concerns that 'traditional' thin cap regimes are vulnerable to excessive interest rates on related party loans, the discussion document proposes a cap on the deductibility of such interest. However, as in Australia and numerous other jurisdictions with thin cap regimes, we consider that orthodox transfer pricing rules are adequate to ensure that related-party lending is conducted on arm's length terms.

As a result, we do not support the proposed interest rate cap. We are concerned that the cap is a blunt instrument which will increase horizontal inequity between locally and foreign owned businesses. The proposal is untested and to our knowledge is without international precedent (and in this regard we have identified fundamental/conceptual concerns above, and further specific concerns below). We are also concerned that, particularly when combined with the other proposals, the interest rate cap will introduce a unique level of complexity to New Zealand thin cap relative to other jurisdictions.

The cap also introduces a substantial double taxation risk where the lender's jurisdiction applies transfer pricing principles. Although the same could be true for thin cap interest apportionment to a certain extent, it is relatively straightforward for a taxpayer to manage debt levels within thin cap thresholds. The mutual agreement process has also historically allowed competent authorities to resolve more complex double taxation issues. However, we are concerned that the impact of the interest rate cap, together with the proposed treatment of non-debt liabilities, introduces a more substantial risk of double taxation.

As a way of addressing these deficiencies, we submit that the concerns sought to be addressed by the proposed interest rate cap should be dealt with instead through orthodox transfer pricing rules. We consider that this more closely aligns with, and less invasively gives effect to, the stated policy objective of preventing profit shifting by way of excessive interest deductions.

We note the discussion document's warning that if an interest limitation rule will not achieve its stated objectives, then an EBITDA based rule (as suggested by the OECD) may need to be adopted. We do not agree that an EBITDA based rule is a necessary result of rejecting the interest rate cap. As recognised in the discussion document, such a rule has its own challenges and, as noted above, the policy concern can be adequately addressed via existing transfer pricing rules.

Further, given the recent bolstering of the NRWT rules with respect to related party debt, we consider that New Zealand should be less concerned with base erosion and profit shifting resulting from interest on related party debt. New Zealand's comprehensive application of NRWT to passive income streams (including now where consortia will not be able to access the approved issuer levy regime) can be contrasted with the difficulties of European Union members and some other nations, who are unable to use withholding tax with similar efficacy[1]. Further, in certain related party situations (i.e. involving associated persons) where NRWT is only a minimum tax, investors may nevertheless be subject to a full New Zealand income tax burden on the relevant income stream. As a result, we consider that some of the concerns leading to the recommendation of an EBITDA based measure (or indeed, an interest cap rule) are not relevant in a New Zealand environment.

Finally, if the interest rate cap proposal does proceed, FSI considers that it should have application only as a 'safe harbour' backstop for the existing transfer pricing rules. Taxpayers who are willing and able to undertake a full transfer pricing analysis to support arm's length pricing for related party debt should not have interest rate deductions limited by an arbitrary cap. The cap should therefore be limited to circumstances where a taxpayer does not undertake full transfer pricing analysis. We consider this would mitigate some of the concerns with the cap detailed above.

Interest rate cap – design matters

If the interest rate cap proposal does proceed, we submit that the proposed five year maximum term (when looking to senior unsecured debt issuance pricing as a base from which to notch) is too short, particularly in industries with stable cash flows and a solid long term asset base. Too short a term is uncommercial and risks giving rise to non-arm's length outcomes.

---

[1] For further comments in this regard, see for example: OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

Particularly from an infrastructure perspective, a five year term is demonstrably too short. In a New Zealand specific context (e.g. PPPs), Officials will be aware of senior debt with terms of seven years or longer. In Australasian markets, ten year infrastructure bonds are not unusual and longer terms up to thirteen years are available in overseas capital markets. Similarly, from FSI's experience, related party loans will normally have a term between five to ten years. Hence a five year term represents an overly restrictive assumption.

Given New Zealand's status as a net capital importer, we consider it would be unwise to restrict taxpayers' interest rate cap calculations from being based on appropriately priced overseas debt financing in the manner proposed by Officials (or, indeed, to restrict access to such financing itself).

As a result, we consider that the appropriate term needs to vary across industries and across credit cycles. As has been the practice with transfer pricing matters, Inland Revenue could provide more tailored guidance on what it considers uncommercial in the context of intercompany debt.

Alternatively, if a hard cap is imposed, this should err on the side of being higher than the proposed five year term to avoid arbitrarily and unduly penalising investors.

The proposed approach for adding a margin also raises horizontal equity issues. In particular, the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating is inequitable. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. This is preferable as a matter of tax policy to minimise the extent to which investment decisions are impacted by tax rules.

Grandparenting for existing arrangements

The current long-standing tax policy settings have critically informed a number of significant investment decisions, including the FSI-managed consortium's own recent investment in New Zealand.

For any infrastructure investor, the pre and post-tax yields of an investment are significant outputs from the valuation and modelling process that is undertaken prior to making, and in ascertaining the viability of making, that investment. Based on those settings, resulting yields and other factors, FSI made a significant commercial decision to financially sponsor a material investment into New Zealand's energy infrastructure and recommend the investment accordingly to the current consortium members (comprising wholesale infrastructure funds and various institutional/sovereign or quasi-sovereign agency investors).

Uncertainty and risk is of course inherent in any investment, particularly over the extended modelling horizon that is used by long term infrastructure investors. The consortium that has invested into First Gas has already been affected by the changes to availability of the approved issuer levy regime. The impact of the proposals in the discussion document, if enacted in their current form, would further materially affect the post-tax return on the significant investment that the consortium has made in a core feature of New Zealand's infrastructure landscape. As a result, we submit that the proposals, if enacted, should include grandparenting, particularly for arrangements entered into before the release of the discussion document and in particular in the infrastructure sector where long-term investment decisions are made.

This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. The rationale and case for grandparenting for non-PPP infrastructure investment is just as compelling as for the PPP projects referenced at paragraph 5.12ff of the discussion document (except we would submit that owner-linked debt should not be non-deductible as proposed by the discussion document and instead a section FE 31D-style regime should apply as is referenced in paragraph 5.14 of the discussion document: transfer pricing measures can constrain any quality of debt issues). If similar grandparenting is not introduced, then a horizontal inequity will arise as between Government-sponsored and private sector-sponsored key infrastructure investment in New Zealand. To this end FSI also supports the grandparenting of the operation of section FE 31D in relation to non-resident owning body debt entered into prior to enactment of the proposed reforms. FSI also submits that for non-grandparented consortia arrangements it is a disproportionate policy response to deny all interest on shareholder debt.

Concluding comments

Thank you again for the opportunity to submit on the discussion document. Should you have any further queries or wish to discuss this submission further, please contact Jimmy Noh (Executive Advisor, Taxation – Colonial First State Global Asset Management) on 9(2)(a) [redacted] or by email at jnoh@colonialfirststate.com.au.

Yours faithfully,

Gavin Kerr
Director, Infrastructure Investments
First State Investments

NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

Submission of the New Zealand Council of Trade Unions Te Kauae Kaimahi

to the

Inland Revenue Department

on the

Proposals to strengthen New Zealand's rules for taxing large multinationals (BEPS)

P O Box 6645
Wellington
18 April 2017

1.1. This submission is made on behalf of the 30 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With 320,000 members, the CTU is one of the largest democratic organisations in New Zealand.

1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.

1.3. Thank you for the opportunity to comment on the three discussion papers on “Base erosion and profit shifting” (BEPS):[1]

- BEPS – Transfer pricing and permanent establishment avoidance
- BEPS – Strengthening our interest limitation rules
- New Zealand’s implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.

1.4. We have read these and support their general directions. We make this brief submission in order to indicate our ongoing interest in these matters and our wish to be consulted as this area of policy progresses.

1.5. The loss of revenue from tax avoidance and evasion has a direct impact on our members in loss of revenue for public services which we value, and in higher taxes than otherwise necessary on working people.

1.6. One area is of special concern: the avoidance of tax by multinational internet-based corporations such as Google and Facebook puts local carriers of advertising such as newspapers and broadcast television and radio at a competitive disadvantage. The business model of conventional news media is already severely weakened by changes in technology brought largely through the internet and other forms of digital media and communications. The advertising revenue on which the conventional media depend is undermined by these new technologies, which they are struggling to respond to. It makes it even more difficult if their competition can lower their costs by avoiding paying tax on their activities.

[1] http://taxpolicy.ird.govt.nz/consultation

1.7. This is a matter of public interest: the conventional media are still the principal originators of the content on which we largely depend for reliable news, and particularly for news about New Zealand. The steady loss of capacity through lay-offs of journalists and other media staff is creating a major failure in the news media market.

1.8. There is therefore a strong public interest case to ensure that provision of advertising services and platforms is tax neutral. We are gravely disappointed that the proposals do not address the tax avoidance of Google, Facebook and others. We urge IRD to address this.

1.9. The only other matter we would like to comment on is that it would be very valuable for IRD to regularly publish summary information on the taxation of multinationals in the New Zealand. This would give the public the information that is necessary and sufficient for informed discussion of such matters and to judge whether measures such as those discussed in the present documents are effective. We urge IRD to do so.

#007

TP EQuilibrium | AustralAsia LP

A Duff & Phelps Transfer Pricing Alliance Partner

To: Deputy Commissioner of Taxation, Policy and Strategy, New Zealand Inland Revenue

From: Leslie Prescott-Haar, Stefan Sunde / TP EQuilibrium | AustralAsia LP

Subject: BEPS – Interest Limitation Rules

Date: 18 April 2017

TP EQuilibrium | AustralAsia ("TPEQ") has prepared this submission in respect of the New Zealand Government's discussion document, *BEPS – Strengthening our interest limitation rules*, published in March 2017.

TPEQ has prepared these comments on the discussion document specifically from a transfer pricing perspective. In this regard, we have limited our comments to certain proposals contained in Chapter 3 of the discussion document. As such, TPEQ has not commented on all aspects of the various proposals.

We are comfortable discussing these points raised further with Inland Revenue or Treasury officials, as may be requested.

The submission is generally structured in alignment with the structure of the discussion document, unless otherwise indicated.

Overall Comments

Our primary concern is the need to maintain the arm's length standard as a 'base case' for transfer pricing analyses. Any departures from the arm's length approach should be well supported on the grounds of protecting New Zealand's tax base, rather than based on the Inland Revenue's issues encountered in audits. As discussed below, some of the proposed changes require further consideration and explanation as to their necessity and justification as part of the wider Base Erosion and Profit Shifting ("BEPS") project.

In principle, TPEQ supports the proposed symmetry of inbound and outbound approaches, expressed in Para. 1.8. However, given the predominantly inbound nature of financial transactions in New Zealand that would be impacted by the proposed interest rate limitation rules, we acknowledge the inbound context of this discussion, but consider that the symmetrical approach is commercially disadvantageous to New Zealand-based multinationals.

Moreover, the proposed departure from the OECD's thin capitalisation approach under BEPS Action 4 by legislating an interest rate limit will adversely impact the compliance burden for multinationals with New Zealand operations, and arguably is inconsistent with the arm's length principle embedded in New Zealand's DTAs. Our technical view is that the Inland Revenue's position with respect to the arm's length nature of the proposed interest rate cap is inconsistent with seminal international case law (*The Queen v. General Electric Capital Canada Inc., 2010 FCA 344; Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092*). Referencing paras. 3.38 and 3.60, the IRD should clearly articulate why its preferences should outweigh and override the OECD BEPS guidance.

Further justification is needed to support the proposed non-arm's length approach

We are of the overarching view that the interest rate limitation outlined in paras. 3.17 et. seq. reflects a broad rejection of the arm's length principle for financial transactions. While we acknowledge the theoretical compliance and enforcement benefits of this approach to the Inland Revenue, we consider this 'rule making' an attempt to pre-determine or disregard an arm's length outcome. Para. 3.19 suggests an implicit acknowledgement by the Inland Revenue that the proposal does not necessarily reflect the behaviour of independent parties, given the provision would not apply to uncontrolled finance transactions as well. This is arguably discriminatory with regard to inter-company funding within multinationals, and therefore inappropriate from a policy perspective, particularly given the Government's stated commitment to FDI (para. 2.1). In this regard, intercompany funding is commercially cost-effective for multinationals, which is the primary reason these financial transactions arise. Although presented as the opening premise of the proposal (para. 1.1), the use of intercompany debt is not determinative of shifting of taxable profits. Multinationals should not be penalised for seeking to minimise financial costs, and the financial institutions operating in New Zealand should not be commercially advantaged through taxation legislation.

Capping the interest rate may not provide adequate flexibility to accommodate actual facts and circumstances

Further to the above, we are concerned that the interest rate cap is likely to be inflexible in its application. Consider an example where offshore borrowing costs are 5%, New Zealand borrowing costs are 7%, and offshore investment returns are 8%:

- From the borrower's perspective, the intra-group funding cost to the New Zealand borrower should arguably be at least 7%, as this is reflects the conditions that independent New Zealand or offshore parties borrowing in New Zealand would likely face.
- From the lender's perspective, by limiting the inbound interest rate to the New Zealand entity of 5% "plus some margin", the proposal reduces the attractiveness for multinationals to invest their global resources in New Zealand subsidiaries, relative to the offshore investment options. The New Zealand government should not create a framework which could discourage inbound foreign direct investment by multinationals.

Further, we note the real-world possibility that a New Zealand subsidiary may be able to borrow at an interest rate lower than its parent entity. Under the interest rate limitation proposal, the higher cost of funds available to the parent entity would presumably allow the New Zealand entity to enjoy interest rate deductions on a loan from its parent in excess of what is arguably an arm's length amount for the New Zealand borrower. A true arm's length comparison would be simpler.

Determining the "some margin" remains subjective, and 'pegging' the interest rate to a parent's cost of funds appears arbitrary and does not offer significant advantages over a true arm's length approach

Per para. 3.27 et. seq., the "some margin" proposed may reflect a practical approach to accommodate actual facts and circumstances of a particular case. However, determining the appropriate margin will likely be subjective. Imposing, as a starting (and approximate finishing) point, the interest rate at which the ultimate parent could borrow is arbitrary and does not appear to offer any significant advantages with regards to simplicity or objectivity, as compared to a true arm's length approach. Therefore, we suggest the introduction of this rule as a safe harbour only, rather than as a blunt legislative instrument which prevents an arm's length analysis.

Clearly, the additional margin to be adopted should take into account currency differences, market conditions, specific country/company issues, administrative costs of funding, etc. For example, should a New Zealand parent be forced by the Inland Revenue to lend to its USA subsidiary at New Zealand interest rates? Not all countries are equal in global financial markets. Thus, again, a true arm's length approach would be simpler.

Other specific details of the proposals are too rigid

Per para 3.41, there may be circumstances wherein third parties may agree to re-assess the interest rate and/or margin on a given loan, for example to account for changing conditions, mergers, acquisitions, etc. The IRD should account for such flexibility and consider a less rigid approach to the fixed margin / rate rule proposed.

Per para 3.53, the maximum term or tenor should be lifted to 10 years for determining the appropriate interest rate and additional margin. A 10 year tenor is not 'uncommercial' for long term inbound investments and in bond markets.

#008

Level 5 Central Plaza Two
66 Eagle Street
Brisbane QLD 4000
Australia

18 April 2017

Commercial in Confidence
Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON 6140

Dear Deputy Commissioner

Submission on the government discussion document - "BEPS - strengthening our interest limitation rules"

QIC Private Capital Pty Limited is a leading investor in the global infrastructure market and manages a 58% interest in Powerco NZ Holdings Limited (PNZHL) on behalf of Australian superannuation funds, Queensland Government entities and other large sophisticated investors. PNZHL is the holding company for Powerco Limited, which is New Zealand's second largest Electricity and Gas Distribution Company. Powerco Ltd owns infrastructure assets that transport electricity and gas to end customers in the residential, agricultural and industrial sectors.

We are writing in relation to the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). We appreciate the opportunity to make a submission on this discussion document.

The key items we raise in our submission are summarised as follows:

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact industries such as regulated infrastructure industries which have traditionally been funded using greater than average gearing given the predictable cash flows generated by their underlying businesses;
- This is exacerbated by the inclusion of deferred tax liabilities in the calculation of the deductible debt limit which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity;
- The interest rate cap is a novel and untested approach which we believe is unnecessary in light of the current and proposed transfer pricing rules and is inconsistent with internationally accepted transfer pricing requirements;
- In our view, the issue being addressed by the proposed interest rate cap is best solved through the application of the current and proposed transfer pricing rules;
- The proposed changes create an unequal playing field between foreign and New Zealand investors, which can have the impact of reducing appetite from foreign investors as well as potentially harming local New Zealand investors who frequently invest alongside foreign investors.
- As a net importer of capital, the proposed changes would increase the average cost of capital in New Zealand, particularly for capital-intensive industries where capital structures would likely

become less efficient, increasing the cost to New Zealand of building the infrastructure necessary to support and grow its economy.

BACKGROUND

QIC appreciates that New Zealand needs to ensure that all businesses contribute an appropriate level of tax. However, in this context, we note the OECD as part of its BEPS project acknowledges that special rules may be needed for infrastructure businesses given their long-term capital intensive nature and public benefit outcome. The proposals suggested in the discussion document however are likely to result in horizontal inequity between businesses based on the residency of their owners and it will have the greatest impact on long term infrastructure businesses, which typically rely on at least a portion of overseas capital. Further, a series of recent law changes have already significantly reduced the perceived tax benefits that these measures are seeking to curtail.

TREATMENT OF NON-DEBT LIABILITIES - INTRODUCTION OF AN ARM'S LENGTH FALL BACK

The discussion document proposes changes in the current thin capitalisation rules to be based on assets net of non-debt liabilities rather than total assets. We consider the existing 60% gearing ratio to be too low for regulated public benefit infrastructure as external debt can be secured on economic terms in excess of the existing 60% thin capitalisation gearing ratio. The impact of moving to a net asset calculation will reduce this gearing threshold even further.

MEASUREMENT DATE FOR ASSETS AND LIABILITIES

The proposal to require quarterly or daily measurement risks imposing significant and unnecessary compliance costs given that the calculation is based on IFRS accounting values which may not be prepared on a quarterly basis. IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. To require these to be done solely for tax purposes at points in the year when they are not already being done for financial reporting purposes imposes additional and unnecessary compliance costs.

INTEREST RATE CAP – USE TRANSFER PRICING PRINCIPLES INSTEAD

The discussion paper suggests a bolster to the asset-based thin capitalisation rules in the form of an interest rate cap. This is a novel and untested approach. We consider that the cap on related party loans adds significant complexity, limits flexibility in raising debt capital, increases horizontal inequity between local and foreign-owned businesses and when combined with the reduced debt to asset ratio, makes New Zealand a uniquely complex thin capitalisation regime in the international community. We expect this would result in a higher cost of capital for New Zealand infrastructure assets, resulting in higher charges to end users and/or cost to Government.

The interest rate cap introduces a high risk of double taxation when dealing with jurisdictions that apply transfer pricing principles. The ability to utilise the mutual agreement process in our double tax treaties (MAP) helps avoid double taxation and supports the integrity of the global tax system. While thin capitalisation adjustments have always been unilateral, managing debt levels within the current safe harbour rules has been relatively straightforward. However, the combined impact of the thin capitalisation rules and the interest rate cap will make it much harder to avoid double taxation where interest is not deductible in New Zealand but assessable in the offshore jurisdiction.

These fundamental concerns can be addressed if the interest rate cap is replaced or supplemented by an arm's length debt pricing test relying on transfer pricing rules.

ALTERNATIVE APPROACHES

Paragraph 2.19 of the discussion paper notes that failure to address the perceived problems with the rules may mean an EBITDA based rule is adopted. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by the discussion paper, there are also a number of problems with the EBITDA approach and as noted above, the OECD recognises that public benefit infrastructure has special characteristics that might mean an exemption from the EBITDA test is appropriate.

In the discussion document "New Zealand's taxation framework for inbound investment" (June 2016), it is noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish". In our view, the imposition of an EBITDA based rule without an exemption for public benefit infrastructure would be at odds with this priority.

Further, in that discussion document the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to income tax...minimising the potential for base erosion by [related party interest] payments" . The OECD 2016 update emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules (which focused on closing a perceived gap in taxation of related party lending) negates the need for New Zealand to consider an EBITDA approach.

We submit that following a series of recent amendments to the deductibility of interest on shareholder loans, the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well supported by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

IMPLEMENTATION CONCERNS

We note that a common theme of recent law changes affecting interest deductions is the New Zealand Government's focus on reducing the use of loans from equity investors. We wish to make Treasury aware that where we have considered proposals to reduce loans from equity investors in response to the law changes, a number of New Zealand tax provisions (e.g. general anti avoidance rule) have had the potential to result in very significant New Zealand tax consequences when such loans are repaid. This is in addition to tax consequences in the foreign investor's home jurisdiction (i.e. realisation for tax purposes of foreign exchange gains due to appreciation of the NZ dollar).

For these reasons, should our earlier comments on the appropriateness of the proposed amendments be put aside, we request that consideration be given to grandfathering existing arrangements given regulated infrastructure investments are large investments made with long term investment horizons based on the policy settings at the investment time, or at the least, providing relief where loans from equity investors are repaid.

GENERAL

We trust you find our comments useful. If you have any questions, please contact Warren Knight, Principal - QIC Global Infrastructure on 9(2)(a) [redacted] or at w.knight@qic.com.

Yours sincerely

Ross Israel
Head of QIC Global Infrastructure

Warren Knight
Principal, QIC Global Infrastructure

18 April 2017

Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Email: policy.webmaster@ird.govt.nz

Dear Deputy Commissioner

Submission on "BEPS - strengthening our interest limitation rules"

We are writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). We appreciate the opportunity to submit on this discussion document.

AMP Capital Investors Limited (AMP Capital) is a Global Infrastructure manager 85% owned by AMP Limited, a company dual listed on NZX and ASX. AMP Capital manages an interest in Powerco NZ Holdings Limited (PNZHL) on behalf of Australian superannuation funds and other institutional investors. PNZHL is the holding company for Powerco Limited, which is New Zealand's second largest Electricity and Gas Distribution Company. Powerco Ltd owns infrastructure assets through which electricity and gas flow to residential customers.

Summary of submissions

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact appropriately highly geared industries such as regulated infrastructure industries.

- This is exacerbated by the inclusion of deferred tax liabilities in the calculation of the deductible debt limit which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity.

- The interest rate cap is a novel and untested approach that may cause inequities at the boundary. It is also unnecessary in light of the current and proposed transfer pricing rules and is inconsistent with internationally accepted transfer pricing requirements.

- In our view, the issue being addressed by the proposed interest rate cap is best solved through the application of the current and proposed transfer pricing rules.

- The proposed changes create an unequal playing field for foreign and New Zealand investors as they have a greater impact on foreign investors, and can harm local New Zealand investors who frequently invest alongside foreign investors.

- The proposed changes may negatively impact valuations of New Zealand assets which can impact both foreign and New Zealand investors.

Background

AMP Capital appreciate that New Zealand needs to ensure that all businesses are subject to an appropriate tax burden. However, in this context, we note the OECD as part of its BEPS project acknowledges that special rules may be needed for infrastructure businesses given their long-term capital intensive nature and public benefit outcome. The proposals suggested in the discussion document however are likely to result in horizontal inequity between businesses based on the residency of their owners and it will have the greatest impact on long term infrastructure businesses especially those with regulated asset bases which are supported by overseas capital. Further, a series of recent changes to the NZ thin capitalisation rules have already significantly reduced the perceived tax benefits that these measures are once again seeking to curtail.

Treatment of non-debt liabilities - Introduction of an arm's length fall back

The discussion document proposes changes in the current thin capitalisation rules to be based on assets net of non-debt liabilities rather than total assets. We consider the existing 60% gearing ratio to be too low for public benefit infrastructure. Powerco's Australasian peers in the regulated transmission and distribution sector have consistently maintained an average gearing above 60%. The impact of moving to a net asset calculation will reduce the total asset ratio even further.

Measurement date for assets and liabilities

The proposal to require quarterly or daily measurement risks imposing significant and unnecessary compliance costs given that the calculation is based on IFRS accounting values which may not be prepared on a quarterly basis. IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. To require these to be done solely for tax purposes at points in the year, or even daily, when they are not already being done for financial reporting purposes imposes significant additional and unnecessary compliance costs.

Interest rate cap – use transfer pricing principles instead

The discussion paper suggests a bolster to the asset based thin capitalisation rules in the form of an interest rate cap. This is a novel and untested approach. We consider that the cap on related party loans adds significant complexity, limits flexibility in raising debt capital, increases horizontal inequity between local and foreign owned businesses and when combined with the reduced debt to asset ratio makes New Zealand a uniquely complex thin capitalisation regime in the international community. In the longer run, we expect this would result in a higher cost of capital for New Zealand infrastructure assets, resulting in higher charges to end users and/or cost to Government.

The interest rate cap introduces a high risk of double taxation when dealing with most other jurisdictions which apply transfer pricing principles. For example, a circumstance could arise where the NZ interest rate cap is 6% while the Australian transfer pricing rules based on OECD principles require an arm's length rate of 8% to be returned as income. This scenario results in the inequitable outcome of the NZ interest deduction being capped at 6% and interest income of 8% being assessable in Australia.

The ability to utilise the mutual agreement process in our double tax treaties (MAP) helps avoid double taxation and supports the integrity of the global tax system. While thin capitalisation adjustments have always been unilateral, managing debt levels within the current safe harbour rules has been relatively straightforward. However, the combined impact of the thin capitalisation rules and the interest rate cap will make it much harder to avoid double taxation where interest is not deductible in New Zealand but assessable in the offshore jurisdiction.

These fundamental concerns can be addressed if the interest rate cap is replaced or supplemented by an arm's length debt pricing test relying on transfer pricing rules.

Alternative approaches

Paragraph 2.19 of the discussion paper notes that failure to address the perceived problems with the rules may mean an EBITDA based rule is adopted. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by the discussion paper, there are also a number of problems with the EBITDA approach and as noted above, the OECD recognises that public benefit infrastructure has special characteristics that might mean an exemption from the EBITDA test is appropriate.

The discussion paper "New Zealand's taxation framework for inbound investment" published in June 2016 noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish"[1]. It our view imposition of an EBITDA based rule without an exemption for public benefit infrastructure risks failing that priority.

Further, in that paper the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to … income tax…minimising the potential for base erosion by [related party interest] payments"[2]. The OECD 2016 update[3] emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is a limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules focused on closing a perceived gap in taxation of related party lending reduces the need for New Zealand to consider an EBITDA approach.

We submit that with series of recent amendments to the deductibility of interest on shareholder loans, the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well supported by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

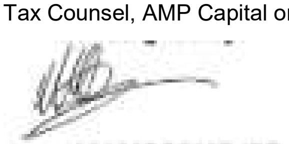
Implementation considerations

A common theme of recent law changes affecting interest deductions is the New Zealand Government focus on reducing the use of loans from equity investors. We wish to make you aware that where we have considered proposals to reduce our level of loans from equity investors in response to the law changes, a number of New Zealand tax provisions (e.g. general anti avoidance rule) have the potential to result in very significant New Zealand tax consequences when such loans are repaid. This is in addition to tax consequences in the foreign investors home jurisdiction (i.e. foreign exchange gains due to appreciation of the NZ dollar).

For these reasons, should our earlier comments on the appropriateness of the proposed amendments be put aside, we request that consideration be given to grandfathering existing arrangements, or at the least, providing relief where loans from equity investors are repaid.

General

We trust you find our comments useful. If you have any questions, please contact Kelly Heezen, Senior Tax Counsel, AMP Capital on 9(2)(a) [redacted] or at kelly.heezen@ampcapital.com.



Michael Cummings
AMP Capital, Head of Australian and New Zealand Infrastructure Funds

---

[1] Page 3, New Zealand's taxation framework for inbound investment, June 2016
[2] Page 15, New Zealand's taxation framework for inbound investment, June 2016
[3] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

#010

Corporate Office

Powerco Limited
Level 2
NPDC Civic Centre
84 Liardet Street
Private Bag 2061
New Plymouth 4342

0800 769 372
powerco.co.nz

18 April 2017

Cath Atkins
Deputy Commissioner, Policy & Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Dear Cath

BEPS - strengthening our interest limitation rules
Submission on the government discussion document

Powerco Limited is writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (discussion document). We are appreciative of the opportunity to provide comments and look forward to discussing the proposals with officials.

By way of background and introduction Powerco Limited (Powerco) is New Zealand's second largest Electricity and Gas Distribution Company, but the largest distributor in kilometres of line. Powerco owns infrastructure assets outside the national grid that electricity and gas flows through to reach residential customers. Powerco is owned via a holding company in New Zealand, Powerco NZ Holdings Limited (PNZHL), which is ultimately owned by five Australian superannuation funds and Queensland Treasury (being a political subdivision of the Queensland Government) via a number of unit trusts and companies.

1. Summary of our submission

The key points of our submission for your consideration are:

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact highly geared industries such as regulated infrastructure industries and reduce horizontal equity in the tax system;

- This is exacerbated by the inclusion of deferred tax liabilities which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity;

- The interest rate cap is a novel and untested approach that may cause inequities at the boundary. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap.

- In our view, the issue being addressed by the proposed interest limitation rules is best solved through the application of the current and proposed transfer pricing rules.

- We are supportive of the proposed grandparenting of existing financial arrangements for non-residents acting together.

- Other changes around measurement dates and asset valuations are not practical and contradictory and should not go ahead.

- The implementation date for any of the proposed amendments should be no earlier than 1 April 2019 to allow taxpayers time to restructure, should it be required.

2. Background

2.1 Powerco supports work done by Officials to ensure business are paying their appropriate level of tax, but as a company operating in a competitive environment with regulated returns on assets, it is a poor policy outcome when Powerco is put at a disadvantage simply because it is funded by foreign rather than domestic capital.

2.2 Powerco agrees with the comment at 2.1 of the discussion document "New Zealand relies heavily on foreign direct investment to fund domestic investment". Powerco agrees that the New Zealand Government should remain committed to ensuring that New Zealand remains an attractive place for non-residents to invest. However, over the last couple of years we have seen through our own mergers and acquisitions processes the ability for various taxpayers/investors into NZ to build in tax efficiencies/inequities into their bid prices. Tax systems should not distort investment choices or discourage foreign investment into NZ.

3. Excluding non-debt liabilities from total assets – adoption of arm's length test

3.1 The exclusion of the value of non-debt liabilities from total assets effectively reduces the thin capitalisation ratio for most companies to below 60%. The quantum of the reduction will vary, but for very few taxpayers will the impact be small. We do not see change in methodology and intended tightening of the rules as having any connection to BEPS.

3.2 The discussion document relies on international thin capitalisation precedent to exclude non-debt liabilities but does not present the analytical case for their exclusion. Non-debt liabilities are legitimate funding sources for business assets and we do not see the logic in excluding them. Or, put another way, genuine business assets are required by a company to ensure that the obligations represented by non-debt liabilities can be satisfied. Examples 4 and 5 in the discussion document seem to ignore this reality. They are mathematical exercises that are not reflective of the real world. In each example, the directors of the New Zealand subsidiary would be unlikely to approve the suggested dividends as the solvency test cannot be satisfied with dividends at that level.

3.3 The existing 60% gearing ratio is too low for the industry that Powerco operates in. Powerco's Australasian peers in the regulated transmission and distribution sector consistently maintain an average gearing above 60%. While we recognise that Officials have rejected the identification of specific industries we consider it would be appropriate to introduce an arm's length test to supplement the safe harbour test. If the nature of an industry supports higher commercial gearing (because it has a quality, long term sustainable asset base and inelastic cash flows) there is nothing offensive in allowing a tax deduction for interest incurred; either external debt or related party.

3.4 Further, we consider that the proposal to effectively reduce the acceptable debt to asset ratio by changing from a total asset to a net asset requirement, if it proceeds should be better designed. In Australia a similar test excludes deferred tax liabilities as they often do not reflect what a debt funder would consider a real liability and can be classified as equity for debt covenant purposes. We submit that a much more considered approach to which non-debt liabilities reduce the total asset base is required and in particular, a deferred tax liability should not be treated as a non-debt liability that would reduce the assets base for safe harbour purposes.

3.5 Both PNZHL and Powerco's accounts reflect a significant deferred tax liability, the majority of which relates to adjustments required under IFRS on acquisition of the business or change in ownership. The "adjusted deferred tax liability" is not real in the sense that were the group's assets to be sold (due to a debt default) no tax liability would crystallise (other than an amount of depreciation recovery; but that does not form part of the adjusted deferred tax liability). Banking funders of the group do not consider this as a liability when considering whether to provide finance or not to the group but reclassify it for debt covenant purposes as equity.

3.6 We disagree with Officials' comments that the impact of this will be small (paragraph 4.27 discussion document). The impact is significant for PNZHL & Powerco, and while it may only impact certain taxpayers the nature of the adjustments (relating to asset revaluations and uplifts) are such that the impact is likely to be significant when it arises.

4. Limiting the interest rate on related party loans

4.1 We understand the principal concern to be addressed by the introduction of an interest rate cap is a "quality of debt" issue in that Officials consider that some related party loans feature necessary and uncommercial terms which result in excessive interest rates. Officials note that this concern is one of the reasons the OECD favours an interest limitation which links interest deductibility and EBITDA.

4.2 The introduction of an interest rate cap for related party lending is an excessive response to the non-pervasive use of uncommercial terms in relation to related party lending. We accept that those situations may arise and are potentially difficult to resolve under the existing transfer pricing rules but in a discussion document of 3rd March 2017[1] Officials recommend an alignment of the New Zealand transfer pricing rules with those in Australia to the extent that they have regard to the economic substance of the transaction. Reconstruction of transactions which are not commercially rational is proposed (5.40). All of this provides more than adequate legislative ability for the Inland Revenue to deal with the minority of cases where excessive rates are applied.

4.3 In Australia and other jurisdictions that use the asset based test transfer pricing rules are considered adequate to ensure that the lending is commercial. The proposed changes in the New Zealand transfer pricing rules should ensure that New Zealand Inland Revenue has similar level of confidence.

4.4 In addition we note that OECD in "Limiting Base Erosion Involving Interest Deductions and Other Financial Payment Action 4 – 2016 Update" recognise the need to minimise the risk of double taxation and favour a consistent approach between countries to ensure multinationals do not face excessive compliance costs and double taxation.

4.5 The introduction of an interest rate cap is inconsistent with all other countries and the NZ discussion document does not recognise or comment on the resulting double taxation under this method. Furthermore Officials do not acknowledge that NZ has a very different withholding tax environment to Europe and a number of other jurisdictions[2].

4.6 A fundamental principle applied in international taxation is that transactions need to be undertaken on an arm's length basis. Limiting the interest deduction available in New Zealand to the parent's credit rating plus a margin will result in double/over taxation. This is likely to occur when the foreign taxing jurisdiction demands a higher interest rate be charged to reflect the arm's length rate, which will likely differ to the rate under the interest rate cap. We submit that the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well support by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

4.7 We understand that thin capitalisation adjustments are typically unilateral but this cap is one sided by design and is much harder to manage than an absolute gearing limit. Furthermore it requires all companies with over $10m related party debt to go through additional compliance even if the gearing levels are well below the appropriate asset percentage.

4.8 Powerco considers that the term of the cap (the restriction of the rate to unsecured debt with a maximum term of 5 years) does not reflect commercial reality in a global context. Powerco submits that a commercial loan may commonly be up to ten years (NZ Government issues 10 year bonds) or at least be based on the borrower's average debt term. We note a number of Powerco's external debt issues are for a period in excess of 10 years, due to the nature of the infrastructure assets

4.9 Powerco's Treasury team have had discussions with our bankers to understand a benchmark rate currently for a 10 year unsecured bond for a BBB and are unable to source a reference rate within the NZ market. Powerco most recently issued debt within NZ for an 8 year period, but to get a NZ

---

[1] BEPS – Transfer pricing and permanent establishment avoidance

[2] Para13, page 24 Limiting Base Erosion Involving Interest Deductions and Other Financial Payment Action 4 – 2016 Update

benchmark based on a BBB rating for longer than this we would most likely need to go offshore, which means that for many organisations with longer debt profiles linking the interest rate cap back to the NZ market doesn't align with their external debt portfolio and is artificial in nature.

4.10 Clarification as to the impact of foreign exchange movements on related party debt and how they would apply in relation to the cap is also important (preferably by way of example). We also consider that officials should be clear how they view the use of derivatives (in particular interest rate swaps) and how they tie into the effective related party interest rate calculation for the purposes of the cap. We note that the current rules require revaluation of foreign denominated debt based on the spot rate and fail to take into account any hedging, which can cause significant fluctuations in the group debt percentage and interest expense depending on the exchange rate movement. For most taxpayers with significant offshore denominated borrowings, the debt and all associated payments would be largely hedged so that the taxpayer have a clear understanding of their obligations at each payment date. With the proposed tightening of the measurement rules, a policy solution is required to remove the fluctuations that are distorting a taxpayers true debt percentage and interest obligations.

4.11 We also submit that the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating also raises horizontal equity issues. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. Tax systems should not distort investment choices.

4.12 Officials note at paragraph 2.19 that failure to address the problems with the rules may mean an EBITDA based rule is adopted. We do not accept that and EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by Officials there are also a number of problems with the EBITDA approach. Again, in our view using arm's-length principles under a transfer pricing approach solves these issues and has a much stronger alignment with the core policy principle of preventing excessive related party debt deductions.

4.13 In the discussion document "New Zealand's taxation framework for inbound investment" June 2016, Officials noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish". It our view imposition of an EBITDA based rule would fail that Government's own identified priority.

4.14 Further, in that discussion document the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to income tax…minimising the potential for base erosion by [related party interest] payments"[3]. The OECD 2016 update[4] emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is a limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules focused on closing a perceived gap in taxation of related party lending negates the need for New Zealand to consider an EBITDA.

5. Related Party Debt – Non-residents acting together

5.1 Currently the worldwide debt percentage safe harbour provides that where a group can support external gearing at high levels groups can have an additional level of shareholder debt. We understand that the comments in 5.20 that **any** owner linked debt should be disallowed in the event of gearing levels above 60%, refers only to the proportion of owner linked debt above the 60% level and so have not commented further on that aspect.

5.2 It is Powerco's view that equity investors should be able to take a debt interest in a company if it is at a level that a third party would bank. The tax system should not force investors to take bank debt and give debt margin away. There are legitimate reasons as to why an investor may want/desire equity and debt returns. On this basis Powerco submits that where related party debt is a substitute for third party debt (i.e. it would meet an arm's length debt test) it should remain deductible even with gearing levels about 60%.

[3] Page 15, New Zealand's taxation framework for inbound investment, June 2016
[4] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

5.3 We note that the use of multiple terms around related party lending is confusing and clarification should be provided as to the difference between related party and owner linked debt.

5.4 While this amendment may be seen as improving equity between foreign investors coming into New Zealand directly rather than as part of a collective of investors, there is still inequity in that thin capitalisation rules do not apply to all foreign investors (those co-investing by way of 49% shareholding with a New Zealand resident company for example); there is still a cut-off point. The logic behind just changing this position is not altogether clear.

5.5 Disallowing taxpayers who are deemed to be acting together access to the worldwide group test (for those arrangements not grandfathered or post maturity), also creates inequity for investment into NZ. We appreciate allowing a taxpayer access to the worldwide group test in the case of public private partnerships, but there seems to be no rationale to prevent a group of investors holding an interest in a new business access to the worldwide test, when if the same investment and capital structure had been used by two single foreign investors with a 51%/49% holding, they would have access to the worldwide group test.

6. Other matters

6.1 Officials propose that asset values should be restricted to the value in the accounts (rather than using a value that would be an option under IFRS but is not used in the accounts for various reasons). We consider that the rationale for introducing this restriction doesn't stack up. It is common and reasonable for Inland Revenue to request accounting and valuation opinions to support the use of different asset values for thin capitalisation purposes in this context.

6.2 To suggest that the independent third parties providing this support would misstate the value and that company officials would be lackadaisical because the numbers are for the Inland Revenue rather than for audited accounts is simply not correct.

6.3 Similarly the suggestion that the measurement date be moved to quarterly or daily is not commercially realistic, and contradicts the assertion above that numbers must be audited to be sensible. Most companies would not prepare IFRS compliant and audited accounts on a quarterly basis. A requirement to calculate thin capitalisation levels this often is simply not meaningful or practical.

7. Implementation Date

7.1 The discussion document notes that if implemented, the proposals will apply from the beginning of the first income year after enactment in most cases.

7.2 The proposed changes will materially impact on Powerco and a number of other foreign owned taxpayers and they should be given an opportunity to get their affairs in order. It takes time and consideration to work through the restructure of an organisation (especially where there is a group of un-related investors deemed to be acting together) to agree a proposed structure, obtain advice both locally and offshore and draft and review documentation prior to implementation. Also given the current tax environment often restructures require a level of certainty from Inland Revenue with regards to anti-avoidance arrangements.

7.3 For the above reasons taxpayers need at least 9-12 months from the time the legislation is finalised to work through these processes and as a result the implementation date for these proposals should be no earlier than 1 April 2019.

8. Concluding comments

We reiterate our concern regarding the breadth of the proposals. In our view, the issues being addressed by the discussion document is best solved through the application of the current and proposed transfer pricing rules combined with an arm's length debt test.

We would be happy to discuss the matters raised in this submission further with Officials. If you have any questions or would like to discuss any of our comments please do not hesitate to contact me on [redacted] or alternatively [redacted].

Yours faithfully

Anna Tootill
TAXATION MANAGER

KPMG
10 Customhouse Quay
PO Box 996
Wellington 6140
New Zealand
T: +64 4 816 4500

Our ref: 170418BEPSIntLimitation

BEPS - Strengthening our interest limitation rules
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

19 April 2017

Dear Madam

KPMG submission on BEPS - Strengthening our interest limitation rules

KPMG is pleased to make a submission on the *BEPS – Strengthening our interest limitation rule* discussion draft (the "Document").

Summary of our submission

Our detailed submissions are attached. In summary:

— We endorse the rejection of an EBITDA based test for limiting interest deductions.

— We do not believe the interest rate cap proposal should proceed. The proposal seeks, in substance, to avoid globally agreed approaches to determining an arms-length interest rate. Any concerns about interest rates on related-party cross border funding should be should be resolved through orthodox transfer pricing analysis.

— If an interest rate cap proposal proceeds, the starting point for the analysis should be the standalone credit rating of the New Zealand borrower, notched up for parental affiliation and credit support, rather than notching down the ultimate parent's credit rating.

— We do not support a deemed maximum loan term of 5 years (or any maximum loan term) for setting interest rates. This is inconsistent with genuine commercial arrangements for which long term funding needs to be secured.

— Taxpayers should be able to rely on year-end values for asset and liabilities for calculating compliance with the debt to asset thin capitalisation safe harbour test. Removal of the year-end valuation option will impose compliance costs on the vast majority of compliant taxpayers for little gain.

In the Document and the accompanying discussion draft *BEPS – Transfer pricing and permanent establishment avoidance* there is an acknowledgement that the transfer pricing issues discussed are complex and resource intensive. We agree. However, the response appears to be legislate away complexity for Inland Revenue, such as with the interest rate cap proposal.

This is not the right approach in our view and risks uncertainty and double taxation for taxpayers (e.g. if the foreign jurisdiction does not accept the NZ interest rate cap as many are likely to). These issues are complex because the underlying transactions involving cross-border goods, services and financial flows are often complex. Deeming a simple answer does not address the core issues.

Instead, we strongly support Inland Revenue (and Government) investing in additional resourcing to meet these demands. This includes skilled investigators with sound commercial knowledge and transfer pricing experience. Both documents draw extensively on the current practice in Australia. We note the Australian Taxation Office is actively increasingly its resourcing in these complex areas and we believe it is imperative that Inland Revenue does the same.

Further information

Please contact us, John Cantin on (04) 816 4518, Bruce Bernacchi on (09) 363 3288, or Darshana Elwela on (09) 367 5940 if you would like to discuss our submission.

Yours sincerely

John Cantin
Partner

Bruce Bernacchi
Partner

KPMG's detailed submissions on the Document

Chapter 1 – Scope of review

Proposal

The proposals in the Document will apply to both foreign owned firms operating in NZ (i.e. inbound investment) and New Zealand firms with offshore operations (i.e. outbound investment in subsidiaries).

Submission

The proposals should be restricted to inbound investment only, until a considered approach to outbound investment can be developed.

Comment

We consider that the Document's base protection concerns do not exist with respect to outbound investment. For a start, we would expect Inland Revenue to have better information on cross-border funding arrangements where the parent lender is in the NZ tax base. This should allow Inland Revenue to evaluate the relevant transfer pricing risks more easily and efficiently than for inbound loans. This is also consistent with the different safe harbour thresholds, under the thin capitalisation rules, for inbound and outbound investment (where the threshold for limiting interest for outbound investment is higher).

If the proposals do proceed, we submit that inbound investment should be the sole focus of the proposal until a considered approach to outbound investment issues can be developed.

Chapter 2 - The New Zealand approach to thin capitalisation

Proposal

The Document does not consider whether New Zealand should change to an EBITDA-based rule. However, it considers that the current rules are working well and the preferred approach is to address specific problems rather than abandon the general framework

Submission

We agree that the current thin capitalisation approach is appropriate and submits that an EBITDA based rule for New Zealand be explicitly rejected.

Comment

As outlined in the Document, there are significant disadvantages to an EBITDA based test for limiting interest deductions, including the potential for interest deductions to be denied due to poor trading conditions and other factors that are outside the control of the business. In our view the disadvantages of an EBITDA-based rule outweigh any tax base protection advantages. We believe the current NZ group debt thin capitalisation safe harbour test, combined with the 110% worldwide group test, strikes the right balance.

For avoidance of doubt, our support for the current approach does not extend to the interest rate cap proposal in the Document, for the reasons discussed later in this submission. We would however welcome the opportunity to discuss alternative measures to prevent excessive interest deductions being taken against the NZ tax base. In our opinion developing a fair alternative should be the focus and the introduction of an EBITDA style test should be clearly rejected.

Chapter 3 - Limiting the interest rate on related party loans

Proposal

The Document proposes to cap the deductible interest rate on related party loans from a non-resident parent to a New Zealand borrower based on the credit rating of the parent. The Document explicitly states that this should not apply to outbound (from New Zealand) loans. For ease of reference, we have referred to this as the "interest rate cap" proposal in our submission.

Submission

We do not support the interest rate cap proposal. Interest rates on inbound related-party loans should be determined in accordance with normal transfer pricing principles, with appropriate resourcing of Inland Revenue's transfer pricing capability to resolve difficult issues.

Comment

Unprincipled approach

The justification given for an interest rate cap is that "while in principle transfer pricing should limit the interest rate, these rules are not always effective". This is the extent of the analysis in the Document in support of the interest rate cap proposal. In our view, it is insufficient to justify the implementation of a very blunt instrument.

We submit that the better response is appropriately resourcing Inland Revenue's transfer pricing capability to deal with these and other complex transfer pricing matters, not implementing arbitrary solutions like an interest rate cap. There is nothing to suggest that the relevant concern – high interest rates in conjunction with high gearing – cannot be managed through orthodox transfer pricing principles. This is what Australia and other countries do. The fact that New Zealand will be an outliner if the proposal proceeds – as no other country takes this radical approach to limiting interest deductibility – should be cause for concern.

Further, the interest rate cap is aimed at achieving a transfer pricing result which Inland Revenue already argues for, i.e. pricing inbound related party debt at little more than what a foreign parent can raise debt at has been Inland Revenue's stated position in a number of transfer pricing disputes. However, this has been framed in the Document as being a thin capitalisation measure, when it is clearly not. (Paragraph 3.49 of the Document which confirms the cap will not be subject to general transfer pricing adjustments confirms this – if these were separate issues, transfer pricing should not be impacted by the application of the cap.) This has wider implications, which we discuss below. The cap is at odds with the general tone of the other proposals in the Document, which seek to bring New Zealand further into line with OECD guidance on transfer pricing and the arm's length principle.

Inland Revenue will be able to argue it both ways – i.e. to arbitrarily limit high price inbound debt, while arguing that outbound loans should have normal transfer pricing rules applied (i.e. without an interest rate cap). This is conceptually flawed. It is at odds with the application of the arm's length principle. There should be no distinction in how the arm's length principle applies based on whether the loan is inbound or outbound. In our view, the proposal is unprincipled as a result.

"Dressing up" the proposal as a thin capitalisation anti-avoidance measure does not change the substance of the proposal. It is a derogation from the globally agreed arms-length principles.

This mis-labelling to justify a derogation, amongst other proposals in the BEPS documents, is a worrying trend. It is counter to principles of transparency and certainty.

The interest rate cap proposal echoes the OECD's proposal to allocate the global interest costs of a multinational across the jurisdictions it operates in. That proposal did not proceed because it required re-thinking of fundamental concepts – e.g. allowing deductions in excess of the amount actually incurred in New Zealand (if the allocation basis supports this) or allowing non-arm's length arrangements to allocate interest expense around the global group. For the same reasons that the interest apportionment proposal has not proceeded, the interest rate cap proposal should not proceed.

Double taxation risk

This proposal will naturally lead to a greater risk of double taxation. Foreign lenders will be required, under the transfer pricing laws that apply in their own jurisdictions, to charge an arm's length interest rate. If this rate is higher than what the proposed cap allows as a deduction in New Zealand (which would no doubt be a common occurrence) foreign lenders may be subject to income tax in their home country on the full interest rate charged, but would not be able to claim a full deduction in New Zealand. Further, NZ will also charge non-resident withholding tax on the full interest rate.

Such an outcome is possible under existing thin capitalisation rules, but foreign lenders can mitigate this by not leveraging up their New Zealand operations beyond the NZ safe harbour threshold of 60%. However, with an interest rate cap, any amount of debt funding (over the existing $10 million transfer pricing safe harbour for interest rates) will be subject to the cap, meaning even a relatively small amount of lending can result in a mismatch between global transfer pricing principles and New Zealand's thin capitalisation regime. Further, if the result is driven by a thin capitalisation adjustment in New Zealand, as opposed to application of arm's length transfer pricing principles, this means there is no recourse to Competent Authorities for resolution. This further supports the case for a transfer pricing solution to this issue.

Consistency with Australia and global practice

We note that throughout both the Document, and the accompanying discussion draft "*BEPS – Transfer pricing and permanent establishment avoidance*", there are repeated references to the Australian position. This is generally reasonable as Australia is one of our largest trading partners and comprises the lion's share of New Zealand taxpayers' related party cross border activities. (We have reservations regarding some of Australia's measures, particularly, where they depart from the global consensus – see our deemed PE submissions) However, the interest rate cap proposal is a substantial departure from the Australian position and given the substantial amount of cross border activity between the two nations, there is the very real risk of potential double taxation given the Australian Taxation Office's corresponding position on Australian transfer pricing.

Given the significant degree of co-operation between the Australian Tax Office and Inland Revenue, we would expect that trans-Tasman interest rate pricing issues should be relatively straightforward for the two revenue authorities to resolve using orthodox transfer pricing principles. The prevailing Inland Revenue view, which has been echoed in the accompanying discussion draft "*BEPS – Transfer pricing and permanent establishment avoidance*", is to encourage the use of Advance Pricing Agreements (APAs) to gain certainty. The interest rate cap proposal runs contrary to that view – its aim is to reduce administrative costs for Inland Revenue, at the expense of greater uncertainty and double taxation risk for taxpayers.

Further, a key objective of Inland Revenue's Business Transformation programme is more regular reporting of business information by taxpayers. This should mitigate some of the concerns raised around timely access to information to resolve transfer pricing and other complex tax issues.

Finally, other jurisdictions experience similar challenges, yet none have sought to introduce the concept of an interest rate cap in response to transfer pricing complexity. New Zealand should not be a "leader" in this respect. Particularly, as the introduction of a blunt and "unique" approach for limiting interest deductions is likely to be perceived unfavourably by our trading and investment partners. We believe this is ultimately likely to be detrimental for a small capital importing nation such as New Zealand. New Zealand should be making policy decisions that accommodate and encourage foreign investment, not penalising genuine funding arrangements by imposing arbitrary restrictions on how much interest can be claimed on debt funding.

One of our key competitive advantages is the ease with which companies can do business and the certainty of our tax and regulatory environment. That is, we do not generally do things which are outside of the international norm. We are too small a country to introduce laws that are unique. Where we have tried to be different, this has often been at an economic cost and has required reversion to the norm. The interest rate cap proposal risks a repeat of the original incarnation of our CFC rules, which saw New Zealand's rules described by many as the "Star Trek" approach to international tax reform. That is, the absence of an active/passive distinction in our CFC rules meant we boldly went where no-one had gone before in the design of a CFC regime, supposedly confident that other countries would soon follow. They did not and the regime was belatedly amended. New Zealand needs to learn from that experience.

For avoidance of doubt, we are not saying that BEPS concerns around excessively high interest rates on inbound related-party loans should be ignored. We believe the transfer pricing rules are the appropriate toolkit to deal with such concerns, and our experience with Inland Revenue is that these issues are well litigated in transfer pricing disputes.

The interest rate cap could be used as a safe harbour

While not our preference, the interest rate cap proposal could be included as an additional safe harbour for transfer pricing compliance.

It would reduce compliance costs for taxpayers that elect to apply it, as well as investigative time and effort for Inland Revenue. It would still allow taxpayers the ability to demonstrate that their interest rates are arm's length under normal principles. Not only would this better align the treatment of inbound and outbound debt, it would allow taxpayers to better manage their tax positions in other jurisdictions, and would still enable the use of Competent Authority processes to mitigate the risk of double tax.

Chapter 3 - Cap based on parent credit rating plus an appropriate margin

Proposal

To base the proposed cap on the interest rate that the borrower's ultimate parent could borrow at on standard terms.

The maximum deductible interest rate:

- where the ultimate parent of the borrower has a credit rating for senior unsecured debt, would be the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin.
- where the ultimate parent has no credit rating, would be the interest rate that would apply if the parent raised senior unsecured debt on standard terms, plus a margin.

The allowable margin would be limited to that which could be derived from appropriate bond yields one credit rating notch below that of the senior unsecured rating attributable to the ultimate parent.

Submission

If our above submission that the interest rate cap proposal should not proceed is rejected, the interest rate cap for a borrower that has an identifiable ultimate parent should be determined as follows:

- Step 1: the borrower's standalone credit rating should be determined using a globally recognized credit rating methodology (such as Standard & Poor's) without any account of parental affiliation.
- Step 2 the borrower's credit rating calculated under Step 1 should be increased by up to three notches, up to a maximum of one credit rating notch below that of the ultimate parent.

Comment

Proposal is inconsistent with principles of company law

Using the ultimate parent's credit rating as the starting point to derive an interest rate on New Zealand inbound debt is not desirable, regardless of the inclusion of an appropriate margin.

For a start, it is contrary to company law, endorsed in New Zealand courts, that treats subsidiaries as separate legal entities to their parent. It is in essence "piercing the corporate veil" by deeming a subsidiary to have almost no separate legal existence to its parent company.

More importantly, it implies that the New Zealand subsidiary has a similar business profile to that of the parent, which is often not the case. In general, the New Zealand operations of foreign multinationals are often several multiples smaller and will typically comprise a single function or asset, or at the very most a less diverse set of functions or assets when compared to the ultimate parent.

The existing transfer pricing approach for related party loans used by Inland Revenue, which starts with the borrower's credit rating is more in line with the arm's length principle. Not only does it give regard to the credit quality of the specific borrower, but it provides flexibility to notch the borrower's stand-alone credit rating upwards to reflect the specific circumstances of that company and its position in relation to the wider group. This approach is also more consistent with the credit rating analysis we would expect to see undertaken by a bank or other third party lender in practice. Further, such an approach does not preclude a credit rating being consistent with that of the ultimate parent should the facts and circumstances support such a finding.

Standard & Poor's guidance on credit ratings

Standard & Poor's "*Group Rating Methodology*" considers that no uniform approach exists when assessing a credit rating for a subsidiary in light of its parent's rating. Further, "*…no single factor determines the analytical view of the relationship with the business venture in question. Rather, these are several factors that, taken together, will lead to one characterisation or another*". This expressly indicates that such a "notching" process will depend largely on the facts and circumstances of the multinational in question, and that a uniform one notch downgrade from the parent's credit rating is not consistent with market and arm's length practice.

Further, Standard & Poor's also suggest that for a subsidiary to generally be rated the same as its ultimate parent or one notch below its ultimate parent, the subsidiary must either be considered:

- Core (i.e. integral to the parent group's current identity and future strategy); or

— "Highly Strategic" (i.e. almost integral to the parent group's current identity and future strategy).

Given the relative size of the New Zealand economy, with the possible exception of Australasian groups, generally it would be a gross exaggeration to describe the New Zealand subsidiaries of foreign multinationals as either core or highly strategic.

At best, we believe most New Zealand subsidiaries could be considered "strategically important" under the Standard & Poor's methodology, which describes such entities as *"less integral to the group than high strategic subsidiaries. The rest of the group is likely to provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support."* For strategically important subsidiaries, Standard & Poor's recommends generally increasing the stand-alone credit rating calculated for the subsidiary by three notches.

Further, increasing a subsidiary's credit rating by three notches is also consistent with global jurisprudence and, in particular, the decision in *Canada v. Generic Electric Capital Canada Inc.* ("GE Capital").

We consider that our alternative approach, if the interest rate cap proposal proceeds, will provide a result that is more reflective of arm's length and commercial principles, thereby enabling multinationals to better manage their global transfer pricing positions. In addition, we consider that our submission strikes the appropriate balance in allowing Inland Revenue to manage some of the key issues arising in its transfer pricing financing disputes.

Chapter 3 – Cap for borrowers with no identifiable parent

Proposal

Where a New Zealand borrower has no identifiable parent, the appropriate interest rate cap for related-party debt is to be determined based on the rate at which the New Zealand borrower could issue senior unsecured debt, with no margin.

The Document considers that there are two options to address the concern that the NZ capital structure may be manipulated:

— determine the borrower's credit worthiness based on an arm's length amount of debt, as determined under transfer pricing rules (this is the approach taken in Australia); or

— deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

Submission

If the interest rate cap proposal proceeds, where a New Zealand borrower has no identifiable parent, the appropriate interest rate should be determined with reference to the stand-alone credit rating for the borrower in relation to senior unsecured debt using an arm's length amount of debt.

Comment

We welcome the approach proposed in this instance insofar as it supports an assessment of the cost of borrowing by using the NZ borrower's stand-alone credit rating as the starting point.

We consider that basing such an assessment on an arm's length level of debt, as determined under transfer pricing methodologies, is the most principled approach.

This approach has been endorsed in Australia and, if adopted in New Zealand, would minimise the risk of double tax in the event of dispute. Further, consistent with our comments above, applying an arm's length level of debt is likely to result in the derivation of an interest rate that better satisfies the arm's length test in counter-party jurisdictions, thereby further minimising the potential for double taxation and disputes.

The alternative, treating related party debt as equity even where a NZ subsidiary's total debt (including the related-party debt) is within an arm's length level, is inconsistent with established market practice for establishing the debt capacity of capital structures. Notwithstanding limited exceptions, companies across all industries are funded by a combination of debt and equity. Whether debt is provided by third parties or shareholders should have no bearing as to the arm's length debt level of a company To ignore related party debt is therefore tantamount to taking a position that entities should be funded through equity and/or bank debt only, which is unrealistic.

Further, any assessment by a bank of an appropriate credit rating would take into account their estimate of an arm's length level of debt for the borrower, to ensure that they have adequately captured the borrower's risk of default, as well as ensuring that covenant levels have been appropriately set. As a consequence, observed market practice generally allows for an arm's length level of debt to be factored into any assessment of a credit rating.

Chapter 3 – Guarantee fees

Proposal

Guarantee fees will be limited to the margin allowable under the interest rate cap.

Submission

The treatment of guarantee fee should have regard to our submission above on the calculation of the interest rate cap for borrowers with an identifiable parent.

Comment

The allowable guarantee fee should be set by reference to normal transfer pricing principles. However, per our submission above that the cap should be calculated by reference to the NZ borrower's standalone credit rating being increased by three notches, up to a maximum of one credit rating notch below that of the ultimate parent, the treatment of guarantee fees should follow.

Chapter 3 - De minimis exclusion from the interest rate cap

Proposal

Where all cross-border related party debt is less than NZ$10 million, ordinary transfer pricing rules will apply, allowing a specific margin above the benchmark rate to be used.

Submission

We support the interest rate cap not applying in the above circumstances.

Comment

The de minimis is a sensible compliance cost reduction measure for companies with small amounts of inter-company debt.

Chapter 3 – Application of the General Anti-Avoidance Rule

Proposal

While a specific anti-abuse rule is not proposed, taxpayers breaking loans may be subject to application of the general anti-avoidance rule.

Submission

The application of section BG 1 in these circumstances needs to be carefully considered, as not all loan re-sets will be to take advantage of rising interest rates or borrowing margins.

Comment

The Document notes that breaking a loan may defeat the intention of the proposal and be subject to a section BG 1 challenge by Inland Revenue if done to take advantage of a higher interest rate environment.

Care needs to be taken as there may be genuine commercial reasons why borrowers and lenders will look to refinance early and/or renegotiate loan terms prior to the original maturity date. The general anti-avoidance rule should therefore only be applied where there is a clear purpose of avoiding the interest rate cap proposal.

Chapter 3 - Maximum loan term of 5 years

Proposal

For the purpose of determining the appropriate interest rate on a related party loan, any loans with a term of longer than five years will be treated as having a term of five years.

Submission 1

This proposal should not proceed.

Submission 2

If our primary submission is not accepted, there should be carve outs for:

- long term infrastructure projects, such as debt funding for Public Private Partnerships;
- finance leases; and
- life financial reinsurance.

Comment

While we acknowledge that commercial loans terms generally do not exceed five years, there will be sound commercial reasons for some loans having longer terms. Typically this will be because the loan will be funding an asset or project with a life in excess of five years and security of funding for the asset/project is desirable throughout the entire period. Independent lenders will also generally be willing to lend if the lending is effectively secured against a tangible asset. Therefore, we do not support an artificial requirement for the interest rate to be based on a loan term of 5 years, where the actual term is longer (and potentially significantly longer).

In the event that our principal submission is not accepted, exceptions should be made for infrastructure projects and finance leases.

In the case of infrastructure projects, these are inherently long term (10 years plus) in nature and project owners and operators will want to ensure continuity of funding throughout the life of the project. This is particularly important as the NZ Government is actively pursuing Public Private Partnerships (PPPs) to fund key New Zealand infrastructure needs. To the extent that non-resident capital is required to fund PPP investments, the proposal will simply pass the cost back to Government (and ultimately the NZ taxpayer) as this will impact the rate of return on such projects.

In the case of finance leases, the deemed loan from the lessor to the lessee would be caught by the interest rate cap proposal. Where a finance lease has been entered into on normal commercial terms, pricing of the lease should be able to be undertaken with reference to the actual lease term, rather than a 5 year cap.

In the case of life financial reinsurance, the "loan" term will vary with the performance of the underlying book. Life insurance business and reinsurance is typically written over a long term view of how the policies will perform. A five year limit is uncommercial. (Further, the interest rate will reflect commercial perceptions of risk of the book rather than perceptions of credit worthiness. This further justifies an exclusion.)

Chapter 3 – Consistency of the interest rate cap proposal with New Zealand's tax treaties

Proposal

The interest rate cap is considered consistent with New Zealand's double tax agreements (DTAs) including the articles referring to the arm's length principle

Submission

The analysis in paragraphs 3.58 and 3.59 is contradictory. The proposed cap cannot both be consistent with the arm's length principle and override it.

Comment

Paragraph 3.58 and other parts of the Document state that the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Paragraph 3.59 states that the interest rate cap is a domestic anti-avoidance rule.

However, the interest rate cap cannot both be consistent with the arm's length principle and override it. We consider that it is not consistent with our DTAs.

This highlights the unprincipled nature of the proposal – it is being promoted as something that it is clearly not. This is simply an attempt to justify an override of DTAs.

For completeness, we disagree with the characterisation in 3.58. If this really was the case the interest rate cap would not be necessary. If the interest rate is arms-length it should be deductible. We consider the characterisation at 3.59 to be closer to what is being proposed. However, it is difficult to see the rue as an anti-avoidance rule if the interest rate is arms-length. The "anti-avoidance" label applied by Officials seems to be no more than a complaint that transfer-pricing for related party debt may be difficult. That is not a principled position for the proposals. (See also our transfer pricing submissions.)

Chapter 4 – Treatment of non-debt liabilities

Proposal

Non-debt liabilities (other than interest-free shareholder loans) will be deducted from an entity's gross assets when calculating the thin capitalisation safe harbour test. The result will be that the thin capitalisation safe harbour test will measure assets net of non-debt liabilities.

Submission

Deferred tax liabilities should not be deducted from gross assets.

Comment

We agree that it is appropriate to deduct non-debt liabilities, such as trade credits and provisions, from gross assets in measuring compliance with the thin capitalisation safe harbour test. This would make the calculation more akin to a debt to equity test (which is commonly used internationally) and align more closely with the thin capitalisation regime in Australia.

However, there should be no adjustment for deferred tax liabilities. The Document states that non-debt liabilities can be used to artificially inflate balance sheet gross assets to allow an entity to pass the safe harbour test (e.g. through the use of trade creditors to buy a significant amount of assets just before year end). It provides no support for such a statement. We consider that such a practice is rarely found in practice. There are commercial constraints to such acquisitions. Materially, the company must pay the trade creditors. The concerns are overstated. See further for our comments on the measurement date proposals.

Assuming this concern is valid, it does not exist with respect to deferred tax liabilities. They typically arise due to timing differences between accounting and tax income and expenditure recognition rules and to different assumptions being used for financial reporting and tax purposes. They arise therefore due to the tax rules themselves as opposed to any structuring. They are not a de facto means of financing the ownership of assets. Deferred tax liabilities should therefore be excluded from non-debt liabilities deducted from an entity's gross asset balance.

Chapter 5 – Infrastructure projects controlled by single non-residents

Proposal

Single non-resident investors will be able to breach the 60 percent safe harbour test in respect of third-party funding for infrastructure projects that meet certain criteria.

Submission

While we support the exemption for single non-resident controllers, we believe the exemption should be aligned with that for "non-resident owning bodies".

Comment

Where the NZ investment is by a group of non-residents acting together (i.e. the group meets the non-resident owning body definition), there is presently the ability to exclude third party debt from the application of the thin capitalisation rules. This is without regard to the nature of the underlying investment. We believe the proposed exemption for single non-resident controllers should be similarly broad. (We believe this is further buttressed by the proposal to exclude any related-party debt from both calculations.)

Chapter 5 – Removal of the year-end measurement option

Proposal

Taxpayers will only be allowed to measure compliance with the thin capitalisation safe harbour tests using the average of daily or quarterly values for asset and liabilities. The year-end measurement option will be removed.

Submission

The proposal should not proceed. Taxpayers should continue to be able to use year-end values for assets and liabilities in determining compliance with the capitalisation safe harbour tests.

Comment

The Document states potential abuse of the year end valuation option as justification for its removal. Further, the Document refers to the current specific anti-abuse rule being in-effective.

We are not aware of any specific examples of abuse of this rule, let alone that such abuse is widespread or that Inland Revenue has unsuccessfully attempted to apply the specific rule.

We assume that taxpayers are considered to be "gaming" the rules by, for example, by paying down related-party debt prior to balance date and then re-financing at the start of the following year. We are not convinced that this is an example. The payment would need to be sourced from either debt or equity. If it is debt, the thin capitalisation rules would still apply. If it is equity this is more likely to be long term equity for which no deduction is available. On these assumptions it is difficult to see why the specific rule would apply. If there is more, past history would suggest that Inland Revenue would seek to apply the general anti-avoidance rule to deny interest deductions. It may be able to apply the existing anti-abuse provision.

It would seem to us that strengthening the specific rule rather than penalising the vast majority of (fully compliant) taxpayers with increased compliance costs is a better approach. However, as Officials specific concerns are unclear, we are not in a position to comment on what those amendments should be.

The use of year end values is a pragmatic feature of New Zealand's thin capitalisation rules as it allows taxpayers to use the balances in their financial statements, which they will have already had to produce and in many cases will have been audited. Quarterly or daily management accounts, which would necessarily be what the averaging calculations will be based on, do not undergo the same degree of scrutiny and review as year-end figures for many taxpayers.

Such accounts also do not necessarily apply the full valuation and other judgements that are applied to year-end financial statements. This may under or over value assets at each of these measurement dates. They will provide no more accurate measure than a year end test. The result would be the use of less reliable data or the introduction of costly rules requiring the production of more robust daily or quarterly financial data.

We further note that the proposal to include non-debt liabilities as a deduction to assets will constrain the ability of companies to excessively gear their New Zealand operations. To the extent that, for example, acquiring assets through trade credit at year end is a real concern, that problem is already dealt with by the non-debt liabilities proposal. We consider that the trade-off for that proposal is to retain the year-end valuation option.

#012

Plenary Origination Pty Ltd

Level 43, Rialto South Tower
525 Collins Street
Melbourne VIC 3000 Australia

Telephone +61 3 8888 7700
Facsimile +61 3 8888 7701

www.plenarygroup.com

18 April 2017

Hon Steven Joyce – Minister of Finance
Hon Judith Collins – Minister of Revenue

Inland Revenue
PO Box 2198
Wellington 6140

Dear Hon Steven Joyce, Hon Judith Collins,

Plenary's submission on "BEPS – Strengthening our interest limitation rules" Discussion Document

Through our engagement with Dan Marshall and Treasury's PPP unit, we welcome the opportunity to make a submission in relation to Inland Revenue's discussion document around the strengthening of New Zealand's interest limitation rules from the perspective of a long term infrastructure investor. Plenary has reviewed the document and notes the following:

i. Plenary primarily invests in availability infrastructure PPPs which is typically more highly geared than other 'real' asset classes and as such we will always need to consider rules around interest limitation and denial in each specific jurisdiction in which we operate. We positively view the NZ Government acknowledging the need to treat qualifying infrastructure projects as needing a special thin cap rule due to the potential gearing outcomes.

ii. Plenary agrees with 5.7; non-recourse, third-party project financing used in funding infrastructure projects presents minimal risk of BEPS.

iii. A minor comment in relation to 5.10 and 3.8 around the "commerciality" of debt and debt terms specific for infrastructure project investment – infrastructure investments typically have a defined maximum investment horizon, ie the concession term. As such, an infrastructure investor may elect to pay a premium for extending the tenor of debt which de-risks the investment from a refinancing point of view, closer aligning assets and liabilities.

iv. In relation to 5.12 and noting the current framework described in 5.8, 5.9, 5.10, and 5.11, Plenary welcomes the proposed carve-out for infrastructure projects with third-party financing. Reliance on an overarching and blunt instrument such as a worldwide gearing test (at the current threshold) may in some circumstances result in suboptimal outcomes if as a result of interest limitation or denial (as a result of infrastructure related genuine, third-party, non-recourse financing), projects are forced to de-leverage beyond what could be commercially achieved given its risk profile.

   This infrastructure carve-out will address current issues around thin capitalisation in relation to investments controlled by a single non-resident, levelling the playing field and making New Zealand an even more attractive investment destination. It will also ensure New Zealand infrastructure is delivered with optimal capital structures. This proposal ultimately gives greater flexibility than at present and also assists with the secondary market for equity transfers.

Also in relation to 5.12, we recommend that the proposal should be implemented to ensure Limited Partnerships undertaking a qualifying infrastructure project to be the tested entity rather than tracing through and testing the individual partners comprising the Limited Partnership.

On a connected note, in relation to 5.13 we acknowledge the proposal that the thin capitalisation exemption is limited to third party debt and would not apply to non-qualifying debt such shareholder loans.

v. In response to 5.17, the conditions contained in 5.12 are sufficient from Plenary's point of view to very precisely define the form of project where the proposed carve-out would apply. We do note that the criteria should be should be sufficiently wide to include Local Authorities as well as Central Government.

vi. Further to our above point (v), in relation to 5.15, 5.20, and 5.21, we understand that for a group of non-residents holding a controlling interest acting together are already 'effectively exempt' from thin capitalisation rules. Given the clear conditions proposed in 5.12 and how the proposed carve-out would operate, Plenary's position with respect to infrastructure projects is that for clarity and simplicity of application of intent, the carve-out should extend to all infrastructure projects which meet the conditions in 5.12 irrespective of equity holding structure.

This should not contravene the intention of guarding against BEPS while ensuring government sanctioned infrastructure projects are not incorrectly penalised.

vii. There are instances for infrastructure projects where at the suggestion of the procuring government authority, all senior debt is replaced with the full use of government funding on the basis that the government can borrow at cheaper rates than the private sector. In this circumstance, a superior outcome for government would be achieved if there was no interest limitation on related party non-recourse financing – in the context that the government would be the ultimate beneficiary of a more cost effective offering from the private sector.

Plenary appreciates the constructive steps Inland Revenue is taking to strengthening New Zealand's interest limitation rules in a considered manner with reference to international best practice and guidance, and we see the positions put forward in the Discussion Paper with respect to infrastructure project finance as positive for direct inbound investment into New Zealand.

Please do not hesitate to contact me on 9(2)(a) [redacted] should you wish to discuss our submission further.

Yours sincerely,

Paul Crowe
Executive Director
Head of Origination
Plenary Group

#013

BEPS – Strengthening our interest limitation rules

20 April 2017

Chartered Accountants Australia and New Zealand

Level 1, Carlaw Park, 12-16 Nicholls Lane, Parnell,
PO Box 3334, Shortland Street, Auckland 1140, New Zealand
0800 469 422   P +64 9 430 8859

charteredaccountantsanz.com

20 April 2017

BEPS – Interest limitation rules
c\- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath,

BEPS – Strengthening our interest limitation rules

CA ANZ welcomes the opportunity to respond to proposals in the Government's Discussion Document on BEPS – Strengthening our interest limitation rules.

We support the Government's work to combat BEPS by reducing the opportunities that allow multinationals to inflate interest deductions artificially and shift profits offshore. Our submissions are aimed at helping the Government ensure the reforms fit within New Zealand's overall tax framework and do not unduly discourage the foreign investment needed for a small capital importing economy like New Zealand.

Striking balance – attracting foreign investment and collecting 'reasonable' amount of tax

The Discussion Document acknowledges that the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest while recognising it is important that firms operating here pay "a fair amount of tax". The Government also considers our current approach to limiting interest deductions is working well but needs to be bolstered by rules to restrict the ability of taxpayers to use excessive interest rates for related party loans.

We commend the Government for not proposing to adopt the OECD recommended approach of using an EBITDA-based rule. In our view an EBITDA-based rule is not appropriate for New

Zealand and the disadvantages of such a rule (such as the loss of interest deductions during periods of poor trading conditions) outweigh any benefits.

However, we have a number of concerns with the proposals raised in the Discussion Document, which, if implemented, could have significant and far-reaching consequences for many taxpayers.

Our principal concern is that the interest rate cap approach is a blunt instrument. Perhaps it is for this reason that only New Zealand appears to be planning to implement such a rule. We are also concerned that the proposal is not accompanied by any analysis or examples of the practical difficulties that arise in the application of the transfer pricing rules, which is the stated justification for the cap. This lack of analysis makes it difficult for us to support the proposed solution.

The Discussion Document notes the transfer pricing rules require taxpayers to adjust the price of cross-border related party transactions so it aligns with the arm's length price that would be paid by a third party on a comparable transaction. We do not think the revised transfer pricing rules should be dismissed as an effective solution. In our view, the revised transfer pricing rules are the appropriate rules for dealing with excessively-priced debt.

The interest rate cap proposals effectively intermingle two policy initiatives. The first is a change to the measurement of debt levels for thin capitalisation purposes and is targeted at the volume of debt on taxpayers' balance sheets. The second is an interest rate limitation which, although framed as such, is not a thin capitalisation measure. It is a transfer pricing measure aimed at the pricing of debt, and is a wholly arbitrary measure, quite inconsistent with the arm's length principle which underpins all other transfer pricing and anti-avoidance rules.

It appears to us that a key driver for this proposal may be lack of appropriate Inland Revenue resourcing for transfer pricing matters. If so, that issue should be addressed directly. An arbitrary attempt to cap New Zealand interest deductions in order to simplify the administrative burden on Inland Revenue at the cost of uncertainty and almost certainly double tax for taxpayers if the cap is disregard by other jurisdictions, as is likely to be the case, is not an appropriate solution.

The Government is proposing to strengthen the transfer pricing rules including by adopting economic substance and reconstruction provisions similar to those in the Australian rules. Given these additional measures and measures in line with other BEPS Actions that address base erosion issues arising in respect of interest deductibility, we do not believe the interest rate cap approach is needed.

Changes to the measurement of volume of debt

We are also concerned that the proposed changes could affect perceptions of New Zealand as a destination for foreign capital that boosts investment in the economy. One of New Zealand's advantages is the ease of doing business here, which is facilitated by our generally well regarded and certain tax and regulatory frameworks. New Zealand is well regarded partly because it is not seen as being out of step with international norms. The interest rate cap approach will mean New Zealand is seen as being out of step, and, under the current proposals, funding will almost always result in some element of double taxation. This may directly affect foreign investment in New Zealand and increase the cost of capital with any additional funding costs being passed on to local consumers. Furthermore, the proposals will result in double tax becoming mainstream, rather than something that occurs at the margins.

We address the specific issues raised by the interest rate cap proposal in the attached Appendix.

Please note, that given the significant workload on our advisory group members, our submission is of necessity a preliminary response. We may raise other issues once we have had more to consider the detail.

We would be happy to discuss our submission with you and look forward to the opportunity to do so.

Yours sincerely

T Welham

Teri Welham
Senior Tax Advocate

Paul Dunne
Chair, New Zealand Tax Advisory Group

Appendix

Chapter 2: New Zealand's approach

We agree that the current thin capitalisation approach is appropriate and submit that the EBITDA-based rule is inappropriate in a New Zealand context. The disadvantages to an EBITDA approach as outlined in the Discussion Document convince us that this approach is not appropriate for New Zealand. However, this does not mean we support an interest rate cap approach.

We are concerned that the Discussion Document considers there are only two solutions to address a relatively minor problem for a limited number of firms that borrow from their foreign parents at high interest rates which results in very large interest rate deductions. The Discussion Document agrees that the problem is not the volume of debt but the measurement of the impact of the interest rate (pricing of the debt) which is a transfer pricing issue. In our view it is more appropriate for the interest rate between related parties to be addressed via transfer pricing rules.

We are concerned that the effect of shifting to arm's length conditions for the transfer pricing rules is not discussed. We note Australia has decided it is comfortable relying on its MAAL, arm's length debt and the thin capitalisation rules. The Australian Government also considers it is unnecessary to take any further action in relation to related-party debt. Australia relies on its transfer pricing rules to set the appropriate pricing of debt.

Furthermore, we note that the OECD proposals are not mandatory and they are driven by European interests and principles.

We consider it appropriate for New Zealand to rely on the transfer pricing rules to price related party debt. If debt pricing is a significant issue the Government should increase its investment in, or transfer resources to, the transfer pricing area as part of Inland Revenue's Business Transformation.

Chapter 3: Limiting interest rate on related party loans

Proposal: Is the proposed cap broadly the right approach?

The Government is not convinced that the transfer pricing rules are the most effective way to prevent profit shifting using high-priced related party debt.

Submission

The proposed interest rate cap is not the right approach to address concerns about high-priced related party debt.

Comment

CA ANZ acknowledges concerns that related party loans and interest deductions can be used to shift profits, as can pricing of other related party transactions. However, it seems clear from the available evidence and Inland Revenue's own research that the vast majority of related party debt does not result in base erosion or profit shifting. Most groups use related party debt because this is the easiest and most convenient method of financing business activities.

The comment at paragraph 3.17 that the interest rate cap "should generally produce a similar level of interest expense as would arise in arm's length situations" is concerning and plainly wrong in respect of the interest rate cap methodology proposed.

The notion of capping the borrower's interest rate at the rate that their ultimate parent could borrow at does not reflect commercial reality.

Often the parent and New Zealand subsidiary will be involved in significantly different operations. Generally, the New Zealand operations – functions and assets – will be an order of magnitude smaller than the multinational parent's functions and assets and most likely more constrained. In other words, the subsidiary company's role is likely to be narrower than the parent's. Many New Zealand subsidiaries, by virtue of profitability, industry or country specific or local market factors, will have a much lower standalone credit rating relative to their parent. Intrinsically, the ultimate foreign parent is not the correct benchmark.

Inefficient allocation of capital

As well as additional compliance costs, an interest rate cap could result in an inefficient allocation of capital because:

1. the proposals require parent companies to credit enhance their subsidiaries to one credit rating notch below the parent; or
2. depending on the actual credit rating of the subsidiary, third party debt may be preferred over related party debt even if, under the proposals, third party debt is more expensive than related party debt.

The subtext of the analysis in the Discussion Document, which is unclear in parts, suggests that related parties will include terms and conditions in loans between each other that will have the effect of overstating the interest rate as compared to what an arm's length scenario would provide. There is also a perception by Inland Revenue that, because the interest rate is within the control of related parties, it is a relatively straight forward or simple process to overstate the interest rate. The interest rate cap is seen as a way of addressing those issues without having to consider the appropriateness or otherwise of subordination, or not, of those terms and conditions.

The proposal, at paragraph 5.41 of the Discussion Document "BEPS - Transfer Pricing and Permanent Establishment Avoidance", to amend the transfer pricing rules to refer to arm's length "conditions" will address the issues that the Government is concerned about. We are surprised that this Discussion Document does not consider the effect of the other proposals released at the same time because they will have a material effect on the interest rate. This is what is happening in Australia. The Australian Tax Office is using transfer pricing methodologies to challenge the terms and conditions of related party loans. It also has an arm's length debt test.

In our view the effect of the overall package of measures and particularly the effect of the transfer pricing rule changes will be to obviate the need for the interest rate cap.

Double taxation

CA ANZ is deeply concerned that, as presently formulated, the proposals will give rise to significant elements of double taxation.

We consider the proposal will create a real risk of groups not being able to achieve an appropriate deduction for their related party interest expense and will create the potential for double tax to arise. This double taxation is not at the margins. Rather it will arise in almost all instances where a subsidiary's credit rating is more than one notch below its ultimate parent company's own credit rating and the loan counterparty is in a jurisdiction with modern transfer pricing rules.

The double tax issue is most likely to arise because a foreign country will require an arm's length interest rate whereas New Zealand will operate to deny a deduction. We suggest consideration should be given to whether an exclusion from the interest rate cap proposals for countries with a modern transfer pricing regime (that could take the form of a grey list or white list) is appropriate. There does not seem much point in denying what is an arm's length interest rate when the other country is going to tax the interest in full.

Single entity

An interest rate cap based on the parent's credit rating seems to assume that a group is in effect a single entity and ignores the fact that groups are made up of separate legal entities, and the transactions between them are real both legally and contractually.

These contractual arrangements will still be taken into account when pricing the loan in the parent's home jurisdiction, under normal transfer pricing principles. As discussed below, given the nature of New Zealand business operations, it is unlikely that a New Zealand subsidiary will enjoy a credit rating one notch below its parent, with the consequence that there may be a mismatch between the New Zealand treatment and the treatment in the parent's jurisdiction.

Compliance costs

The proposal will also add considerable compliance cost to businesses, particularly as the approach proposed, the interest rate cap, is unique to New Zealand. Furthermore, the level of disputes with lender countries is likely to increase, particularly as the New Zealand adjustment will arise under our thin capitalisation rules, limiting the ability for Competent Authority resolution (which would be available if the dispute was in relation to differences in transfer pricing approaches).

Transfer pricing rules

In our view the transfer pricing rules are a better way of tackling the problem than an interest rate cap. The proposals to strengthen the transfer pricing rules should assist with ensuring that excessive interest costs are not allocated to the New Zealand tax base. We question the need for an interest rate cap approach in these circumstances.

Proposal: Should cap be based on parent credit rating or something else?

To limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower to the interest rate that the borrower's ultimate parent could borrow at on standard terms. That is, where the ultimate parent of the borrower has a credit rating for senior unsecured debt, the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin. Government considers that the interest rate a multinational could obtain is a reasonable approximation of the multinational's cost of funds.

Submission

If the interest rate cap proposal is implemented, logically the parent company credit rating is a starting point. The issue is not so much whether the interest rate cap is based on the parent company's credit rating but which adjustments should be made to that credit rating.

Comment

The proposed approach makes an adjustment based on five year senior debt. The interest rate cap should not be based solely on the parent company's credit rating but on its credit rating and several other factors. An interest rate cap should not be based on only one factor.

In our view, basing the interest rate cap on the parent company credit rating is incorrect. State Owned Enterprises are a good illustration. Under the proposed approach the credit rating of SOEs would be one notch below Sovereign. Based on Inland Revenue analysis the failure of Coalcorp would not have happened. Parent company support is not implicit even in a Government context.

Proposal: What is the appropriate margin?

A margin be added to the interest rate at which the borrower's ultimate parent could borrow on standard terms.

Submission

If, contrary to our submission, the interest rate cap is implemented, the margin should be at least greater than 2 credit notches. Ideally, the margin should accord to debt on arm's length terms and conditions.

Comment

The incoherence of the proposal in a policy sense is demonstrated by the fact Officials have confirmed that, if the situation were reversed, and outbound debt was subject to foreign interest limitations, New Zealand's expectations will not be influenced and an arm's length amount would be levied on the loan and treated as taxable income in New Zealand. Accordingly, an interest rate cap cannot by definition make an arm's length interest rate unless the company did more to enhance the credit. New Zealand cannot have it both ways.

Design of cap

Proposal: Borrowers with no identifiable parent

When a New Zealand borrower has no identifiable parent, the appropriate cap for related party debt will be determined based on the rate at which the New Zealand borrow could issue senior unsecured debt.

The Discussion Document considers that there are two options to address the concern that a New Zealand company may be loaded with uncommercial levels of debt to push down its creditworthiness:

1. determine the borrower's credit worthiness based on an arm's length amount of debt, as determined under transfer pricing (this is the approach taken in Australia); or
2. deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

Submission

If the interest rate cap proposal is implemented, the appropriate cap for a borrower with no identifiable parent should be based on the rate at which the New Zealand borrower could issue senior unsecured debt using an arm's length amount of debt as determined under the transfer pricing rules.

Proposal: "meaning of related party"

For the purposes of the interest rate cap, a loan that originates from a member of the firm's worldwide group, member of a non-resident owning body or an associated person of the group or body will be treated as being from a related party.

Submission 1

We support the proposed definition of "related party".

Submission 2

We recommend consideration be given to allowing taxpayers to be excluded from the related party debt rules when a loan is provided on an arm's length basis without any reference to the related party.

Comment

We consider that, because there is no mischief, taxpayers should not be subject to the related party debt rules when a loan is provided on an arm's length basis without reference to the related-party. For example, a parent company is in the business of lending and lends to a related party on the same terms and conditions as a third party without regard to the fact the borrower is related.

Proposal: treatment of guarantee fees

Guarantee fees cannot be greater than the margin allowable under the interest rate cap.

Submission

The treatment of a guarantee fee should be consistent with the approach to setting the interest rate cap.

Proposal: De minimis

To reduce compliance costs for smaller firms, the ordinary transfer pricing rules will apply where the principal of all cross-border related-party loans is less than $NZ10m.

Submission

We support the proposal to include a de minimis. Consideration should be given to increasing the de minimis threshold for countries with a modern transfer pricing regime (that could take the form of a grey list).

Proposal: Override of transfer pricing rules

The interest rate cap will override the general transfer pricing rules.

Submission

We do not support the proposal for the interest rate cap to override the general transfer pricing rules.

If the interest rate cap is implemented, it should be part of the transfer pricing rules, not an override.

Comment

The interest rate cap is not a thin capitalisation measure. Rather it is a transfer pricing measure. We are concerned that the implications of the proposed changes to the transfer pricing rules have not been factored into these proposals.

Proposal: No specific anti-avoidance rule

A specific rule will not be introduced to prevent taxpayers from breaking loans to take advantage of increasing interest rates or borrowing margins. The general anti-avoidance rules could be used.

Submission

We support the proposal not to introduce a specific anti-avoidance rule.

Comment

The proposals are anti-avoidance rules and we do not believe it is appropriate to have a further anti-avoidance rule.

We are disappointed with the way the Discussion Document describes the circumstances in which the general anti-avoidance rule might apply. The example at paragraph 3.51 is not supported by any analysis and does not reflect the hallmarks of anti-avoidance. We would be very concerned if that depth of analysis is sufficient for investigators to raise assessments against taxpayers for changing loans. The example at paragraph 3.51 does not reflect commercial reality when a loan term may be broken to take advantage of a longer term benefit.

Proposal: Maximum loan term

A related-party loan with a term of longer than five years will be treated as having a term of five years for the purpose of determining the appropriate interest rate.

Submission

The proposal should not proceed.

Comment

The loan term, on which the interest rate is priced, should reflect the commercial conditions underlying the funding arrangement and/or nature of the asset being financed (e.g. infrastructure).

There is no commercial or policy basis for concluding that it is unusual for a commercial loan to be longer than 5 years. We note the following bond issues all have terms longer than 5 years:

- Z Energy
- Genesis Energy
- KiwiBank
- Auckland Airport
- Vector Ltd
- Meridian Energy
- Air New Zealand

Furthermore, certain Government bonds are issued for 10 years or more.

Proposal: No transitional rule

There will be no transitional rule for existing related-party cross border financing arrangements.

Submission 1

The proposal is acceptable for inbound investment provided the application date is sufficiently prospective so taxpayers can reexamine and reorganise their loans and this is expressly contemplated in the legislation and interpretative documents.

Submission 2

The Government should consider carrying out a separate review of the outbound rules.

Proposal: Consistency with New Zealand DTAs

The interest rate cap is consistent with New Zealand's double tax agreements, including articles relating to the arm's length principle.

CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

Submission

We disagree with the assertion that the interest rate cap proposal is consistent with New Zealand's double tax agreements.

Comment

We understand the Government's position is that the interest rate cap proposal is consistent with the arm's length principle or, to the extent it goes beyond a strict application of the arm's length principle, is a domestic anti-avoidance rule and therefore is not subject to our double tax agreements (DTAs). It is plainly evident that these proposals do not create an arm's length interest rate. Therefore the only basis for overriding the DTAs is avoidance. We suggest the proposals are re-examined.

In an environment where there is a significant amount of work being undertaken to address hybrid mismatches that involve double deductions, non-inclusion or double non-inclusion, we do not believe it is appropriate for the Government to put out a proposal that makes double tax more likely than not.

Chapter 4: Treatment of non-debt liabilities

Proposal: assets to be measured net of non-debt liabilities

To require an entity to deduct its non-debt liabilities (e.g. provisions, deferred tax) from the gross asset value.

Submission 1

In broad terms we support the proposal. However, we believe the measurement rules are not correctly defined.

Submission 2

Further more detailed work should be undertaken, with consideration being given to the issues referred to below.

Submission 3

Provisions that do not involve the diminishing of funds, such as deferred tax, should be excluded.

Comment

Paragraph 4.24 implies that the proposal to deduct non-debt liabilities is based on the Australian approach. However, we note that the Australian exclusions that make the rule workable have not been included. We suggest provisions that do not involve the diminishing of funds should be excluded, for example, deferred tax.

We recommend the proposals be examined further. From a public policy perspective, a measurement rule that will closely align arm's length volume of debt with an organisation's ability to borrow on an arm's length basis would be appropriate. We do not consider the proposals achieve that.

We suggest consideration be given to the following issues:

- the effects of the proposal will be uneven across industries. For example, those with high provisions and liabilities, such as distributorships and insurers, will be most affected. We recommend consideration be given to including industry specific concessions to minimise anomalies;

- lenders focus on cash flow as well as an entity's balance sheet. Paragraph 4.11 fails to recognise this issue;
- the valuation of assets will be important because not all organisations are subject to financial reporting rules which allow for and encourage the recognition of intangibles; and
- thin capitalisation is compromised when assets are undervalued.

Finally, we also recommend that the effect of the hybrid proposals be considered when establishing what counts as debt and what does not.

Proposal: No grand-parenting proposed

No grand-parenting for existing arrangements.

Submission 1

The proposal is acceptable provided the implementation date is sufficiently prospective to allow taxpayers to review and rearrange their affairs.

Submission 2

The Government should reconsider the application date, particularly in relation to outbound investments.

Comment

The implementation date could be a 2 year moving average to mitigate the effect of short term fluctuations.

Proposal: Industry specific rules – are they required for insurers, miners, SMES

Specific rules are not necessary for any industry.

Submission

We recommend you consult directly with industries that have significant levels of provisions such as insurance, long term construction, SMEs and 'tech' industries and those entities that have balance sheets that are evolving or based on future cashflows, for example start-ups and crowdsourced activity.

Chapter 5: Other matters

Proposal: De minimis for inbound thin cap phased out same as for outbound

To extend the existing de minimis in the outbound rules so that it applies to inbound entities as, well provided none of the entity's debt is owner-linked debt.

Submission 1

We support the proposal to extend the de minimis rules to apply to inbound entities.

Submission 2

Consideration should be given to simplifying the inbound and outbound de minimis rule to $2m of interest deductions.

Proposal: Infrastructure projects controlled by single non-resident

To allow the 60% safe harbour to be exceeded in relation to public-benefit projects that meet a number of specified criteria, because such projects are considered unlikely to present any BEPS risk.

Submission

We consider the targeted exemption is appropriate but the effectiveness of the proposed exemption will be very dependent on how the exemption will work in practice.

Proposal: Non-residents acting together – restriction

To amend the rules for entities controlled by a group of non-residents acting together. If an entity exceeds the 60% safe harbor, any owner-linked debt will be non-deductible.

Submission

We support the amendment. The amendment will provide certainty to investors.

Proposal: Asset valuations - removing net current value method

To remove the net current valuation method from the list of available asset valuation methods.

Submission 1

We oppose the removal of the net current valuation method.

Submission 2

If more robust valuations are needed, we recommend the net current valuation rules be amended to achieve this objective.

Comment

We believe the removal of the net current valuation method is inappropriate and the reasons put forward are not persuasive. The ability to use net current asset values allows an entity to use a better proxy for the market value of assets if such market values are not reflected in financial statements. Not all taxpayers are subject to financial reporting rules.

The removal of the net current valuation method will

- affect those who do not have cash generating assets on the balance sheet;
- create issues for SMEs;
- add complexity; and
- increase compliance costs.

Proposal: Measurement date for assets and liabilities – removing option to measure on last day

To no longer allow entities to value their assets and liabilities on the last day of their income year. Instead, taxpayers will be expected to value their assets and liabilities either on a daily or quarterly basis.

Submission

We do not support the proposal to remove the option that allows taxpayers to value their assets and liabilities on the last day of the income year.

We suggest that, as an alternative, consideration should be given to allowing taxpayers to value their assets and liabilities based on a moving average.

Comment

The removal of the option that allows entities to value their assets and liabilities on the last day of their income year is impractical. Taxpayers will not want to incur the significant compliance costs involved in measuring their assets on a daily basis for tax purposes. It is also highly unlikely that they will have sufficient information for daily valuation of assets and liabilities.

If Government is concerned about taxpayers bed and breakfasting loans, anti-avoidance rules are more appropriate than increasing compliance costs for all.

Proposal: Remedial re trusts and owner-linked debt

To amend s FE 18(3B) so it operates clearly in relation to trusts.

Submission

We support the proposal to amend s FE 18(3B) to ensure it operates clearly in relation to trusts.

Chartered Accountants Australia and New Zealand

Level 1, Carlaw Park, 12-16 Nicholls Lane, Parnell,
PO Box 3334, Shortland Street, Auckland 1140, New Zealand
0800 469 422   P +64 9 430 8859

charteredaccountantsanz.com

#014

Ernst & Young Limited
100 Willis Street
Wellington 6011 New Zealand
PO Box 490 Wellington 6140

Tel: +64 4 499 4888
Fax: +64 4 495 7400
ey.com/nz

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

21 April 2017

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

Dear Cath

BEPS – Strengthening our interest limitation rules

We support the consultative approach adopted by the Government in its adoption of measures associated with the G20/OECD-led Base Erosion and Profit Shifting ("BEPS") project.

BEPS – Strengthening our interest limitation rules forms part of an interconnected package, alongside *BEPS – Transfer pricing and permanent establishment avoidance* and *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.* The package is a powerful combination, which will put New Zealand at the forefront of worldwide approaches to BEPS implementation.

This submission should therefore be read alongside our submissions on the other elements of the package.

Overall approach to New Zealand's interest limitation rules

Overall, we accept the case for the Government revising aspects of our interest limitation rules, given it has consistently expressed support for the OECD's work.

We do not support the proposed limit on interest rates on related party loans as this will lead to double taxation in many cases and is incompatible with the arm's length principle. The combination of the proposed limit on interest rates and proposed changes to the thin capitalisation rules are a duplication and overreach.

When making final decisions, it is essential for the Government to give weight to the following:

- New Zealand already has robust interest limitation rules, which are in the main well policed by Inland Revenue. EY's study regarding gearing levels shows no evidence that multinational businesses pay less tax than New Zealand owned equivalent entities. We agree it is preferable to put forward specific proposals without abandoning our current framework.

- Any responses should be proportionate to the scale of the problem in New Zealand – that is, only limited reform is required. The Government should consider whether any measures should be targeted at highly geared outliers rather than applying to the vast majority of moderately geared entities.

- The potentially punitive impact on New Zealand taxpayers of an interest rate cap for New Zealand tax purposes only, where such a cap is not respected or reflected in foreign lending territories.

- The need for a coordinated international approach, with New Zealand staying within international norms.

- The interest rate cap methodology has not been adequately considered. It does not take into account currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing.

- The importance of foreign investment for the New Zealand economy, consistent with New Zealand's taxation framework for inbound investment published in June 2016.

- The importance of minimising compliance costs, uncertainty and the potential for disputes over the meaning of any rules or between revenue authorities.

We agree that an interest limitation rule based on the level of interest relative to earnings – typically based on earnings before interest, tax, depreciation and amortisation ("EBITDA") – is not the best approach for New Zealand. The volatility of interest rates, earnings and difficulties associated with loss making companies argue against an EBITDA-approach. We also note that EBITDA-style rules do not work well for commodity based economies, given that New Zealand companies are price-takers in volatile world markets.

Limiting the interest rate on related-party loans

We oppose the implementation of the interest rate cap. Our submissions may be summarised as follows:

- The proposed changes to the transfer pricing rules, including the ability for the Commissioner to reconstruct transactions, will adequately address issues with the pricing of cross-border associated party lending. We consider that the proposed changes to the transfer pricing regime perform substantially the same role that the interest rate cap is intended to achieve, without some of the costs and negative aspects of an interest rate cap outlined below. Accordingly, we would suggest strengthening the transfer pricing rules as a first approach, and consider an interest rate cap at a later date only if the combination of new and existing transfer pricing rules fails to achieve the desired outcome.

- The proposed cap, being a unilateral New Zealand approach to interest rate quantum, will inevitably lead to double taxation for multi-national groups. If the proposals are implemented, the Government will need to substantially increase the resources available to the Competent Authority to deal with a number of mutual agreement procedures ("MAPs") and disputes.

- The interest rate cap will frequently lead to transfer pricing outcomes that are not arm's length and not taken by our treaty partners. This represents a fundamental and, in our view unnecessary, shift in approach from that of alignment and harmonisation in respect of international tax favoured by the OECD and strongly supported by New Zealand.

- The interest rate cap is a novel approach which is untested in other jurisdictions. Given the significance of the other proposed changes, and the extent to which they already address concerns about the pricing of multinationals' debt, we submit that implementation of the interest rate cap should be deferred until the impact of the other proposals has been fully seen.

- The interest rate cap methodology does not take into account the likes of currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing. A good example is a regulated business like an insurer. The ultimate parent senior unsecured five year debt cost is not a proxy for the group cost of borrowing. In such an example, the majority of the group debt has appropriate regulatory recognition, is heavily subordinated and for a long minimum term. Countries such as the United Kingdom are extending, rather than restricting, deductions for such debt.

Further detail is provided in Appendix A, ordered consistently with the discussion document.

Treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities but note:

- This will lead to a material increase in gearing levels for some multinationals, particularly those with large provisions, trade creditors or deferred tax liabilities.

- The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.

- The proposal to move to quarterly, or daily, calculations will increase compliance costs and should not proceed.

- There should be an arm's length debt option as there is in Australia.

- Existing loans have been entered into under current law in good faith and should be grandparented for an extended period.

Further detail is provided in Appendix B.

Further consultation

The consultation period following release of the discussion documents has been short. To that end, our submission is intended to flag issues which we consider require further analysis, and, where appropriate make recommendations on the approach. We look forward to continuing to engage in discussion on the proposals throughout the coming policy-making and legislative stages.
We understand that these submissions may be the subject of a request under the Official Information Act 1982, and consent to the submissions being made publicly available.

We would appreciate the opportunity to discuss our submissions in person. Please contact David Snell (david.snell@nz.ey.com, +64 21 845 361) in this regard.

Yours sincerely

Aaron Quintal
Partner – Tax Advisory Services
Ernst & Young Limited

Appendix A – Limiting the interest rate on related-party loans

Proposal should not proceed (paragraphs 3.1 to 3.16)

The proposal to limit the interest rate on related-party loans should not proceed as it will lead to double taxation as other jurisdictions will continue to rely on the arm's length principle, and is likely to increase compliance costs.

The combination of the proposed limit on interest rates and proposed changes to the thin capitalisation rules are a duplication and significant overreach. The interest rate cap methodology has not been adequately considered and in many cases is a significantly inaccurate proxy for the group cost of borrowing.

Proposals to strengthen the transfer pricing and thin capitalisation rules will be a better means for ensuring arm's length terms and conditions on related party loans than an interest rate cap.

We understand that the Government has concerns regarding high-priced related party debt, and that transfer pricing rules have in its view not always been effective. In our view, however, transfer pricing rules are ineffective in only a very limited number of cases. These should be better addressed through targeted measures, many if not all of which are proposed in the suggested amendments to New Zealand's transfer pricing rules.

Double taxation is inevitable under the proposed interest rate cap given that this is a New Zealand specific rule applying to cross border arrangements. It will not lead to deductions in line with arm's length pricing. It will frequently, if not always, lead to double taxation as the lender cannot reduce the interest rate below an arm's length amount. Other jurisdictions will see this "thin capitalisation" measure as undermining or positively moving away from the arm's length principle in loan relationship matters and more MAP cases will result.

Of course, a lender could seek to reduce the interest rate charged to the amount determined by the interest rate cap, but may risk that lower interest amount being adjusted by the lender's tax authority as being non- arm's length. We consider this approach by lenders to be unlikely.

The interest rate cap methodology does not take into account the likes of currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing. A good example is a regulated business like an insurer. The ultimate parent senior unsecured five year debt cost is not a proxy for the group cost of borrowing. In such an example, the majority of the group debt has appropriate regulatory recognition, is heavily subordinated and for a long minimum term. Countries such as the United Kingdom are extending, rather than restricting, deductions for such debt.

The combination of the above implications produces the risk of deterring inbound investment beneficial to New Zealand.

Transfer pricing is factual and subjective because by nature there is no one answer to the problem it seeks to solve. As the discussion document notes, there are many factors affecting the price of debt, which an interest rate cap would ignore.

It would be more efficient and equitable to rely on robust and updated transfer pricing law and protocols to ensure that commercial levels of debt and terms of the debt instrument are taken into account in debt pricing. We note that this has been the Australian approach and is generally considered to have proven effective.

In our view, none of the arguments provided in the document suggest that the imposition of a wholly arbitrary interest rate cap is the appropriate means to deal with excessively priced related party debt. Capping the interest rate limits a lender's ability to re-coup their cost and earn an appropriate return for risk.

The proposed interest rate cap is neither objective (since it ignores many terms of intercompany loans which may be entirely commercial) nor certain (as it will lead to considerable uncertainty where the result is an interest rate which, from the perspective of the lender, is not arm's length).

Suggested alternative - Proposed transfer pricing and thin capitalisation rules should be given a chance to take effect (paragraphs 3.5 to 3.7)

The document does not discuss in what respect debt is considered to be overly priced into New Zealand.

Our experience is that most inbound related party debt is senior unsecured debt for terms less than five years and genuinely priced at what a bank could lend. Only a small minority of loans would be priced as subordinated debt and/or for terms greater than five years. These loans will generally have longer terms for sound commercial reasons, with investments such as forestry or public private partnerships dependent on long term finance.

Many factors influence the pricing of a loan. These factors are present in both related party and third party lending. Like third parties, related parties often have sound commercial reasons for any "non-vanilla" terms in their loan agreements. The transfer pricing rules allow for some flexibility in pricing what can ultimately be very complex, but commercially rational, third party loans.

We accept that the transfer pricing rules have historically only allowed the Commissioner to challenge whether the amount (being the interest rate) is an arm's length amount (paragraph 3.6). This has limited the Commissioner's ability to challenge other terms of the lending, but will be addressed by the new reconstruction provisions in the updated transfer pricing rules. [1]

It is considered that the proposed amended transfer pricing rules should go a long way to alleviating if not eliminating current challenges around the ability to assess and challenge debt pricing. Such rules should be given a chance to succeed, before introducing a novel instrument in contravention to the arm's length principle. The document highlights the tension between the interest rate cap and transfer pricing at paragraph 3.49: that problem would be eliminated were the interest rate cap not to proceed.

Indeed, we consider there is a risk that the proposed interest rate cap renders the amended transfer pricing rules obsolete in practice with respect to loan relationships. The point being that challenges are naturally drawn to the "path of least resistance" approach of asserting a rate cap over applying improved transfer pricing rules to genuine commercial arrangements.

Related party and third party borrowings compared (paragraphs 3.8 to 3.12)

The Government states that when borrowing in a third party situation there is pressure to drive the borrower to seek to lower interest rates by offering security or not borrowing to an extent such that it will impact credit rating. We have concerns with this approach:

[1] In addition to those conferred by the general anti-avoidance rule, for example those relied upon by the Commissioner in *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

- Inland Revenue tends to argue that security to ensure realisation in case of default makes little difference to the rate offered by a bank.

- Most New Zealand companies have no formal credit rating. Although conscious of their creditworthiness, they will not be influenced by defending a given rating.

- Transfer pricing reforms proposed in *BEPS – Transfer pricing and permanent establishment avoidance* will reinforce the arm's length debt test for pricing purposes. Both the terms and conditions will need to be commercially justifiable.

- Factors increasing the riskiness of a loan between unrelated parties may be less relevant in a related party context, but they are not irrelevant. Transfer pricing allows for these relevant risks to be balanced in a fact-specific way.

- The proposition that "the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with related-party debt or equity" in paragraph 3.10 is not always accurate. Consider for example a parent entity which funds a majority-held New Zealand subsidiary through a mix of debt and equity. There may be other shareholders which own a small parcel of shares as well. The subsidiary also has a range of other debtors which might rank preferentially to the parent's own debt, or might rank after. If the company is later liquidated, the debt is less risky vis-à-vis the equity investment, and the risk associated with the debt will vary depending on its terms, and the relative terms of the debts owed to third parties.

- The document notes that "some related-party loans feature unnecessary and uncommercial terms" (paragraph 3.11). Under the transfer pricing reforms proposed in *BEPS – Transfer pricing and permanent establishment avoidance* the Commissioner could reconstruct such a transaction if it was not commercial.

- The document notes that it can be difficult to challenge arrangements where the taxpayer can identify a comparable arm's length arrangement (paragraph 3.12). However, if the taxpayer can identify a comparable arm's length arrangement, then by definition the taxpayer's arrangement is arm's length.

Compliance costs will increase (paragraph 3.13)

The highly factual and subjective nature of transfer pricing can make the rules complex and uncertain, leading to high compliance costs. While we agree with this statement, we do not see that it leads to an interest cap as the preferred approach. Compliance costs arise for debt structures as for any other transfer pricing arrangements. Royalty transfer prices, for example, can be compliance cost intensive.

The proposed interest rate cap is likely to increase compliance costs. Loans between a foreign parent and a New Zealand subsidiary will now need to be priced twice – once from the perspective of the foreign parent, for which the foreign tax jurisdiction will require an analysis under orthodox transfer pricing principles (i.e., using the New Zealand subsidiary's credit profile as a starting point), and once from a New Zealand perspective using the parent's credit profile as a starting point. An analysis still has to be done to benchmark the interest rate even if the parent has a credit rating. If it does not have a rating, then a rating analysis has to be done. Companies could even choose to obtain a credit rating solely for tax purposes, at considerable compliance cost.

At present a single analysis is done for both borrower and lender to find the arm's length amount.

Moreover, the different interest rates which would result under the two different analyses will in many cases give rise to double taxation, which will only increase the likelihood of disputes with Inland Revenue.

The proposed interest rate cap ignores the specific requirements of several industries

Some industries require a more fact-specific response to pricing their lending than an arbitrary interest rate cap. For example, the forestry industry has a particular requirement for loans extending over a long (but fixed) period. Further, in this industry it is commercial practice to defer cash flows to the end of the loan period (for example, as a Payment In Kind, or “PIK” loan). This can result in a higher interest rate, but is a necessary response to the commercial factors behind investment in forestry (that is, the long time period to forest maturity). The proposed interest rate cap could make these loans untenable and discourage investment on usual commercial terms for the industry.

In other cases, funding may be provided in a form to meet regulatory requirements to hold loss-absorbent capital as a proportion of balance sheet size and risk. Funding in this form may have certain equity-like features relating to loss absorbency and interest deferral which are mandated by regulators. These equity-like features are mandated by regulation, are not designed to deliver profit stripping by way of high interest and are essential in supporting certain capital intensive regulated industries.

Our comments on design issues below should be read on the basis that our primary submission for the interest rate cap not to proceed is declined.

Proposal is based on flawed premise (paragraphs 3.17 to 3.19)

A cap will not bring interest rates on related-party loans in line with the interest rate the borrower would agree to with a third-party lender.

Our experience is that a New Zealand subsidiary will typically have a credit rating well below (not just one notch below) that of its ultimate parent. The rate at which a New Zealand subsidiary could borrow from a bank is considerably different than the parent’s cost of funding, especially in the absence of an explicit parental guarantee. This is why, in the absence of tax, multinational enterprises will often borrow at the parent company level and finance offshore subsidiaries through related party funding.

Interest rate cap based on parent credit rating (paragraphs 3.23 to 3.37)

An interest rate cap should assume a greater than one notch difference below that of the senior unsecured rating attributable to the ultimate parent. It is difficult to provide any guidance on the appropriate difference as this will vary on a case-by-case basis.

Pricing based on senior unsecured debt does not meet the arm’s length standard.

Please note this section is drafted on the basis that an interest rate cap is introduced. Our primary submission is that such a cap should not be introduced given this adopts a one size fits all approach, ignoring the commercial arrangements entered into. Our comments below should not be taken as inconsistent with this primary submission.

We do agree that a hard interest rate cap would not be well-targeted, and does not take account of the facts and circumstances to which an approach through the transfer pricing regime is much better suited. A cap based on parent credit rating is preferable to a hard cap.

However, one notch suggests that the New Zealand subsidiary is “highly strategic” to the group (Standard & Poor’s grouping methodology 2013 suggests a highly strategic subsidiary would have a rating one notch below group rating). Standard & Poor’s define “highly strategic” as being “almost integral to the group’s current identity and future strategy; the rest of the group is likely to support these subsidiaries in almost all foreseeable circumstances”. In our experience, very rarely would that be the case for New Zealand subsidiaries. Moody’s is even more conservative for notching for this “implicit support” than Standard & Poor’s.

The discussion document calls for submissions on what the appropriate margin would be. Assuming that there are at least some subsidiaries of foreign multinationals in New Zealand which could meet the requirements of Standard & Poor’s “nonstrategic” category (that is, of “no strategic importance to the group; these subsidiaries could be sold in the near to medium term”) then Standard & Poor’s guidance suggests these entities are generally rated at their own standalone credit profile and therefore receive no implicit parental support.

Where the shareholder debt into New Zealand is subordinated to actual senior bank debt, it seems unreasonable and not arm’s length to price it as senior unsecured debt (paragraph 3.24). A bank loan to the New Zealand subsidiary would invariably price lower than subordinated shareholder debt to the New Zealand subsidiary.

Para 3.25 notes that *“We consider it unlikely that a multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational’s cost of debt, since this would lower its overall profits.”*

It is worth considering why higher borrowing costs in New Zealand may be justified. The group’s cost of borrowing may be lower because, for example, it may have many subsidiaries with low standalone credit risk (for example, in countries with high sovereign credit ratings, or that are consistently very profitable). By contrast the New Zealand entity might be a much higher credit risk; for example, it could be a start-up in a different industry, in a smaller, more isolated market.

If the parent itself borrows from a bank, the bank does not take any less risk. The parent may get a lower interest rate because it has a collection of lower risk investments which will more than offset the risk of the New Zealand investment to the New Zealand bank. The parent is effectively offering collateral greater than just the New Zealand subsidiary, and so there is some diversification of the risk. The group’s risk is not representative of the New Zealand subsidiary’s risk.

International comparison (paragraphs 3.38 to 3.39)

That no other country has proposed an interest rate cap suggests the cap should not proceed.

We are concerned at this novel approach. A coordinated multilateral approach will be the most efficient way to resolve inconsistencies in cross border taxation: departure from international norms proved unsustainable with regards to our controlled foreign company and foreign investment fund rules.

Treatment of guarantee fees (paragraphs 3.44 to 3.45)

Guarantee fees have commercial value, which should be reflected by the proposals.

A guarantor is taking on real liability, as shown by the impact on the availability and pricing of funds when an explicit written guarantee from a bone fide guarantor is in place.

To ensure this meets the arm's length standard, the OECD Guidelines then recognise that parent is then taking on the credit risk for the New Zealand subsidiary and needs to be remunerated through a guarantee fee.

In other words, that the multinational's cost of funds is lower than what an independent lender would offer the New Zealand subsidiary is no reason to depart from the arm's length standard.

Limiting guarantee fees to the margin allowable under the interest rate cap breaches arm's length principles. The guarantee fee would, in almost all cases, be very small under these proposals given there would only be a one notch difference between the interest rate cap and actual borrowing rate. This has no resemblance to arm's length principles.

We would also welcome comment as to whether the guarantee benefit would be a 50:50 split of the margin, per current practice.[2]

De minimis approach to be retained (paragraphs 3.46 to 3.48)

The de minimis should be increased as a compliance cost reduction measure, perhaps to cover groups where the principal of all cross-border related party loans is less than $20 million.

Retention of the de minimis is welcome as a practical measure. There is a strong case for it to be increased, perhaps to $20 million, if these proposals are to be implemented. In many cases the de minimis position reflects a much higher interest rate than would be achieved under these proposals.

Anti-abuse rule (paragraphs 3.51 to 3.52)

The general anti-avoidance rule should not apply to situations where taxpayers exercise break clauses in loans to take advantage of changing interest rates or borrowing margins.

Taxpayers are entitled to arrange their affairs in such a way as to maximise their commercial outcomes in ways which suit their circumstances. Exercising a break clause in a loan agreement does not amount to tax avoidance.[3]

Transitional rules (paragraphs 3.54 to 3.55)

Existing related-party, cross-border financing arrangements should be exempt from the interest cap for a period of five years following enactment.

The absense of any transitional rule for existing loans would mean that every loan will need to be repriced based on the parent company credit rating for New Zealand tax purposes. It seems unlikely that the lender's jurisdiction would be prepared to accept a lower, non-arm's length, return from investment into New Zealand, unless that jurisdiction does not tax foreign sourced interest income. Double tax is therefore a strong possibility, in addition to the compliance costs of repricing.

We propose an extended transitional period, of perhaps five years, to allow for the majority of existing finance arrangments to reach maturity.

[2] See http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html#11, accessed 18 April 2017.

[3] As discussed with Carmel Peters and Steve Mack on 24 March 2017.

Interest rate cap inconsistent with arm's length principle (paragraphs 3.56 to 3.60)

The proposed interest rate cap contravenes the arm's length principle. It will not "generally produce a similar level of interest expense as would arise in arm's length situations". It will inevitably lead to double taxation, often in circumstances where arm's length pricing has been implemented.

Nor do we agree it consistent with OECD Guidelines that as a general rule there will be no conflict between domestic anti-avoidance provisions and a DTA. OECD Guidelines take this approach only to the extent that domestic thin capitalisation rules do not create pricing that is below arm's length.

The interest rate cap also appears to be incompatible with our domestic legislation confirming that DTAs override domestic legislation (section BH 1(4)).

Para 3.58 notes that *"the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Consequently it should also be consistent with the arm's length principle"*

We submit that the proposal is not consistent with the arm's length principle.

OECD Guidelines discuss thin capitalisation in the context of Article 9 (Associated enterprises). We interpret the Guidelines to mean that thin capitalisation provisions are not considered to contravene Article 9 (requiring arm's length pricing) provided that they do not go so far as to create pricing that would be below arm's length. That is, thin capitalisation rules approximate arm's length borrowing levels. This rate cap will undermine the arm's length principle in the vast majority of cases and hence will result in other countries raising issues in terms of Article 9 (leading to double taxation and invoking MAP).

We note that the discussion document does not address the issue of New Zealand companies lending to foreign subsidiaries. We understand from our discussions with officials that the Government does not intend to apply the interest rate cap in reverse (i.e., for loans to overseas associated parties, taxpayers are expected to continue to apply orthodox transfer pricing principles and price the loans on the basis of the arm's length standard). This demonstrates the interest rate cap is not aligned to the arm's length standard; the Government is seeking to tax business profits neither in accordance with its international commitments through the OECD nor consistently with its long established framework for taxing the income of foreign residents.

Further, the discussion documents do not propose any limitation on the interest rate paid to *third parties* in New Zealand. According to the arm's length standard, the interest rate paid on related party debt should be aligned to what would be paid to independent third parties. The fact that there could be a different outcome if the New Zealand subsidiary borrows from a bank versus borrowing from related parties indicates that this proposal is not aligned to the arm's length standard.

Further, for many New Zealand companies, the rate at which a bank would lend to the New Zealand subsidiary on a standalone basis can be very different to the parent's cost of funding. We submit that it is wrong to assume that implicit support narrows the gap between parent and subsidiary credit ratings in all cases. A typical approach is for the New Zealand subsidiary to borrow from a New Zealand bank, but have the parent guarantee the debt (to achieve something close to the parent's cost of funds). The fact the OECD endorses the payment of a guarantee fee to the parent in such a circumstance is precisely because an interest rate anchored to the parent's cost of funds is not arm's length.

We anticipate the interest rate cap would be a limit, enacted as domestic legislation, reducing the deduction available in New Zealand to something less than arm's length.
Section BH 1(4) of the Income Tax Act states that double tax agreements have an overriding effect on the Inland Revenue Acts. Given that Article 9 of New Zealand's double tax agreements ("DTAs") requires an arm's length outcome (i.e., "conditions between the two enterprises in their commercial or financial arrangements… differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another"), the proposed interest rate cap is incompatible with section BH 1(4). Has the Government considered how it will ensure the proposal actually has effect? Reliance on the incorrect statement that the interest rate cap will produce an arm's length result is extremely risky.

Such a movement away from the arm's length principle in loan relationship matters represents a significant shift in New Zealand tax policy, where an OECD-aligned, harmonisation approach has generally been favoured in international tax matters. It is considered that implementation of an interest rate cap in the manner suggested necessarily leads to a dilution if not outright rejection of the arm's length principle where related party lending is concerned. New Zealand would effectively have separate rules for loan relationships (interest rate cap) and other intra-group arrangements (enhanced transfer pricing rules aligned with OECD recommendations).

The point made above around double tax should be emphasised here. This is a natural and inevitable result of a territory-specific pricing approach that contradicts that generally accepted in counterpart territories.

Appendix B – Treatment of non-debt liabilities and other matters

Debt levels of foreign-owned multinationals

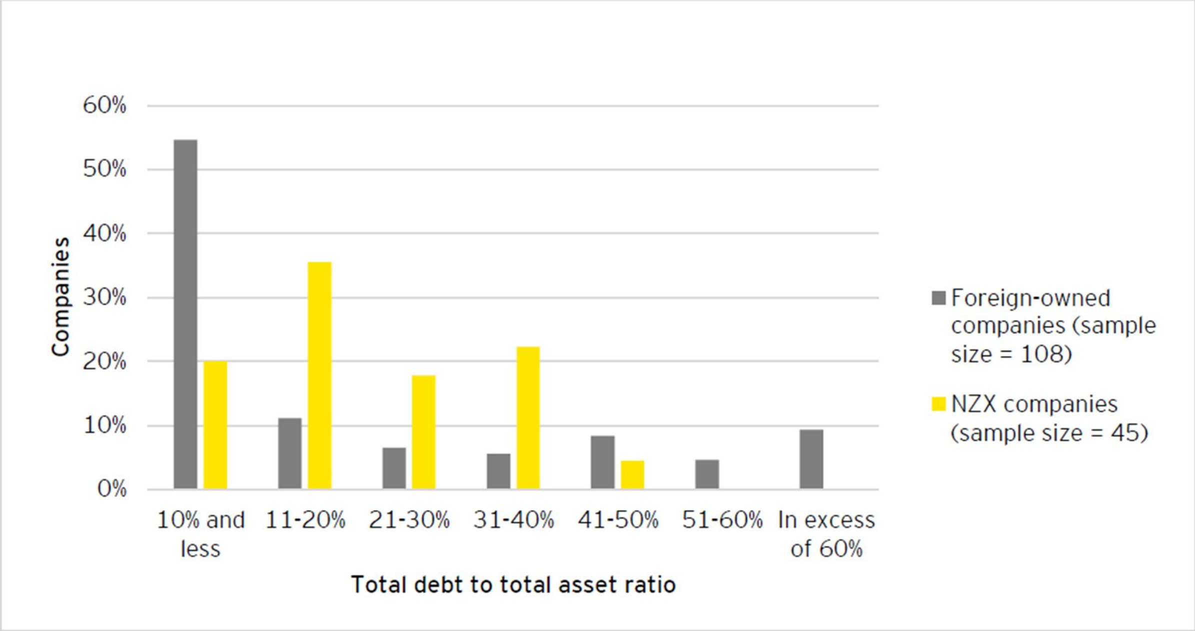
We agree that, in principle, a firm's assets net of its non-debt liabilities is an appropriate base for thin capitalisation rules. The proposals will, however, have a significant effect, with paragraph 4.27 underestimating their impact.

It is important to highlight the current thin capitalisation rules already work well, and that multinationals are mostly moderately geared.

In August 2016, EY released a report, *New Zealand corporate debt levels of foreign multinationals – the elusive case for more tax restrictions?,* which reported EY's market research into the debt levels carried by New Zealand subsidiaries of foreign companies.

Our research shows that most foreign-owned multinationals stay well within the 60% safe-harbour of debt to asset ratio. The average total debt to total asset ratio was just 20%. By comparison, New Zealand based companies also had average total debt to total assets of 20%.[4]

The following chart summarises the results of the analysis.



Our report also considered in more detail whether an EBITDA-style test would be appropriate in New Zealand. Given that the discussion document does not specifically address the practicability of an EBITDA-style test in New Zealand, we do not intend to address this in detail here. Further commentary can be found in our report.[5]

---

[4] We should note the report is not weighted by entity size. It would be possible for a small number of large, highly geared, outliers to have a material impact on the level of interest deductions claimed. This possibility strengthens arguments for targeted measures rather than wide ranging reforms.
[5] http://www.ey.com/nz/en/services/tax/ey-is-the-tax-crackdown-on-multinationals-justified

In the period since the release of the discussion documents, it has not been possible to undertake an in-depth study on the effects of the proposed changes to the thin capitalisation regime. That said, we have revisited the 108 foreign companies from our 2016 survey and performed a high-level calculation, charting the impact of the new thin cap rules. Our findings can be summarised as follows:

- The debt percentages of all 108 companies increases (where the companies have positive net assets), which is to be expected;
- 23 companies in our sample (i.e., approximately 22% of those surveyed) would be moved from a conservative debt position to an "at risk" debt position (that is, a debt ratio greater than 40%); and
- 11 companies in the sample group (or 10% of the sample) would find themselves moving from inside the safe harbour to now breach the 60% debt level.

The results show that the proposed changes to the thin capitalisation have will have considerable bite.

Non-debt liability definition (paragraph 4.22)

Non-debt liabilities should not include deferred tax liabilities. The definition of interest-free loans requires clarification.

The definition of non-debt liabilities is based on the Australian definition. Deferred tax should be excluded from that definition.

Deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS.[6] Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

We would also appreciate clarification on the definition of interest-free loans as a non-debt liability. Would an interest-on-demand shareholder loan be treated as interest-free?

Grandparenting existing arrangements (paragraph 4.28)

Existing financing arrangements should be grandparented for a period of five years following enactment.

We disagree with the statement that companies will have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time (paragraphs 5.22 to 5.23). This logic applies equally to all multinationals.

[6] Under IFRS entities account for deferred taxes using the New Zealand Equivalent to International Accounting Standard 12 (NZ IAS 12), "Income Taxes." NZ IAS 12 follows a balance sheet approach as opposed to an income statement approach.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature. This is consistent with the proposed application of non-resident withholding tax or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Act. We also note the lengthy transitional arrangements proposed for measures in connection with employee share schemes. The financial impact of disallowing interest deductions can outweigh changes to withholding taxes or the taxation of employee share schemes.

Asset valuations (paragraphs 5.24 to 5.26)

> The ability to use net current asset values allows businesses to use a better proxy for the market value of assets than is sometimes reflected in the financial statements. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained. We see no case for removing an accurate measure of asset value.

We disagree that the valuation method chosen for financial reporting purposes will always be the one that most fairly represents the value of a company's assets (paragraph 5.25). Allowing appropriate values for high value, but hard to value, assets is essential to the working of an asset-based thin capitalisation regime.

Allowing companies to continue to choose to use the net current value of its assets as an alternative to the financial statement values, where this would be allowable under GAAP, appears fair and reasonable. No case has been made for this change.

Experience in Australia suggests that restrictions over the accounting options available regarding asset valuations are of particular concern for industries with substantial intangible assets, where the reported figures in financial statements can significantly underplay an asset's true value. Examples include technology and mining companies.

Measurement date for assets and liabilities (paragraphs 5.28 to 5.30)

> The ability to choose between valuation at year-end, on a quarterly basis, or daily should be retained. The concern around the use of year end calculations is unfounded. An alternative could be to allow the use of the average of opening and closing calculations as is done in Australia.

We have seen no evidence of companies manipulating year-end thin capitalisation calculations. In our experience, often it is not until year-end financial statements are being prepared that thin capitalisation is considered. In the event that a company were to be found manipulating year-on-year calculations then the anti-avoidance rules could be utilised to cover this situation.

In our experience, the daily calculation method is rarely used so in reality the proposal is for quarterly calculations. Reliance on quarterly valuation methods will increase compliance costs. This will particularly be the case for assets requiring formal valuation as part of year-end accounting under IFRS.

Should the Government feel there is a particular problem regarding loans entered into and repaid during the course of the year, it could seek to apply the GAAR and/or develop a targeted extension to section FE 11 of the Income Tax Act 2007. From our perspective, it would be very difficult to envisage an "artificial" year-end balance sheet manipulation structure that achieves a temporary thin capitalisation benefit that would be robust in the face of a challenge on section BG 1 grounds.

Increasing compliance costs for all multinationals to deal with a rare problem which can be targeted effectively by other means is not justified.

Arm's length debt option

There should be an arm's length debt option, as in Australia.

The proposed changes to the thin capitalisation rules largely align the New Zealand methodology with that of Australia. An omission is the arm's length debt test rules that Australian taxpayers can use if their Australian debt levels exceed the safe harbour.[7] The Australian precedent should be followed in New Zealand.

[7] Reviewed in 2015 by the Australian Board of Taxation, which recommended its retention.

Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

sent via email: policy.webmaster@ird.govt.nz

1 May 2017

BEPS – Strengthening our interest limitation rules

Dear Deputy Commissioner

Thank you for the opportunity to comment on the Discussion Document (DD). We appreciate that targeting base erosion profit shifting (BEPS) to ensure multinationals are paying an appropriate level of tax in New Zealand is a key focus for the Government.

We understand that Officials are particularly concerned with excess interest deductions arising from high-priced debt advanced by related parties. As we understand it, the concern arises because of the belief that some multinational groups (MNCs) structure cross-border related-party financing arrangements on non-commercial terms in order to justify a high interest rate being charged under transfer pricing principles, where such terms would not necessarily be available in the context of a third party financing.

In our view a number of the proposals are wider than necessary to deal with this concern, and will significantly increase the compliance burden for taxpayers, including many who currently operate in New Zealand through low risk structures. Officials may not have appreciated the significant adverse effect that the proposals are likely to have on every taxpayer that is subject to the transfer pricing and thin capitalisation regimes.

A summary of our submission points is set out below (all of which we have discussed with Officials in our meetings in recent weeks), with more detail provided in the Appendix:

- a number of the proposals are not in line with the Government's published policy on inbound investment;
- the Government should await the outcome of (a) OECD work on pricing related-party debt, and (b) strengthening the transfer pricing regime, before it decides whether it still wants/needs to introduce an interest rate cap;
- if an interest rate cap is introduced, it should be in the form of a safe harbour in the transfer pricing rules, with taxpayers being given the choice to use accepted transfer pricing principles instead if they prefer (but perhaps with a higher threshold for the taxpayer to satisfy if not using the interest rate cap method);

- the proposed reduction in assets by non-debt liabilities is not needed, and for some industries could have a significant and adverse impact on thin capitalisation capacity. However, if proceeded with, at a minimum the proposed definition of non-debt liabilities for thin capitalisation purposes should contain exceptions for deferred tax and certain other items, similar to the Australian rules;
- the scope of the proposed de minimis exception for inbound investment should be extended;
- the proposed exception to thin capitalisation for infrastructure projects should be implemented, but needs further consideration. A similar exception for securitisation arrangements should be included;
- the ability for taxpayers to use net current asset values for thin capitalisation calculations should be retained;
- measurement of assets and liabilities for thin capitalisation purposes should continue to be able to be based on year end balances. If necessary, it could be altered to be the average of the start of year and end of year values; and
- the application date for any new policy changes should be the income year commencing after 31 March 2019 (or equivalent non-standard tax years) at the earliest.

As discussed with Officials, we would appreciate the opportunity to review and comment on draft legislation before it is released as part of a Bill, if possible, particularly in relation to the interest rate cap proposal, the definition of non-debt liabilities and the use of net current asset values for thin capitalisation calculations.

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely

Peter Boyce
Partner

peter.boyce@nz.pwc.com
T: +64 9 355 8547

Erin Venter
Partner

erin.l.venter@nz.pwc.com
T: +64 9 355 8862

Appendix: Detailed submissions

1. General comments

Proposals are not in line with published Government policy on inbound investment

The Government's published policy with respect to inbound investment includes the following:

> "A priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish. Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to New Zealand."[1]

The published policy sets out a framework that should be considered when making changes to tax policy, and emphasises the need to work through any changes carefully to ensure New Zealand's position as an attractive location to base a business is maintained.

We are concerned that some of the proposals in the DD, and the consultation process being adopted, seemingly conflict with this approach. This is for the following reasons:

- certain of the proposals are not in line with current and/or proposed international norms and OECD recommendations;
- a New Zealand solution to high-priced related-party debt is being considered before OECD work on the same issue is completed;
- certain elements of the proposals appear to be poorly designed given inevitability of double tax without any ability to seek relief under double tax agreements (DTAs); and
- the time for the consultation process has been very short (particularly bearing in mind focus of taxpayers on compliance obligations up to 31 March), proposed effective dates of the proposed law change could be sooner than is reasonably practical, and taxpayers risk not being given adequate time to consider and model the effect of the proposals.

Furthermore, there is no discussion in the DD around how NRWT fits with the proposed law changes, even though the policy framework specifically discusses the importance of NRWT in preserving New Zealand's tax base in relation to related-party debt. In a number of scenarios, it seems there will still be NRWT imposed on the full interest expenses, notwithstanding potentially materially larger amounts of that interest expense will be effectively denied under the proposed thin capitalisation changes. We do not consider this effective double taxing is appropriate.

Application date should be no earlier than 1 April 2019

We understand that targeting BEPS is a key focus for the Government and an early effective date for the proposals may be its preference. In our view, the proposed application date should be no earlier than a taxpayer's first income year after 31 March 2019 (or the equivalent non-standard tax year). The changes proposed in the DD will not just affect those few corporates who may be viewed as having

[1] "New Zealand's taxation framework for inbound investment", Policy and Strategy, Inland Revenue and the Treasury, June 2016.

adopted aggressive tax practices but a significant number of additional taxpayers, including those who currently have in place advance pricing agreements (APAs) with Inland Revenue on the pricing of inbound related-party debt. We consider it is reasonable to allow taxpayers time to consider how best to deal with these issues, and to rearrange their affairs in an orderly manner if they decide it is necessary. It will be in the interest of continued foreign investment from overseas to allow properly for this.

2. *Limiting interest on related-party loans (DD Chapter 3)*

The Government should await the outcome of OECD work on pricing related-party debt and effect of changes to transfer pricing before introducing an interest rate cap

We understand and acknowledge Officials' concerns that the current transfer pricing rules may not be effective to deal with unrealistically high-priced related-party debt, and therefore have proposed the interest rate cap to deal with the issue. In our view, the Government should not introduce an interest rate cap at this stage, given that:

- we expect it is a small number of corporate taxpayers that are engaging in the practices that Officials are concerned about;
- we understand that the OECD is undertaking more work this year in the area of pricing of related-party debt – paragraph 8 of the OECD's Action 4 Paper[2] states that work on transfer pricing guidance for related party financial transactions is being carried out and will be completed in 2017 – this work remains necessary following work already completed under Action 4 (see our further comments on Action 4 below); and
- the Government intends to strengthen transfer pricing rules, (a) to ensure pricing reflects economic value creation rather than strictly reflecting the legal form of an arrangement, and (b) to give Inland Revenue the ability to recharacterise transactions between related parties that would not have been entered into with third parties. To a large extent, the concerns around high-priced debt will be dealt with if the current proposals to strengthen New Zealand's transfer pricing rules are introduced.[3] This is because, following the proposed transfer pricing changes:
  - a loan will be subject to transfer pricing on the basis of its economic substance rather than its legal form where the two differ;
  - a loan will be able to be reconstructed to ensure it is aligned with a commercially rational arrangement that would be agreed by independent businesses operating at arm's length; and
  - the onus will be on the taxpayer to prove the interest rate is arm's length and would have been entered into with a third party.

In our view, the most likely outcome of these changes is that going forward any loans between related parties will no longer have the types of terms that Inland Revenue is concerned are used to justify unrealistically high interest rates. For this reason, and because OECD work in this area is continuing, it

[2] OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update (**Action 4 Paper)**, page 15.
[3] BEPS – Transfer pricing and permanent establishment avoidance – A Government discussion document, Chapter 5 (March 2017).

is too early for the Government to introduce an interest rate cap under our domestic thin capitalisation regime. Furthermore, New Zealand should be slow to adopt a solution that Officials recognise has not been adopted anywhere else globally.

Concerns around unrealistically high-priced debt should be dealt with in the transfer pricing regime as a "safe harbour" and not the thin capitalisation regime

The interest rate cap is proposed as a change to New Zealand's thin capitalisation regime. In our view, the transfer pricing regime and not the thin capitalisation regime is the appropriate place to address this type of concern. This is because the transfer pricing regime is concerned with ensuring that <u>debt is priced</u> appropriately applying the arm's length principle, whereas the thin capitalisation regime regulates the <u>amount of debt</u> that a New Zealand borrower can have. The issue of high-priced debt is a <u>pricing</u> issue and it is therefore more appropriate if it is dealt with in the transfer pricing regime.

In our view, introducing an interest rate cap is a fundamental shift away from the arm's length transfer pricing principle that underpins the pricing of cross border related-party transactions across the world. As part of the BEPS project, the OECD considered alternatives to the arm's length principle to price cross-border related party transactions. However, it was determined that alternative measures, such as a formulaic apportionment, would require development of an international consensus on a number of issues that would be too difficult to achieve. In addition, formulaic apportionment could be subject to manipulation and may result in transactions not being priced according to economic reality. Accordingly, the arm's length principle (adjusted to reflect economic realty and not just solely focused on legal form) was determined to be the most effective and efficient way to price transactions under transfer pricing rules going forward.

However, if New Zealand is to take this formulaic approach to capping related party interest rates, then an interest rate "cap" should be no more than a "safe harbour" available to taxpayers under the transfer pricing regime, which if the safe harbour was applied, would mean that the interest rate on related-party debt would not be challenged by Inland Revenue. This would allow a taxpayer to continue to apply arm's length principles under New Zealand's transfer pricing regime if it exceeds the interest rate cap but the taxpayer takes the view that this can be justified (but perhaps with a higher threshold for the taxpayer to satisfy if not using the interest rate cap safe harbour).

The reasons why we think this approach would be preferable for taxpayers, while still meeting Officials' concerns, are set out below.

(a) Compliance should be simple

Compliance should be made as easy as possible for taxpayers, and costs of compliance should be minimised.

It should be relatively simple to apply the interest rate cap where the ultimate parent has a credit rating, and we can see the superficial appeal of such an approach. However, where a parent does not have a credit rating, establishing the terms on which the parent would have been able to borrow may be very difficult – it will require consideration of a hypothetical situation, based on information outside the control of the New Zealand borrower, and it is likely to be costly and time-consuming for the New Zealand borrower to undertake this exercise.

If the hypothetical credit rating exercise is required to be undertaken in respect of multiple overseas companies (e.g. if the credit rating of main operating company is also required to be determined), the difficulty and compliance costs will increase accordingly.

Introducing the interest rate cap as a safe harbour measure would allow a taxpayer to make a choice as to how to proceed, acknowledging that if it chooses not to apply the interest rate cap safe harbour, it is at increased risk of challenge from Inland Revenue.

(b) The parent's cost of funding may not reflect the New Zealand borrower's true cost of funding

In many cases it may be appropriate for debt of a New Zealand borrower to be priced using the credit rating of its ultimate parent as an approximation for the real cost of funding for the New Zealand borrower. However, there are many situations where parts of a group will have third party borrowing at a higher rate than what the parent would be able to obtain. For example:

- in very large groups, local subsidiaries often effectively operate independently – the parent does not necessarily step in to guarantee debt of all subsidiaries, and banks do not price based on an assumption that a parent would support a failing subsidiary – for example, a client of ours was considered by banks to be a significant credit risk due to solvency issues following a number of previous restructures, and banks were only willing to fund at interest rates that were unacceptably high regardless of the company being part of the large MNC;
- groups may operate through regional hubs – for example, a European group may have an Asian regional group that operates relatively independently and without support from the European group;
- a subsidiary that is not material to the parent or to the group operations overall, and which consequently may have a significantly lower credit rating than the parent, in many cases will obtain third party lending at a higher rate and without parent support;
- the parent may not be a 100% parent – if for example the parent holds 51% and other shareholders have a significantly lower credit rating, a bank is most unlikely to price debt based on the parent's credit rating;
- the subsidiary and the parent may be in different industries, or a subsidiary may operate in only one of the numerous industries of the group – if the industry of the borrower is riskier than the remainder of the group, a bank would charge a higher interest rate;
- taking into account foreign exchange risk and hedging costs may lead to a different commercial decision regarding lending than simply looking at the parent's cost of funds;
- certain industries (e.g. infrastructure) have complex financial instruments due to the nature of the business, which cannot be matched to what the parent's cost of funding would have been.

In these circumstances and others where the New Zealand borrower actually has third party borrowing, this is the best evidence of what the New Zealand borrower's cost of funding is, and interest deductions for related-party debt priced by reference to these actual third party borrowings should be permissible. If an intermediate company in the group has third party borrowing and on-lends to a New Zealand subsidiary this is also legitimate evidence of the New Zealand borrower's true cost of funding and the interest deductions should be permissible.

A taxpayer who decides not to apply an interest rate cap safe harbour and instead apply transfer pricing principles will do so knowing that it faces an increased risk of challenge from Inland Revenue (and potentially a high evidential threshold to support the interest rate). Where a taxpayer does not want to face this risk, it could apply the safe harbour instead. Inland Revenue could gather information from taxpayers as to whether they have applied the interest rate cap or a higher rate by adding a question into the International Questionnaire or requiring the information to be provided through the Basic Compliance Package process. Our expectation is that if this approach were adopted, a significant number of taxpayers would simply apply the interest rate cap. A taxpayer would only choose to apply a higher rate if that the higher rate was clearly justifiable on arm's length principles, in light of Inland Revenue focus on this area and consequential likely scrutiny.

Finally, we note Officials' concerns about the possibility that a New Zealand borrower may be able to borrow excess levels from third parties, thereby lowering its creditworthiness. Our observations in response to this are as follows:

- a third party lender is not going to advance funding to a borrower that the lender does not see as supportable from a commercial perspective, so this alleged concern seems misplaced;
- a bank's lending will be senior to related-party lending so the level of related-party lending will not affect the amount or price at which a bank will lend; and
- the level of third party debt relative to the worldwide group is already dealt with in the thin capitalisation regime.

(c) Risk of double tax should be able to be minimised and relief should be available

A risk of double tax arises in respect of a cross-border financial arrangement where two jurisdictions have rules resulting in interest income and interest deductions that do not match. At present, this risk is mitigated if the two jurisdictions have entered into a DTA – if one jurisdiction increases income based on arm's length conditions, the other jurisdiction must allow for a compensating transfer pricing adjustment.[4] The taxpayers have access to the mutual agreement procedure where they are not satisfied that the relevant competent authorities have applied the DTA appropriately.

We acknowledge that this risk of double tax already exists where interest deductions are effectively denied under New Zealand's current thin capitalisation regime and the same issue would arise with an EBITDA test. However, in these cases, the debt is <u>priced</u> in both jurisdictions by applying the arm's length principle under each jurisdiction's domestic transfer pricing regime and applicable DTA. Accordingly, while we acknowledge that not all jurisdictions will apply the arm's length principle to result in the exact same price for a related-party transaction in all cases, the taxpayer should have the ability to obtain double tax relief under the DTA and to ensure consistency of approach across the 2 jurisdictions.

Introducing the interest rate cap as a transfer pricing safe harbour rather than an absolute rule would still allow a taxpayer who is concerned by this issue to choose to price related-party debt using arm's length principles and accept a higher risk of Inland Revenue challenge and / or tax adjustment. However, the taxpayer will retain access to double tax relief mechanism through the application of the DTA, and through the mutual agreement procedure if necessary.

---

[4] Article 9, OECD Model Convention with respect to Taxes on Income and Capital.

(d) Adopting the interest rate cap as a safe harbour is consistent with OECD work on Action 4

Allowing taxpayers an option of continuing to price debt on an arm's length basis is consistent with the OECD's work on BEPS involving interest deductions as set out in the Action 4 Paper. In relation to this:

- The OECD noted that thin capitalisation rules limiting the level of debt (as per New Zealand's rules) would need a further mechanism, such as an arm's length test under transfer pricing, to address BEPS concerns where an excessive rate of interest is applied to a loan (paragraph 58). In our view, applying an arm's length test (considering the actual substance of the amount and terms and with the onus on the taxpayer, as per proposed law changes) alongside New Zealand's existing regime, would deal with the issue of excessive interest.
- The OECD appears to have dismissed a rule based on the level of debt plus a further mechanism in favour of the EBITDA approach because such a rule would "add a step to the operation of a rule and increase complexity" (paragraph 58). These are practical considerations rather than any type of acknowledgement that that arm's length pricing is inappropriate as a matter of policy. In New Zealand's context, we already have a rule based on the level of debt that as Officials note is well understood. The concerns raised by the OECD are therefore less relevant for us.
- The OECD expressed a concern (paragraph 12) that interest limitation rules based on arm's length considerations as to the amount and terms of debt (such as the Australian arm's length debt test alternative to their safe harbour, and the UK's equivalent, where in both cases the main focus in applying the rules is on the *amount* of debt rather than the *price* of debt) may not be effective by themselves to prevent BEPS. However, these comments are in relation to a fundamentally different test to the interest rate cap proposals – they are simply saying that an arm's length test on its own does not deal with Action 4 concerns. There is no statement to the effect that using arm's length principles to price debt are not appropriate.

  In fact, the OECD says the opposite – countries may adopt an arm's length test alongside the best practice approach – the amount of interest claimed would be in accordance with the arm's length principle, but this amount is then subject to limitation under the EBITDA approach. This type of approach makes sense because (i) an EBITDA approach is based on <u>net</u> interest expense of an entity, which may borrow under a number of loans and also advance funds - it is not a "per loan" approach, and (ii) an entity that is profitable but lowly geared would not necessarily be subject to any limitation. In both of these situations, a mechanism for pricing each individual loan remains necessary.
- The OECD states that an advantage of an arm's length rule (albeit in a different context as explained above) is that it recognises that entities may have differing levels of interest expense depending on their circumstances (paragraph 12).

Our recommended approach of applying the interest rate cap as a safe harbour, assuming the Government is determined to proceed with some form of interest rate cap (which we do not agree with), would allow for these comments around policy design to be accommodated in appropriate cases. We acknowledge concerns around resource constraints associated with the application of the arm's length principle (although this applies to all cross-border related party transactions so making an exception to just inbound funding does not address the actual resourcing issue). However, as mentioned above, only taxpayers who can clearly justify their position will price using arm's length terms, and Inland Revenue will be able to easily identify relevant taxpayers, thereby mitigating this issue. Furthermore, in our submission in relation to transfer pricing proposals, we have stated that increased qualified resourcing in Inland Revenue's transfer pricing team is needed.

A taxpayer should be able to obtain certainty through obtaining an APA or a Determination

A taxpayer who decides to price related-party debt based on arm's length principle rather than the interest rate safe harbour should be able to obtain certainty through applying for an APA. Another alternative could be giving taxpayers the ability to apply for a Determination (as permitted in other contexts under the financial arrangement rules) that may be published in a sanitised form.

Interaction with other tax rules and tax treaties needs to be made very clear

Any denial of a deduction should not be considered anti-avoidance which does not benefit from protection under a DTA, unless section BG 1 applies. If the arrangement is challenged under section BG 1, this would be as per the current setting. If Officials' view is that this proposed interest rate cap is an anti-avoidance rule which overrides DTAs, the relevant domestic legislation needs to make it very clear how this is achieved.

Similarly, how any new rule applies in the context of New Zealand's other domestic tax rules around interest deductions should be made clear, and Determinations under the financial arrangement rules will need to be updated.

Maximum loan term for an interest rate cap safe harbour rule should be longer than five years

Many of our clients have third party loan terms of longer than 5 years. Terms of loans up to 10 years are common and in some cases are even longer. Generally speaking, our clients aim to match liabilities with expected life of assets. For example, industries such as forestry, infrastructure and mining tend to seek funding with a term longer than 5 years because the expected life of their important assets is usually over 5 years. Companies seeking funding to invest in manufacturing operations will also often seek long term funding.

From our discussions on this issue, we understand Officials will reconsider what a more appropriate loan term for calculating an interest rate cap may be under the proposals.

Transitional rules will be needed in relation to APAs

A number of taxpayers have spent significant time, effort and costs obtaining APAs from Inland Revenue which include confirmation of interest rates, for the purpose of achieving certainty. Transitional rules for existing APAs should be considered so that New Zealand's attractiveness and perception of political stability regarding taxation of overseas investment is not diminished.

Treatment of non-debt liabilities (DD Chapter 4)

Proposal requiring calculations to include non-debt liabilities should contain exceptions

We do not support this proposed reduction of asset base by non-debt liabilities. We do not think it is necessary and we note that the change will have a significant effect on many taxpayers in types of businesses and industries that traditionally carry higher levels of provisions or other non-current liabilities which do not materially impact on the borrowing ability of the company. Officials should consider the following:

- If the rationale for the changes is to better reflect what a borrower would be able to borrow from a third party, more work is required to determine what the third party would actually take into account. Usually banks will not overly focus on the level of non-debt liabilities unless the relevant creditors have better priority over specific assets than the banks. For example, deferred tax liabilities should be excluded from the calculations, as per the Australian equivalent rules.[5] Some of our clients have significant deferred tax liabilities that should not be relevant to their thin capitalisation position. For example, significant deferred tax balances can arise if (a) companies have valuable intellectual property that is amortised for accounting but not for tax purposes, and (b) in the forestry industry, where asset values grow significantly over years but tax is not due until sale of the trees. There are many more examples. Other liabilities should also be excluded if they are not funding a taxpayer's balance sheet, and other items such as provisions for dividends and preference shares. A number of other types of provisions, while correct from a technical accounting perspective, would have limited impact on the borrowing ability of the company.
- A number of industries are likely to be significantly disadvantaged under these rules – for example, industries with significant rehabilitation requirements or other unique features such as securitisation / securities lending / retirement village arrangements; industries with significant creditor balances and other provisions. If the proposals proceed we recommend that specific carve outs for some of these industries or scenarios will be needed. Retirement village operators, for example, often receive significant non-interest bearing cash deposits from the licences of retirement units (as payment for the right to occupy) but which technically are shown as liabilities on their balance sheet.
- Taking non-debt liabilities into account will introduce volatility to taxpayers' thin capitalisation calculations. The volatility will broadly be equivalent to the volatility recognised as a problem with an EBITDA-based test, and therefore protection from volatility (such as ability to carry denied interest deductions forwards and backwards) should be considered.
- Taking non-debt liabilities into account could put taxpayers into a negative equity position. For example, one of our clients which has recently become subject to the thin capitalisation regime due to the "acting together" rule has negative equity due to a significant deferred tax liability and therefore under the proposals would have all interest deductions disallowed – this does not seem an appropriate outcome.
- Several of the examples in Chapter 4 are not commercial or realistic as they would risk the company failing the company law solvency test.
- To give just a couple of examples of the effect of including non-debt liabilities, one client's current thin capitalisation ratio is 49.5%, and it would become 56.6% taking into account non-debt liabilities, even though the company is not particularly highly leveraged and all debt is third party bank debt. Another client's ratio would move from 40% to 93%, if the proposal for asset values (discussed below) is also adopted.

[5] Income Tax Assessment Act 1997 – section 820-682.

Other matters (DD Chapter 5)

Scope of proposed de minimis exception for inbound investment should be extended

We support the introduction of a de minimis for inbound thin capitalisation rules. However, the proposal to introduce a de minimis in cases where there is no owner-linked debt is unlikely to be useful in practice. The de minimis should instead apply to all cases where the inbound thin capitalisation rules apply. This would be in line with the OECD's proposals as referenced in the DD.

Carve out for infrastructure projects with third party funding needs further consideration

We support a proposed carve out for infrastructure projects. However, further consideration should be given to the following:

- there may be situations where the asset holding entity is different, but related to, the funding entity, e.g. a limited partnership holds the assets and a related party entity secures the required third party funding. The exception should still apply providing that the third party funding is on-lent to the related entity (even though technically the funding may be owner-linked debt);
- the entity will generally not own the asset at the end of construction phase, so how the proposals as to valuation of the assets will need to take into account the service charge the entity has received;
- the rate should apply to an offshore infrastructure entity that is globally funded by third party borrowing where it can allocate funding to a New Zealand infrastructure project;
- an exemption should be included (similar to Australia) for securitisation vehicles and arrangements which by their nature are highly geared.

Ability to use net current asset values should be retained

We understand Officials are concerned that asset valuations used for thin capitalisation purposes but not for financial reporting purposes may not be subject to a reasonable level of independent valuation or scrutiny. We understand this potential concern, but as we have discussed with you, it could be addressed in ways other than restricting asset values to those included in financial statements. The DD, at paragraph 5.25 states "…we consider that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets".

This is incorrect. Your Tax Information Bulletin: Volume Seven, No.11, Page 19 (March 1996) correctly said (when the thin capitalisation rules were first introduced) – "…it is recognised that the valuations for financial reporting purposes are likely to have been adopted for other than tax reasons". Consequently it was concluded that a taxpayer should be able to use net current value if that taxpayer could have adopted it for assets under GAAP (now IFRS) but has chosen not to.

Net current values (or fair value) are permissible under IFRS 13 but taxpayers instead choose not to adopt them for financial reporting purposes for non-tax reasons. These reasons include:

- in the context of worldwide groups that prepare consolidated accounts at the ultimate parent level, groups choose not to go to the additional expense of preparing entity accounts in the New Zealand group on a net current value basis and instead simply adopt historical cost;
- many entities within a group are not required to prepare individual entity financial statements;

- using net current value for financial reporting purposes can give rise to volatility in earnings ratios presented to shareholders which companies prefer to minimise, even though the changes in market value of the assets is a fact of life.

If the ability to use net current value is not retained, taxpayers will, for tax reasons, adopt net current value for financial reporting purposes despite it making no sense for commercial reasons. This change of accounting policy in financial statements under IAS 8 can be made (i.e. it is elective) if the result is more reliable or relevant. This will particularly be the case when there is a significant difference between historical cost and fair value.

As we have discussed with Officials in our meetings, we strongly submit that the ability to use net current values for thin capitalisation purposes needs to be retained.

Officials' concerns could be addressed by requiring valuations being adopted for thin capitalisation purposes to be supported by a valuation from a registered valuer, or a similarly qualified independent person.

Measurement of assets and liabilities should continue to be able to be end of year values (but perhaps average of start of year and end of year)

We understand Officials' concerns that the value for an asset or a liability can be manipulated if a value at a single point in time is used. We think this concern is already dealt with by the existing specific thin capitalisation rules regarding temporary differences. But if this is not enough then as we have discussed with you, continuing to be able to use year end values is very important, and a proposal that the average of opening and closing values is used would be more acceptable. This is preferable to quarterly or daily measurement because:

- the majority of taxpayers currently have no other need to value assets and liabilities quarterly or daily – the increased compliance burden and financial cost that would be imposed in obtaining such values (which often are only properly determined at year end) should not be underestimated;
- valuation outside the financial reporting cycle is inconsistent with the proposal referred to above that values used in financial statements should be used; and
- some balance sheet items are only measured annually – for example, asset impairment – it would not be possible to properly take these into account if measurement was required quarterly or daily.

Outbound thin capitalisation rules

Further consideration regarding the potential impact under the outbound thin capitalisation rules for New Zealand groups (especially SMEs and emerging fast growth businesses). If they have to apply most of these proposals, then the impact and compliance costs could be very material to New Zealand groups which the New Zealand Government should be wanting to support.

#016

AMP CAPITAL

27 April 2017

BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir/Madam

Submission on Discussion Document: BEPS – Strengthening our interest limitation rules

The following submission has been prepared by AMP Capital Investors (New Zealand) Limited (AMP Capital New Zealand) on the Discussion Document: BEPS – Strengthening our interest limitation rules. AMP Capital New Zealand is a specialist investment manager that manages a number of funds that are Portfolio Investment Entities (PIEs), as well as private equity investments. Our submission focuses on the potential affect of the interest limitation proposals contained in the discussion document on some of the investments that we manage on behalf of investors.

Background

New Zealand has a broad base, low rate tax system with limited exceptions. We understand what you are trying to achieve which is ensuring that the New Zealand tax base is protected and non-residents pay their fair share of tax here, as appropriate. However, the necessity to collect tax from non-residents needs to be balanced with the fact that New Zealand is heavily reliant on foreign direct investment and must remain an attractive place for non-residents to invest[1].

The proposals outlined in the discussion document will affect non-residents investment into New Zealand. In particular as they create tax mismatch and a high risk of a double taxation impact. This in turn will affect investor's returns. Non-resident investment in New Zealand is highly likely to reduce post investor's returns being impacted. Our comments on the proposed approach and the specific interest limitation proposals set out in the discussion document are detailed below.

Overall approach

The proposed interest rate cap is a unique approach and is uncalled for due to the recommended strengthen transfer pricing rules. The overall outcome of the interest rate cap proposal for inbound entities (New Zealand entities owned by non-residents), is a potential tax mismatch and a high risk of double taxation. This is best outlined through an example;

- A New Zealand company has a loan from its Australian owner,
- In New Zealand deductions are available to the company for the interest on the loan, say at 5% under the proposed interest cap,
- In Australia the non-resident owner is required to use an arms length interest rate under its transfer pricing rules, say at 7% which is returned as income,

There is a tax mismatch between the jurisdictions and double taxation of 2% as outlined above. The double taxation will affect the non-resident's shareholders or investor's returns from their investment. There is also the unknown factor of what actions will be undertaken in the non-residents owners' jurisdiction by its tax authority for the effect of the interest rate cap in New Zealand. The purpose behind

[1] Page 4, point 2.1, Discussion document – BEPS – Strengthening our interest limitation rules

T +64 4 494 2200 F +64 4 494 2123 Ground Floor, 113 – 119 The Terrace, Wellington 6011 PO Box 3764, Wellington 6140 New Zealand
AMP Capital Investors (New Zealand) Limited

the BEPs actions was to eliminate these types of international tax issues or mismatches not potentially create them.

There is no comment in the discussion document about how outbound investment (New Zealand entity with an offshore subsidiary) would be treated. Do they continue to use the arms length basis for transfer pricing, if yes how is this justified given the proposed interest rate cap for inbound investment?

Further, if introduced the interest rate cap will create inequity between New Zealand entities owned by New Zealanders and those owned by non-residents due to the double taxation outlined above. We expect that this inequity would result in reduced future non-resident investment in New Zealand. This would cause a higher cost of capital for New Zealand entities and infrastructure projects. These results are at odds with the statement made that New Zealand is heavily reliant on foreign direct investment and must remain an attractive place for non-residents to invest[2].

Marginal cost of debt

The statement "at the very least the marginal cost of debt should be no more than the marginal return from further investment" has been made in point 2.7 of the document. Where is the back up or justification for this statement? Is this some sort of economic theory or does this occur commercially?

Effectiveness of transfer pricing rules

It has been stated in the document that we are not convinced that the strengthened transfer pricing rules will prevent profit-shifting through the use of high-priced related party debt[3]. Has an exercise been undertaken to:

- Determined the scope that would be available for related parties to use high priced debt under the proposed amended transfer pricing rules, and
- Modelled the actual risk, if any, and
- Considered solutions for removing any scope available for the use of high priced debt?

Further, it has been stated that it is difficult to challenge a high level of related party debt loaded into a New Zealand subsidiary which depresses a subsidiary's credit rating and is used to justify a higher interest rate, as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and similarly high interest rates[4]. If taxpayers can find commercial comparatives for transfer pricing purposes that match their circumstances, would this not point to the fact that commercial lenders are not just undertaking the pure third party financing, which your proposals refer to. If this is the case, are these proposals creating an artificial environment which does not mirror actual commercial reality?

Interest cap

We reiterate that in our view the proposed interest rate cap is a novel approach and it is unnecessary due to the recommended strengthen transfer pricing rules. The overall outcome of the interest rate cap proposal creates inequity between New Zealand entities owned by non-residents and those owned by New Zealanders. In the future we expect that this inequity would result in reduced non-resident investment in New Zealand which would cause a higher cost of capital for New Zealand entities and projects.

It is proposed that the cap on the interest rate is based on what the borrower's ultimate parent could borrow at on standard terms. The details are light on how an ultimate parent would be determined. We question whether it's appropriate to use the ultimate parents borrowing terms approach as:

- in large groups the parent entity can be a number of entities removed from the New Zealand entity,
- the ultimate parent entity could have a different risk profile to the New Zealand entity, and
- either the parent or the borrower entity or both could be subject to rules, regulations or restrictions which affect their borrowing profiles.

It is suggested that where an ultimate parent is controlled by a non-resident owning body then the interest rate cap will be based on the rate the New Zealand borrower could issue senior unsecured debt on

---

[2] Page 4, point 2.1, Discussion document – BEPS – Strengthening our interest limitation rules
[3] Page 8, point 3.7, Discussion document – BEPS – Strengthening our interest limitation rules
[4] Page 9, points 3.11–3.12 Discussion document – BEPS – Strengthening our interest limitation rules

standard terms. Limited comments have been made on what is a non-resident owning body. Thus it is difficult to determine if non-resident private equity investors or managed funds would fall within the non-resident owning body concept and the possible impacts of this. Further, there would be a cost for taxpayers subject to this approach in determining what their interest rate would be.

It has been proposed that related party loans with terms longer than five years will be treated as having a five year term when determining an appropriate interest rate[5] due to it being unusual for commercial loans being committed for longer than five years. We have experience of commercial loans being written for periods of longer than five years. If applied, this rule would unfairly penalise New Zealand borrower entities through capping the terms of related party debt to an artificially determined period of time.

Infrastructure projects

We support the proposal that an entity can exceed the thin capitalisation 60% safe harbour ratio for infrastructure projects. However, the exemption should be extended regardless of whom controls the entity that is a single non-resident or multiple non-residents. Infrastructure entities generally require large amounts of capital which cannot necessarily be funded by one non-resident owner. Often potential non-resident owners such as managed funds will be restricted in amount they can invest or lend due to their investment guidelines, so more than one non-resident investor may be required.

Non-residents acting together

There is a proposal to change the way the thin capitalisation rules applying to entities controlled by a group of non-residents acting together. For such entities, where they exceed the 60% safe harbour any non-resident owner-linked debt will be non-deductible[6]. What is the reason behind denying interest on owner-linked debt where the 60% threshold is breached? Surely any denial of interest should be linked to the proportion of the breach, rather than making it all non-deductible.

Measurement date for assets and liabilities

It is proposed that the measurement periods for assets and liabilities for thin capitalisation would be the end of each quarter or the end of every day in the income year[7]. This approach would introduce significant costs for taxpayers subject to these rules, in relation to systems required for the calculations and obtaining the appropriate data. Generally systems that produce daily calculations such as unit pricing for the managed funds are complex and costly. Further, the IFRS accounting data e.g. fair valuing of assets, needed for these calculations are commonly not produced quarterly or daily. To require this information only for tax purposes would impose a significant cost and burden on taxpayers. We recommend that the current ability to measure assets and debts on the final day of an entities income year is retained.

Please feel free to contact the writer on [redacted] if you would like to discuss any of the points outlined above.

Yours sincerely

Adele Smith
Head of Tax
T [redacted]
E adele.smith@ampcapital.co.nz

---

[5] Page 16, point 3.53, Discussion document – BEPS – Strengthening our interest limitation rules
[6] Page 26, Discussion document – BEPS – Strengthening our interest limitation rules
[7] Pages 29-30, Discussion document – BEPS – Strengthening our interest limitation rules

Russell McVeagh

27 April 2017

By email

C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

SUBMISSION: BEPS – INTEREST LIMITATION RULES – A GOVERNMENT DISCUSSION DOCUMENT

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document "BEPS – Interest limitation rules" (March 2017) ("**Discussion Document**"). We would be happy to be contacted to discuss any aspect of the submission.

1.2 In summary, our submissions are:

General comment

(a) There have been a number of reforms over the past few years that will have increased the effective tax rate on foreign direct investment into New Zealand. These include broadening the scope of (and reducing the safe harbour threshold under) the thin capitalisation rules, and broadening the scope of NRWT (and reducing the availability of AIL). Consideration should be given to whether measures that will further increase the rate of effective tax (such as those proposed in the BEPS discussion documents released in March 2017, including the Discussion Document) are appropriate, particularly given New Zealand's headline corporate tax rate is now relatively high by international standards, at a time when there is a tendency towards corporate tax rate reductions by many countries.

(b) The measures proposed in the BEPS discussion documents include layers of overlapping measures, which seek to address the same perceived problem in multiple different ways. The proposed interest rate cap is an example of this, in that it addresses the same concerns as would be addressed by proposed amendments to the transfer pricing rules. Adopting multiple measures to address the same concern results in unnecessary complexity and increased compliance costs which will likely be a barrier to investing in New Zealand.

russellmcveagh.com
Auckland Vero Centre, 48 Shortland Street, PO Box 8, Auckland 1140, New Zealand DX CX10085 P +64 9 367 8000 F +64 9 367 8163
Wellington 157 Lambton Quay, PO Box 10-214, Wellington 6143, New Zealand DX SX11189 P +64 4 499 9555 F +64 4 499 9556

Limiting the interest rate on related-party loans (Chapter Three)

(c) New Zealand should not adopt an earnings-based (eg, EBITDA) interest limitation test. Such a test would result in significant volatility and uncertainty for taxpayers.

(d) The proposed interest rate cap should not proceed, but instead consideration should be given to adopting a safe harbour. It is critical that any interest rate cap be adopted as a safe harbour only, because if not, the interest rate cap:

  (i) would be inconsistent with OECD transfer pricing principles and transfer pricing rules applied in other jurisdictions, and could therefore result in double taxation (where New Zealand denies a deduction under the cap, but there is no corresponding reduction in the amount of interest income subject to tax in the lender's jurisdiction);

  (ii) would make it difficult for certain entities (such as banks and insurance companies) to comply with regulatory capital requirements;

  (iii) would have the perverse consequence that the borrower could raise debt at a higher price from third parties than from a related entity. This in turn could result in the tax system driving commercial behaviour (since businesses would have an incentive in cases to incur a higher pre-tax cost under borrowings from an unrelated party (because that cost is fully deductible) whereas borrowing from a related party may have a lower pre-tax cost but a higher after-tax cost due to being only partially deductible); and

  (iv) would, contrary to what the Discussion Document proposes, require grandparenting provisions for existing arrangements.

Each of these concerns could be addressed by adopting the interest rate cap as a safe harbour.

(e) If the interest rate cap is adopted as a safe harbour, it should be buttressed by other measures to increase certainty. In particular:

  (i) the existing safe harbour credit margin published by Inland Revenue (which applies where a group of companies has cross-border related-party debt totalling less than $10m principal in the relevant year) should be retained; and

  (ii) for loans having a principal value below a certain monetary threshold, Inland Revenue could publish (and periodically update) tables setting out safe harbour guidance as to the credit spread that corresponds to each possible credit rating and tenor, to assist in applying the interest rate cap.

Treatment of non-debt liabilities (Chapter Four)

(f) The proposed adjustment for non-debt liabilities will effectively result in a reduction in the permitted debt-to-assets percentage. Officials should take this into account in any analysis undertaken to determine the overall impact of proposed reforms on the tax burden imposed on foreign investment in New Zealand.

(g) Taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating total assets and total debt for thin capitalisation purposes.

(h) RPS and deferred tax liabilities should be excluded from "non-debt liabilities". (In the case of deferred tax, both deferred tax liabilities and deferred tax assets should instead be excluded from total debt and total assets, respectively.)

Other matters (Chapter Five)

(i) The net current valuation method should not be removed from the list of available asset valuation methods. If officials are concerned that net current values adopted under this method are inaccurate, rather than removing the method, a requirement to obtain an independent valuation when applying the method could be introduced.

2. GENERAL COMMENT

2.1 A number of reforms have been introduced over the past few years which have the effect of increasing the effective tax rate on foreign direct investment into New Zealand. These include broadening the scope of (and reducing the safe harbour threshold under) the thin capitalisation rules, and broadening the scope of NRWT (and reducing the availability of AIL). The question that now arises is the extent to which any further reform to New Zealand's international tax rules is required, and if so, how it should be implemented.

2.2 As Inland Revenue and the Treasury have acknowledged (see "New Zealand's taxation framework for inbound investment: a draft overview of current tax policy settings" (June 2016) at page 3):

> A priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish. Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to New Zealand.

2.3 This passage highlights that tax reform can hamper foreign investment in two ways: first, if the effective tax rate is too high (ie, too much tax is collected), and second, if the tax laws are poorly designed (ie, the tax is collected in an inefficient or economically distortionary way).

2.4 Careful consideration should be given to how the reforms proposed in the BEPS discussion documents released in March 2017 (including the Discussion Document) will perform, judged against each of these two criteria:

(a) With respect to the first point, consideration should be given to whether measures that will further increase the rate of effective tax are appropriate given New Zealand's headline corporate tax rate is now relatively high by international standards, at a time when the general trend is rate reduction.

(b) With respect to the second point, the measures proposed in the BEPS discussion documents include layers of overlapping measures, which seek to address the same perceived problem in multiple different ways. The proposed interest rate cap is an example of this, since it would address the same concerns as are being addressed by proposed amendments to the transfer pricing rules (in particular the proposed power to align the rules with economic substance, to allow reconstruction of transactions and to refer to arm's length conditions as well as to the arm's length amount of consideration).

These measures reflect similar amendments that have been made to Australia's transfer pricing rules. Experience in Australia (see in particular the decisions of the Federal Court and more recently the Full Federal Court in the *Chevron Australia* case) suggests that concerns regarding high-priced debt can be addressed under the transfer pricing rules. Australia does not have and is not proposing a cap that would limit deductible interest expenditure to an amount that is less than an arm's length amount. For the reasons given below, New Zealand should not adopt such a rule either (or should do so only as a safe harbour).

3. LIMITING THE INTEREST RATE ON RELATED-PARTY LOANS (CHAPTER THREE)

First submission: interest rate cap should be adopted as a safe harbour only

Overview

3.1 New Zealand should not adopt an earnings-based (eg, EBITDA) thin capitalisation test (which would create significant volatility and uncertainty). The proposed interest rate cap could be adopted, but as a "safe harbour" only.

3.2 It is critical that the interest rate cap be adopted as a safe harbour only, because if not, the interest rate cap:

(a) would be inconsistent with OECD transfer pricing principles and the rules of other jurisdictions, and could therefore result in double taxation (where New Zealand denies a deduction under the cap, but there is no corresponding reduction in the amount of interest income subject to tax in the lender's jurisdiction) (see paragraphs 3.6 to 3.21 below);

(b) would make it difficult for certain regulated entities (such as banks and insurance companies) to comply with regulatory capital requirements (see paragraphs 3.22 and 3.23 below);

(c) would have the perverse result that the borrower could raise debt at a higher price from third parties than from its parent (see paragraphs 3.24 to 3.30 below); and

(d) would, contrary to officials' assertion, require grandparenting provisions for existing arrangements (see paragraphs 3.31 to 3.33 below).

3.3 Adopting the interest rate cap as a safe harbour would alleviate the above concerns, by allowing a borrower to pay and obtain deductions for a higher rate of interest than that given by the cap if it can show that in its particular circumstances the arm's length rate of interest exceeds the cap. At the same time, it would retain many of the potential advantages of a cap (by providing an incentive to taxpayers to price related party debt conservatively in order to reduce uncertainty and potential disputes with Inland Revenue).

3.4 Any concern that (if the interest rate cap is a safe harbour) taxpayers could seek to adopt a rate exceeding an arm's length rate can be addressed under the transfer pricing rules. Reforms to those rules have been proposed in a separate discussion document ("BEPS – Transfer pricing and permanent establishment avoidance" (March 2017)) ("**TP and PE Discussion Document**"). We submit that the proposed changes to the transfer pricing rules (subject to our comments in our separate submission in respect of that discussion document) are sufficient to address the concerns officials have with the use of high-priced debt.

3.5 If required, the safe harbour could be buttressed by additional procedural protections for Inland Revenue. For example, taxpayers that do not follow the safe harbour could be required to make a disclosure in their returns so that Inland Revenue is on notice in respect of debt being priced over the cap.

Interest rate cap is inconsistent with OECD transfer pricing principles and with New Zealand's double tax agreements

Inconsistencies between interest rate cap and OECD transfer pricing principles

3.6 The proposed interest rate cap is inconsistent with OECD transfer pricing principles, because it would take no account of:

(a) the relationship between the ultimate parent and the subsidiary in the particular case (instead assuming that a "one-size-fits-all" adjustment, such as a one notch downgrade, is appropriate in all cases due to implicit credit support from the parent);

(b) the actual terms of the related-party debt, including subordination, convertibility, tenor (where exceeding five years) and other terms allocating risk between the borrower, lender and third parties; or

(c) other relevant circumstances, for example, the fact that the subsidiary may have a different asset base or be in a different industry (and accordingly have a different risk profile) to that of the ultimate parent.

3.7 With respect to the first point (implicit parent credit support), international transfer pricing practice recognises that the differential in credit risk between a parent and a subsidiary will be a matter of fact and degree. This is confirmed in one of the leading cases (the Canadian Federal Court of Appeal's decision in *The Queen v General Electric Capital Canada Inc.* [2010] FCA 344). The Court in that case rejected the argument that implicit support from the parent company meant that an explicit guarantee had no value.

3.8 The proposed interest rate cap would assume that in all cases the New Zealand subsidiary's assumed credit rating should be the same as that of its parent (less a "one-size-fits-all" adjustment, such as the one notch downgrade proposed). This would be inconsistent with the reality (recognised in the *General Electric Capital Canada* case) that there is no one size fits all approach, and that the facts and circumstances must be considered in each case to correctly determine the arm's length rate for the relevant arrangement.

3.9 With respect to the second point (that the proposed interest rate cap would disregard the actual terms of the related-party debt), OECD transfer pricing guidance makes clear that, other than in exceptional cases, pricing should be based on the terms of the actual transactions undertaken (OECD Transfer Pricing Guidelines for multinational enterprises and tax administrations, as amended by the BEPS Actions 8-10 2015 Final Reports entitled "Aligning Transfer Pricing Outcomes with Value Creation") ("**OECD TP Guidelines**") at [1.123]):[1]

> The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. **Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured**. …
>
> [Emphasis added]

3.10 The OECD TP Guidelines also indicate that every effort should be made to "ensure that non-recognition is not used simply because determining an arm's length price is difficult" (at [1.122]). On the face of it, that is what the interest rate cap seeks to do.

<u>Consequences of inconsistency with OECD transfer pricing principles</u>

3.11 If New Zealand adopts the interest rate cap (otherwise than as a safe harbour), and as a result denies deductions for interest on debt that is determined in accordance with OECD transfer pricing principles, this would result in double taxation, as the lender would not be entitled to a reduction in interest income in the jurisdiction in which its income is taxable.

3.12 It would also result in New Zealand breaching its obligations under the "Associated Enterprises" articles (typically Article 9) in its DTAs. Article 9(1) of the OECD Model Tax Convention reads:

> Where

---

1 The amendments set out in the BEPS Actions 8-10 2015 Final Reports entitled "Aligning Transfer Pricing Outcomes with Value Creation" were approved for incorporation into the OECD TP Guidelines by the OECD Council on 23 May 2016: see http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm (accessed 19 April 2017).

Russell McVeagh

> a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly.

3.13 The proposed interest rate cap would breach this article because it would result in New Zealand including in the profits of the borrower, and taxing, amounts in excess of those which would accrue if its related party transactions were priced in the same way as transactions between independent enterprises.

3.14 The Discussion Document argues that the interest rate cap would not breach New Zealand's DTAs either on the basis that it is a "thin capitalisation" rule which "aims to approximate a similar overall level of interest expense for a taxpayer as would arise in arm's length situations" (paragraph 3.57) or that, to the extent going beyond a strict application of the arm's length principle, it is a "domestic anti-avoidance rule" which is permitted to override New Zealand's DTAs (paragraph 3.59).

3.15 We do not agree with this analysis. The proposed interest rate cap is neither a thin capitalisation rule nor a domestic anti-avoidance rule:

(a) The proposed cap is not a thin capitalisation rule, because thin capitalisation rules (including the EBITDA rule) determine the overall permissible levels of debt or equity funding of an entity, whereas the interest rate cap instead addresses the *pricing* of a *particular* loan.

(b) The proposed cap is not a domestic anti-avoidance rule, because anti-avoidance provisions require some threshold to be met so that the provision applies to transactions having tax-induced features altering the incidence of tax in some way (whereas the proposed interest rate cap is subject to no such threshold).

Rather, the proposed cap is simply a transfer pricing rule, but one that produces results inconsistent with OECD transfer pricing principles and is therefore inconsistent with Article 9 of New Zealand's DTAs.

3.16 The fact that the proposed cap would breach Article 9 is illustrated by two extracts from OECD commentary set out below.

3.17 The first relevant OECD commentary is the report entitled "Thin Capitalisation" (adopted by the OECD Council in November 1986 and published in OECD Model Tax Convention on Income and on Capital 2014 (Full Version) (Vol II, OECD Publishing, Paris, 2014) R(4)-1). This report indicates that thin capitalisation rules ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit (at paragraph 77):

> … the question whether Article 9 may inhibit the operation of … thin capitalisation rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this. One group of countries takes the view that where a provision similar to Article 9(1) is included in the convention, it simply prohibits an adjustment of the profits of the resident company to any amount exceeding the arm's length profit. Another group of countries takes the view that while Article 9(1) permits the adjustment of profits up to the arm's length amount it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. A third group, while accepting that there is an absence of such a prohibition in the language used, nevertheless takes the view that the practical effect of Article 9 must be to impose such a restraint. … **The Committee generally agreed that, in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit** …
>
> [Emphasis added]

Accordingly, even if (which we do not accept) the interest rate cap were a thin capitalisation rule, it would still be required to be consistent with the arm's length principle in Article 9.

3.18 Second, and more recently, the OECD TP Guidelines make clear that adopting for transfer pricing purposes a non-elective safe harbour (ie, a cap) that is set below an arm's length rate without providing a mechanism for alleviating relief from the double taxation that could result would be inconsistent with double tax relief provisions of DTAs (OECD TP Guidelines at [4.115]):

> Where safe harbours are adopted unilaterally, care should be taken in setting safe harbour parameters to avoid double taxation, and the country adopting the safe harbour should generally be prepared to consider modification of the safe-harbour outcome in individual cases under mutual agreement procedures to mitigate the risk of double taxation. At a minimum, in order to ensure that taxpayers make decisions on a fully informed basis, the country offering the safe harbour would need to make it explicit in advance whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbour. **Obviously, if a safe harbour is not elective and if the country in question refuses to consider double tax relief, the risk of double taxation arising from the safe harbour would be unacceptably high and inconsistent with double tax relief provisions of treaties.**
>
> [Emphasis added]

3.19 This passage is directly relevant here, and is difficult to reconcile with the Discussion Document's assertion that the interest rate cap would not breach New Zealand's DTAs.

3.20 For completeness, there is nothing in the OECD BEPS Action 4 Final Report ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments") or in the OECD BEPS Actions 8-10 Final Reports ("Aligning Transfer Pricing Outcomes with Value Creation") which alters the position set out in the passages above, or indicates that the arm's length pricing rules under the OECD TP Guidelines should not continue to apply with respect to interest. Indeed, any suggestion that the OECD transfer pricing rules cannot apply to cross-border funding, or that the OECD BEPS project has in some way "abandoned" the arm's length principle with respect to cross-border debt, would seem difficult to sustain. As the TP and PE Discussion Document itself explicitly acknowledges, "the new OECD [TP] guidelines have a particular focus on funding" (TP and PE Discussion Document, paragraph 5.30).

3.21 Adopting an interest rate cap that results in double taxation and breaches New Zealand's DTAs would create increased uncertainty and potential for disputes, for both taxpayers and Inland Revenue. This concern could be addressed by adopting the interest rate cap as a safe harbour, as this would provide a mechanism for alleviating double taxation where the interest rate cap gives a result inconsistent with OECD TP Guidelines.

Interest rate cap does not make sense where particular conditions are required for regulatory reasons

3.22 In addition to being inconsistent with New Zealand's DTAs, adopting an interest rate cap that does not take into account the actual terms of the relevant related-party debt would be problematic for entities such as banks or insurance companies, that have regulatory capital requirements that are satisfied by issuing debt on certain terms prescribed by the regulations. For example, New Zealand registered banks are required to raise capital meeting certain requirements with respect to their terms such as tenor (which may be required to be perpetual), subordination and convertibility or write-off. These features may be critical to the debt qualifying as regulatory capital, and so it would be anomalous and punitive for the interest rate cap to effectively disregard these features in pricing the debt for tax purposes.

3.23 If the interest rate cap were instead adopted as a safe harbour, this concern would not arise, as regulated entities would be able to elect not to apply the safe harbour, and could instead show that a higher rate should be allowed.

Interest rate cap could result in related-party debt being priced lower than third party debt

3.24 The proposed interest rate cap does not permit regard to be had to the particular terms of the related-party debt, including the fact that the debt may be subordinated, or may have a tenor exceeding five years. Given that New Zealand corporates do in fact issue debt on such terms to third parties, this could have the perverse result that a borrower could issue debt to third parties at a higher rate than to its parent.

3.25 We provide examples of third party debt that is subordinated, and/or has a term exceeding five years, below.

<u>Subordination</u>

3.26 As noted above, the proposed interest rate cap requires loans to be priced based on the credit rating for senior unsecured debt, without adjustment for the fact the related-party debt may be subordinated.

3.27 However, New Zealand corporates do issue subordinated debt to third parties. For example, Genesis Energy Limited has both subordinated and unsubordinated bonds on issue that are listed on the NZDX, being:

(a) subordinated capital bonds having a maturity date in 2041, and paying a coupon of 6.190% (NZDX code: GPLFA); and

Russell McVeagh

(b) unsubordinated bonds having a maturity date in 2022, and paying a coupon of 4.14% (NZDX code: GNE030).

3.28 For the interest rate cap to disregard (in pricing related-party debt) the fact that debt is subordinated, in circumstances where corporates do in fact issue subordinated debt to third parties (as illustrated above), would be inconsistent with OECD transfer pricing principles and have the perverse result that New Zealand corporates could issue subordinated debt to third parties at a higher interest rate than to a related party.

Tenor exceeding five years

3.29 The Discussion Document proposes that a related-party loan with a term of longer than five years will be treated as having a term of five years for the purpose of determining the appropriate interest rate under the interest rate cap. This is based on the incorrect assertion that "it is unusual for a commercial loan to be committed for longer than five years" (at paragraph 3.53). In fact:

(a) in addition to the Genesis example given above, there are currently over 40 instruments[2] listed on the NZDX that have maturity dates after April 2022 (and therefore were issued with a term of more than 5 years) or are perpetual. These are set out in the Appendix to this submission;

(b) as noted above, for regulatory reasons it may be necessary to issue debt having a tenor exceeding five years. For example, in order for debt issued by New Zealand registered banks to qualify as Additional Tier One capital, it must be perpetual;

(c) we understand that in practice, a senior lender may require that any debt issued by a borrower have a tenor at least as long as that of the senior debt (so that the related party debt cannot be repaid before the senior debt).

3.30 These issues would not arise if the interest rate cap were adopted as a safe harbour, because (where appropriate) a taxpayer would be able to price related-party debt taking into account the above features.

Grandparenting provisions should apply if interest rate cap adopted other than as safe harbour

3.31 The Discussion Document indicates that existing related-party cross-border debt will be subject to the interest rate cap, with the relevant rate required to be determined based on historic interest rate data for the day on which the interest rate was struck (see paragraphs 3.54 and 3.55).

3.32 We submit, however, that grandparenting rules should be included so that the proposed cap does not apply to arrangements entered into prior to enactment of the relevant amending legislation. There are two reasons for this:

(a) Interest rate cap will apply to non-wholly owned groups: First, the definition of related-party debt to which the interest rate cap would

---

2 Note that certain of the instruments listed on the NZDX and included in this figure are preference shares. In addition, while we have not analysed the terms of each of the instruments listed, certain of them could be expected to include rights of repayment, or interest rate resets, prior to their stated maturity date.

apply is broad. It includes arrangements where the borrower and lender are not commonly owned, such as where the lender is a member of a non-resident owning body, or where a limited partner lends to a partnership in which it has a 25% partnership share. It cannot be assumed that the borrower and lender will be in a position to easily renegotiate the terms of that loan at a lower interest rate. Where the interest rate cannot be renegotiated, this would likely result in double taxation (in that a portion of the interest would be non-deductible to the borrower, but assessable to the lender).

(b) Restrictions in lender's jurisdiction may prevent renegotiation of existing debt: Second, even in the case of debt lent within a wholly-owned group, issues could arise in the jurisdiction in which the lender is taxed if the borrower and lender renegotiate the terms of existing debt without payment of a break fee, due to the need for the lender (under the transfer pricing rules of the lender jurisdiction) to act at arm's length from the borrower.

For example, suppose a wholly-owned New Zealand subsidiary had entered into a loan agreement under which it agreed to pay to its Australian parent for a ten year term an interest rate of BKBM plus a fixed margin (say, 4%). Suppose that this margin had been determined in accordance with OECD transfer pricing principles, but that under the proposed interest rate cap, the margin would be just 2%. The Australian Tax Office might argue that a third party lender acting at arm's length arguably would not agree to a reduction in the margin without receiving a break fee from the borrower. It might therefore seek to increase the lender's income by an amount equal to such break fee, or simply ignore the reduction in interest rate. In either case, double taxation would arise.

3.33 These issues would not arise (and grandparenting provisions would not be required) if the interest rate cap were adopted as a safe harbour, because the interest rate cap would be elective for the taxpayer.

Second submission: if the interest rate cap is adopted as a safe harbour, it should be buttressed by other measures to increase certainty and reduce compliance costs

3.34 If the interest rate cap is adopted as a safe harbour, this has the potential to reduce uncertainty and compliance costs for taxpayers and Inland Revenue. However, some uncertainty and compliance costs will remain.

3.35 That is because, in order to apply the interest rate cap, it will be necessary to both:

(a) determine the credit rating of the ultimate parent for senior unsecured debt (or the credit rating the ultimate parent would have, if it issued debt; or the credit rating the New Zealand group would have if there was no ultimate parent); and

(b) determine, for the tenor of the related-party debt, the arm's length price corresponding to the credit rating identified at paragraph (a) above.

3.36 There is potential for uncertainty at both stages of the inquiry: first, when determining a credit rating (where the ultimate parent does not have one, or there is no ultimate parent), and second in determining the interest rate corresponding to that credit rating.

3.37 With respect to this second step, the Discussion Document indicates that regard should be had to the yield derived from "appropriate" senior unsecured corporate bonds, and explains that (at paragraph 3.23, footnote 11):

> … the margin on bonds at the same credit rating can vary across industries. A taxpayer should be able to demonstrate that their choice of comparator bonds is appropriate.

3.38 In the New Zealand debt market, there will often be no comparable that perfectly matches a given loan's credit rating, tenor and industry. It will therefore often be necessary to either use a less-close domestic comparable, or use an international comparable (eg, US bonds) and undertake a currency conversion. In either case, uncertainty and disputes can arise as to the appropriate comparable to use, and the appropriate adjustments to make. Indeed, it may be that there is more than one correct interest rate, depending on what comparables and methodology the taxpayer (or Inland Revenue) chooses to adopt.[3]

3.39 Accordingly, we submit that:

(a) the existing safe harbour credit margin published by Inland Revenue (being, currently, 250 basis points over the relevant base indicator, where a group of companies has cross-border related-party debt totalling less than $10m principal in the relevant year) should be retained.[4] This means that for very low value loans, it will not be necessary to undertake the detailed analysis described at paragraphs 3.35 to 3.38 above); and

(b) for loans having a principal value below a certain monetary threshold (eg, $50m), Inland Revenue should publish (and periodically update) tables setting out safe harbour guidance as to the credit spread that corresponds to each possible credit rating and tenor. This would alleviate the uncertainty and compliance costs that would otherwise arise when applying the second step in the analysis under the interest rate cap (described at paragraph 3.35(b) above), and therefore provide further incentive for taxpayers to adopt the interest rate cap.

4. TREATMENT OF NON-DEBT LIABILITIES (CHAPTER FOUR)

General comment

4.1 As a general comment, we note that the proposed adjustment for non-debt liabilities will effectively result in a reduction in the permitted debt-to-assets percentage for taxpayers. In other words, the proposed change is not merely a minor clarification to the way in which assets and liabilities are calculated (which could be beneficial for some taxpayers and not for others), but will in all

3 It is for this reason that, currently, Inland Revenue bears the burden of proving that their method is more "reliable" than the taxpayer's in transfer pricing cases (section GC 13(4)). But this protection will not, as we understand it, apply with respect to the interest rate cap, and is proposed to be removed in transfer pricing cases generally.

4 See http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html.

cases where it applies result in an increased debt-to-assets ratio for the taxpayer.

4.2 The proposal is therefore one which will (in combination with the other proposals included in the BEPS discussion documents released in March 2017, and other amendments to international tax rules in recent years) further increase the tax burden imposed on foreign investment into New Zealand. Officials should take this into account in any analysis undertaken to determine the overall impact of proposed reforms on the cost of foreign investment in New Zealand, and should consider whether other taxpayer favourable changes (for example, permitting off-balance-sheet assets to be included in assets for thin capitalisation purposes) would also be appropriate.

First submission: taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities

Overview

4.3 The Discussion Document indicates (at paragraph 4.5) that out-of-the-money derivatives are an example of a non-debt liability that does not count as debt for thin capitalisation purposes, and so should be subtracted from assets in performing the thin capitalisation calculation.

4.4 This would exacerbate an existing issue that arises under the thin capitalisation rules, namely that fluctuations in the fair value of a financial arrangement (where the taxpayer applies the fair value method under IFRS) can lead to changes in the debt-to-assets ratio for thin capitalisation purposes from year to year. Accordingly, we submit that taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities

Example

4.5 We set out below an example of the volatility that could be created by the proposal to treat an out-of-the-money derivative valued at fair value (in this case, an interest rate swap) as a "non-debt liability".

4.6 Suppose on day one a taxpayer has assets of $170m, has borrowed $100m at a floating interest rate that is hedged under a fixed-floating interest rate swap, and $70m of equity. Suppose interest rates change, and the swap becomes out-of-the-money and so is recorded as a liability in the taxpayer's accounts (say, a liability of $30m). The taxpayer's balance sheet following the change in interest rates would therefore be as follows:

Assets		**Liabilities and equity**	
Assets	$170m	Loan	$100m
		Interest rate swap	$30m
		Equity	$40m

4.7 Under current law, the taxpayer's debt-to-assets ratio would remain, as on day one, 100/170 = 0.58 (ie, no breach of the thin capitalisation threshold). However, under the proposed change, its debt-to-assets ratio would have risen to 100/140 = 0.71 (ie, a breach of the thin capitalisation threshold).

4.8 Changes in the market value of the swap could therefore result in the taxpayer breaching the thin capitalisation threshold in a particular year. Notably, however, if interest rates changed again (and the interest rate swap became an asset the following year), there is no "wash-up" mechanism for the taxpayer to reclaim the previously denied interest deductions in the following year.

Proposed solution

4.9 We submit that taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities. This would enable taxpayers to ensure that fluctuations in fair value (for those taxpayers applying fair value to an asset or liability under IFRS) do not lead to fluctuations from year to year in debt-to-asset ratios due solely to changes in the fair value of an asset or liability.

4.10 The exclusion should be:

(a) at the election of the taxpayer. That is because making the election could lead to increased compliance costs for the particular taxpayer, and may not be appropriate for all taxpayers in all cases;

(b) on a class basis. That is, the taxpayer should be required to make the election with respect to a class of derivatives. For example, a taxpayer might elect that the exclusion:

(i) applies to interest rate swaps (see the above example); but

(ii) does not apply to cross-currency swaps (on the basis that unlike interest rate swaps, fair value movements in the currency swap may match changes in the NZD value of a foreign currency loan, and so in fact act to prevent rather than increase fluctuations in debt-to-asset ratios caused by currency movements).

4.11 The requirement that elections are made on a class basis rather than in respect of particular financial arrangements will prevent taxpayers "picking and choosing" which particular financial arrangements the exclusion applies to based on whether that financial arrangement is likely to be an asset or liability. Restrictions on the ability to change the election between income years could also be included.

Second submission: RPS and deferred tax liabilities should be excluded from "non-debt liabilities"

4.12 The Discussion Document proposes to subtract interest-free shareholder loans from "non-debt liabilities" (at paragraph 4.22). We support the exclusion of interest-free shareholder loans, and submit that, in addition, the following should also be excluded from the definition of "non-debt liabilities":

(a) RPS;

(b) deferred tax liabilities. That is because deferred tax liabilities do not represent true liabilities in the same way as, for example, amounts owed to trade creditors. Rather, they result from differences between the tax and accounting treatments of amounts.

4.13 In the case of deferred tax liabilities, we submit that, instead, both deferred tax assets and deferred tax liabilities should be excluded from the measurement of total assets and total debt. This would align with the position in Australia (see the Income Tax Assessment Act 1997 at section 820-682).

5. OTHER MATTERS (CHAPTER FIVE)

5.1 The net current valuation method should not be removed from the list of available asset valuation methods. If officials are concerned that net current values adopted under this method are inaccurate, rather than removing the method, a requirement to obtain an independent valuation when applying the method could be introduced.

Yours faithfully
RUSSELL McVEAGH

Brendan Brown | Shaun Connolly
Partners

Direct phone:	+64 4 819 7748 | +64 4 819 7545
Direct fax:	+64 4 463 4503
Email:	brendan.brown@russellmcveagh.com
	shaun.connolly@russellmcveagh.com

Russell McVeagh

APPENDIX

NZDX LISTED INSTRUMENTS WITH MATURITY DATE POST-APRIL 2022[5]
(See paragraph 3.29(a) of submission)

Company	NZDX code	Freq.	Coupon (%)	Maturity
ANZBANKNZ	ANBHA	2	5.28	Perpetual
ANZBANKNZ	ANBHB	4	7.2	Perpetual
CAS	CASHA	4	5.04	Perpetual
FONTERRA	FCGHA	4	4.38	Perpetual
INFRATIL	IFTHA	4	3.63	Perpetual
Kiwi Funding	KCFHA	4	7.25	Perpetual
MOTORFINANCE	MTFHC	4	4.47	Perpetual
NUFARM	NFFHA	2	5.89	Perpetual
QUAYSIDE	QHLHA	4	4.32	Perpetual
RABOBANK	RBOHA	4	2.88	Perpetual
RABOCAPITAL	RCSHA	4	8.34	Perpetual
WORKSFINANCE	WKSHA	4	6.29	Perpetual
IAG	IAGFB	4	5.15	15/06/2043
GPL	GPLFA	4	6.19	15/07/2041
LGFA	LGF080	2	3.5	14/04/2033
LGFA	LGF060	2	4.5	15/04/2027
SparkFinance	SPF570	4	3.94	7/09/2026
AUCKCITY	AKC100	2	3.34	27/07/2026
WGTNAIR	WIA050	2	5	16/06/2025
LGFA	LGF070	2	2.75	15/04/2025
WGTNAIR	WIA040	2	4	5/08/2024
NZXR	IFT230	4	5.5	15/06/2024
AUCKCITY	AKC070	2	5.81	25/03/2024
MERIDIAN	MEL040	2	4.88	20/03/2024
AUCKAIR	AIA210	2	3.97	2/11/2023
Z ENERGY	ZEL050	4	4.32	1/11/2023
INFRATIL	IFT210	4	5.25	15/09/2023
KiwiProperty	KPG020	2	4	7/09/2023
ANZBANKNZ	ANB130	2	3.71	1/09/2023
BNZBANK	BNZ110	2	4.1	15/06/2023

5 Source: http://www.anzsecurities.co.nz/directtrade/dynamic/fixedinterest.aspx, accessed 11 April 2017.

WGTNAIR	WIA030	2	4.25	12/05/2023
NZGOVERN	GOV410	2	5.5	15/04/2023
LGFA	LGF050	2	5.5	15/04/2023
MERIDIAN	MEL030	2	4.53	14/03/2023
SparkFinance	SPF560	4	4.51	10/03/2023
FONTERRA	FCG040	2	4.42	7/03/2023
TRUSTPOWER	TPW150	4	4.01	15/12/2022
CONTACT	CEN040	4	4.63	15/11/2022
AUCKAIR	AIA200	2	4.28	9/11/2022
AIRNZ	AIR020	2	4.25	28/10/2022
SKYCITY	SKC040	4	4.65	28/09/2022
Transpower	TRP040	2	4.07	16/09/2022
Transpower	TRP030	2	4.3	30/06/2022
GMT BOND	GMB030	2	5	23/06/2022
INFRATIL	IFT190	4	6.85	15/06/2022

Deloitte.

Deloitte
Deloitte Centre
80 Queen Street
Auckland 0622

Private Bag 115033
Shortland Street
Auckland 1140
New Zealand

Tel: +64 9 303 0700
Fax: +64 9 303 0701
www.deloitte.co.nz

27 April 2017

Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON

Dear Cath

BEPS – Strengthening our interest limitation rules

Deloitte ("We" or "Our") is writing to submit on Chapter 3 of the Government Discussion Document of March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document). For all other aspects of the Discussion Document, we support the submissions made by the Corporate Taxpayers Group.

We appreciate the opportunity to submit on this Discussion Document and would be happy to meet with Officials to discuss any of the matters raised in this submission further.

Summary

We submit that:

The problem of excessive interest rates identified by the Discussion Document should be addressed through the application of transfer pricing rules and the arms-length principle. Proposed changes to transfer pricing rules and guidelines that New Zealand has separately proposed to adopt, should themselves resolve the problem of excessive interest rates.

The proposed approach, capping allowable interest based on a five year term and on the interest rate that would apply to an associate parent entity when raising senior unsecured short term debt, is inconsistent with the OECD's recommended approach, the rest of the world (ROW) approach (including Australia) and with commercial practice. It also seems to be inconsistent with double taxation agreements. A poorly targeted thin capitalisation regime that is out of step with the ROW will undermine New Zealand's ability to attract capital for higher risk and longer term investments. It also creates the potential for double taxation.

A parent company's credit rating is relevant to related debt in only very limited circumstances, where the parent guarantees lending arrangements. It should not be arbitrarily applied to all related party debt without regard to the ability of the parent company to control the subsidiary and to provide credit support to the subsidiary.

In any event, any changes made should be subject to grandparenting, due the long term nature of existing investments which have been made in reliance on the existing thin capitalisation rules and which cannot be easily unwound. The regime should not penalise compliant taxpayers within the 60% thin capitalisation threshold. In our view, the appropriate treatment would be for arrangements entered into prior to the date of enactment to be excluded from any new rules.

Interest rates should be governed by transfer pricing and the arms-length principle

An interest rate cap is proposed to limit allowable interest deductions on non-commercial loans. We submit that changes to transfer pricing rules and guidelines that New Zealand has separately proposed to adopt (including those in the Inland Revenue's transfer pricing discussion document: *BEPS – Transfer Pricing and Permanent Establishment Avoidance*), should themselves resolve any problem of excessive interest rates On non-commercial loans. Under the new proposals, transfer pricing will require consideration of the interest rates, quantum of debt and the terms of the debt. In other words, price (interest rate), quantum (level of gearing) and the terms of the debt need to be considered from a commercial perspective in an integrated approach. Moreover, transfer pricing will seek to disregard the legal form if it does not align with economic substance.

If the interest rate cap proposal is adopted in its current form, it would itself give rise to a result that is inconsistent with a comparable third party transactions and would price debt on an uncommercial basis.

The proposed approach is inconsistent with the OECD's recommended approach and inconsistent with the rest of the world approach

The Discussion Document approach is different from the OECD's recommended EBITDA approach for limiting interest deductibility.

The proposed approach is also inconsistent with the rest of the world approach. In general the rest of the world has "thin cap rules" to determine the overall level of deductible debt or quantum (i.e. 60% of assets/net assets as the safe harbour which is a variant to the EBITDA approach). It is then up to the "transfer pricing" rules to determine arms-length rate.

As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". We submit there is no rational basis for New Zealand to be out of step with the ROW by not applying the arms-length standard.

Australia applies transfer pricing to limit related party cross border interest rates and in doing so can adjust such rates in accordance with identified uncommercial terms along the lines set out in the Discussion Document - the loan being highly subordinated, repayable on demand, having extremely long terms, convertible into shares.

The Australian thin capitalisation rules, including using an arms-length approach for setting maximum debt levels, were recently subject to a comprehensive review by the Australian Board of Taxation[1]. This concluded that the arms-length test is the "central plank of the thin capitalisation rules". While further changes in Australia are possible, we expect the approach to be adopted will be for a parent company's credit rating to be just one factor to be considered, where relevant, when determining whether an interest rate is an arms-length rate. A like approach could be adopted in New Zealand by including reference to the interest rate cap and the five year loan term in the proposed guidelines for the purpose of assessing transfer pricing risk in respect of related party loans.

The proposed approach will raise the possibility of international double taxation

The issues identified above will also increase the risk of international double taxation. For example, New Zealand denies an interest deduction to a parent and in effect treats part of the interest as a non-deductible dividend. The parent company is taxed on interest but not dividends. It could also give rise to a taxable interest stream in a foreign subsidiary which follows the arm's length standard but a denial of interest deductions to the NZ parent.

[1] Australian Board of Taxation[1] – Review of the Thin Capitalisation Arms-Length Debt Test December 2014

Adjusting interest deductions within the transfer pricing framework has the very significant advantage of incorporating measures to reduce the risk of double international taxation. If the New Zealand adjustment to interest deductibility is made under transfer pricing rules then under paragraph 2 of Article 9 of the Model convention a collateral adjustment is required by the parent company jurisdiction so as to avoid double taxation. No such adjustment seems possible under the approach proposed in the Discussion Document.

The proposed changes go beyond the problem identified in the Discussion Document

The policy concern that underlies the thin capitalisation rule changes is that debt can be substituted for equity so that what would in the absence of tax be taxed as an equity return (28% plus any NRWT) is instead taxed at the much lower rates on interest.

We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent, there is an increased risk associated with parent lending which may be used to justify a higher interest rate while not altering the parent's overall investment risk. The underlying assumption in the Discussion Document seems to be that a parent would borrow from third parties using its better credit rating and then on-lends the funds to its subsidiary; and the parent has an implicit duty to support its subsidiary.

However, in most circumstances this assumption will not apply, for example:

> Where an offshore entity does not control or hold all of the shares in the New Zealand entity. The thin capitalisation ownership test does not properly target control of subsidiaries and for example under current rules, non-voting preference shares can be attributed control ownership status;
>
> An offshore parent (such as a Unit Trust) that is precluded by regulatory or fiduciary obligations from providing support to the subsidiary entity; or
>
> Institutional investors which will shield themselves from stand-alone investment risk so as to limit risks to the fund's overall exposure, as part of the "enterprise risk management policy".

In these cases the commercial cost of funds of the New Zealand entity will not reflect the cost of funds of any overseas investor in that entity.

We submit that any interest cap based on the parent's cost of borrowing should be limited to situations where any increase in debt risk can reasonably be viewed as not altering the overall risk assumed by any investor so that the increased interest rate can in substance be viewed as a dividend return on equity. This will clearly not be the case for non-controlled entities and where there are legal, regulatory or other prohibitions to providing support to the New Zealand entity.

Further, the Discussion Document proceeds on the basis that a term over 5 years is uncommercial. Limiting the term to 5 years will give rise to pricing which is not consistent with comparable third party transactions noting that debt instruments such as bonds, tend to have terms exceeding five years. Longer term debt instruments are clearly relevant for longer term investments. We submit that the arbitrary five year term should be removed. The term of the loan should be determined by reference to arms-length standards.

The proposed approach will result in interest adjustments beyond the problem identified in the Discussion Document and will make New Zealand less attractive as an investment destination. The economic costs of unduly restricting the deductibility of the interest costs of New Zealand enterprises are, in our view, high.

Grandparenting

We submit that, if any changes are to be made, they should be subject to grandparenting. Significant investment decisions have been made based on existing settings and a lot of these arrangements involve external commitments (not necessarily internal group arrangements) that cannot be easily unwound.

Uncertainty and risk is of course inherent in any investment, particularly for long term investments. However, the impact of the proposals in the discussion document, if enacted in their current form, would materially affect the post-tax return on significant investments. This would also undermine the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand projects in the future.

As a result, we submit that the proposals, if enacted, should include grandparenting. In our view, the appropriate treatment would be for arrangements entered into prior to the date of enactment to be excluded from any new rules.

Concluding remarks

We have strong reservations about the proposed changes to New Zealand's thin capitalisation regime and in particular on the departure from the arms-length basis which is the global transfer pricing standard.

For any queries in relation to this submission, please contact Teresa Farac (09 303 0845).

Yours sincerely

Teresa Farac
Partner
for Deloitte Limited *(as trustee for the Deloitte Trading Trust)*

28 April 2017

c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Policy.webmaster@ird.govt.nz

Dear Deputy Commissioner,

Submission on the discussion document "Strengthening our interest limitation rules"

Thank you for the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on the *BEPS – Strengthening our interest limitation rules Government discussion document* (the **Discussion Document**). We also appreciate discussion held to date with Officials in respect of the Discussion Document.

ANZ Bank New Zealand Limited (**ANZ**) recognises and supports the Government and IRD Official's work to combat base erosion and profit shifting out of New Zealand using excessively priced related party debt. ANZ considers that any such rules must appropriately balance combatting aggressive behaviour but not extend so far as to limit genuine commercial behaviour. If such a balance is not appropriately struck, the New Zealand economy will suffer through inefficient importation of capital, particularly compared to New Zealand's competitors of imported capital.

The reality of this balance for New Zealand is highlighted at paragraph 1.4 of the Discussion Document:

> *"While the majority of firms subject to the thin capitalisation rules have taken conservative debt positions, there is a minority that engages in more aggressive tax practices. Of particular concern is that some firms have borrowed from their foreign parent at high interest rates, resulting in very large interest deductions in New Zealand. A proposal to address this is discuss in chapter 3.*

It is chapter 3 of the Discussion Document that is the focus of ANZ's submission.

In summary, ANZ considers that the proposals in chapter 3 do not strike the appropriate balance referred to above. While the proposals may appropriately combat the minority of aggressive taxpayers, the blanket approach of the proposals will also penalise taxpayers that apply commercial terms and rates to cross border related party debt, in particular the banking industry where such debt, due to regulatory necessity, is priced above a senior unsecured rate. Such an imbalance has the very real effect of placing inefficiencies on importing capital.

Summary of key submission points

Our submissions, summarised below, focus on the impact of the proposed interest rate limitation on New Zealand registered banks. We provide further context to our submissions in Appendix 1.

1. The proposed interest rate limitation should not apply to New Zealand banking groups:

    - New Zealand banking groups are subject to significant prudential regulation that limits the level of, and requires arm's length pricing for, cross border related party funding. As such New Zealand banking groups do not present the risk that the proposed rules are seeking to target.
    - Bank regulatory capital, as a significant portion of funding from offshore parents, would become inefficient to raise if the proposals applied to New Zealand banking groups, resulting in tax outcomes that do not reflect commercial and regulatory positions, a disadvantage for New Zealand banking groups compared to other industries and double taxation.
    - Excluding New Zealand banking groups from the proposals would not be contrary to the position adopted by the OECD for the banking industry.

2. If our above submission is not accepted, we consider that the interest limitation proposals should apply as a safe harbour only and not over ride application of the transfer pricing rules.

3. If, contrary to the above submissions, the interest limitation proposals proceed, we submit that the limitation should not apply to related party debt arrangements in existence at the date of enactment of the amending legislation.

4. ANZ submits that funding from offshore branches of New Zealand banking group entities are not caught within the proposed rules.

5. ANZ submits that ongoing consultation of the interest limitation proposals continue before a Bill is introduced into Parliament.

About ANZ

ANZ is the largest financial institution in New Zealand and is a regulated bank subject to prudential supervision by the Reserve Bank of New Zealand (**RBNZ**). The ANZ group comprises brands such as ANZ, UDC Finance, ANZ New Zealand Investments, ANZ New Zealand Securities and Bonus Bonds.

ANZ offers a full range of financial products and services including a significant range of financial advisory services, personal banking, institutional banking and wealth management services.

Publication of submission

ANZ requests that this submission on the Discussion Document is kept confidential by the IRD on the grounds of commercial sensitivity.

Contact for submission

ANZ welcomes the opportunity to discuss any of our submissions directly with IRD officials. Please contact me on [redacted] if you would like to discuss our submission further.

Once again, we thank IRD for the opportunity to have input into the proposals on the proposals to strengthen New Zealand's interest limitation rules and look forward to ongoing consultation on this issue.

Yours sincerely

Phleath

Philip Leath
GM Tax, New Zealand
ANZ Bank New Zealand Limited

APPENDIX 1 - Submission points

1. The proposed interest rate limitation should not apply to New Zealand banking groups:

- **New Zealand banking groups are subject to significant prudential regulation that limits the level of, and requires arm's length pricing for, cross border related party funding. As such New Zealand banking groups do not present the risk that the proposed rules are seeking to target.**
- **Bank regulatory capital, as a significant portion of funding from offshore parents, would become inefficient to raise if the proposals applied to New Zealand banking groups, resulting in tax outcomes that do not reflect commercial and regulatory positions, a disadvantage for New Zealand banking groups compared to other industries and double taxation.**
- **Excluding New Zealand registered banks from the proposals would not be contrary to the position adopted by the OECD for the banking industry.**

1.1 ANZ considers the core premise behind the interest limitation proposals is that an offshore parent's average cost of funding is an appropriate approximation of the cost of funding for its New Zealand subsidiary, at least in respect of cross border related party funding. Relevantly, paragraphs 3.24 and 3.25 of the Discussion Document state:

> *"We consider that the interest rate that a multinational could obtain when raising senior unsecured debt (either determined with reference to its credit rating, or calculated based on other factors) is a reasonable approximation of the multinational's cost of funds."*
>
> *"This proposed rule would therefore anchor the deductible interest rate on intra-group debt to a multinational's actual cost of debt. We consider this reasonable. For example, one funding option available to a multinational would be to raise third-party debt and on-lend the debt to its New Zealand subsidiary.* ***We consider it unlikely that the multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational's cost of debt, since this would lower its overall profits."***

[emphasis added]

Such a premise appears to assume that the majority of funding for the New Zealand subsidiary is obtained from its offshore parent, the New Zealand subsidiary would only source, in an economic sense, senior unsecured debt and that there is a choice as to the form or legal terms of related-party debt issued to an offshore parent. This may well be the case for some foreign owned New Zealand corporates. Such a premise, however, is not the case for the ANZ New Zealand banking group.

ANZ's Source of funding

1.2 ANZ predominantly obtains its funding from 3 sources:

- capital (comprising ordinary equity and retained earnings (collectively common equity tier 1 capital) and other bank regulatory capital);
- domestic deposits; and
- offshore and onshore wholesale funding.

1.3 From an ANZ New Zealand geographic perspective, the level of debt funding from the ultimate offshore parent (including offshore subsidiaries) is ~2.4% of its total debt funding[1].

Regulation on funding sources

1.4 ANZ's source of funding is subject to significant prudential regulation. ANZ faces regulation from both the Australian Prudential Regulation Authority (**APRA**) and the RBNZ in respect of the limits and pricing of related party debt.

1.5 APRA's prudential standard APS 222 (Associations with Related Entities)[2] limits an Australian Authorised Deposit Taking Institutions' (**ADIs**) exposure to related ADIs (including overseas based equivalents) to 50% of the amount of the Australian ADI's Level 1 regulatory capital. APRA has imposed further limits on an Australian ADI's exposures to certain New Zealand foreign owned banks which require that, by 1 January 2021, no more than 5% of the Australian ADI's Level 1 Tier 1 Capital comprise non-equity exposures to its New Zealand operations (excluding regulatory capital instruments, which we address further below). As a result, the ANZ New Zealand group (including the New Zealand holding company) can only obtain a minority of its funding from its offshore parent.

1.6 The RBNZ impose various regulations that directly and indirectly impact the source of funding for New Zealand banks. New Zealand registered banks are required to maintain core funding ratios (refer RBNZ Document BS13 – Liquidity Policy)[3]. Broadly, core funding ratios (**CFR**) require banks to have diversity over sources of funding to manage appropriate liquidity within the New Zealand financial system. The calculation of CFR includes a preference for funding from deposits over wholesale funding (which, for CFR purposes, includes related party funding). In addition, a condition of registration for ANZ for New Zealand banking prudential purposes is that *"the bank's constitution must not contain any provision permitting a director, when exercising powers or performing duties as a director, to act other than in what he or she believes is in the best interests of the company (i.e. the bank)"*. This requirement logically requires ANZ to act on arm's length with its offshore parent and cannot deliberately source uncommercial or excessively priced related party debt, for doing so would not be in the best interests of ANZ.

---

[1] From 30 September 2016 Australia and New Zealand Banking Group Limited – ANZ New Zealand Registered Bank Disclosure Statement (excludes debt allocated from ultimate parent to NZ Branch of ultimate parent, which must be reduced to ensure compliance with APRA's APS 222 standard by 1 January 2021).

[2] Australian Prudential Standard APS 222: Associations with related entities, January 2015, available at: http://www.apra.gov.au/CrossIndustry/Documents/141120-APS-222.pdf

[3] RBNZ Document BS13 regarding reporting of liquidity policy, including core funding ratios, available at http://www.rbnz.govt.nz/regulation-and-supervision/banks/prudential-requirements/liquidity-policy

1.7 ANZ considers that such prudential regulation strongly mitigates the risk that the proposals seek to counter.

Bank regulatory capital

1.8 A primary source of ANZ's debt funding from its offshore parent bank is regulatory capital. Regulatory capital contains unique features which are required by prudential regulators (often both RBNZ and APRA). The RBNZ framework for bank regulatory capital as set by the Basel Committee (referred to as the Basel III framework) requires banks to hold 10.5% bank regulatory capital over risk weighted exposures, at least 7.0% of which must comprise Common Equity Tier 1 (**CET1**) Capital (i.e. ordinary shares and retained earnings).

1.9 A bank's regulatory capital can also comprise Additional Tier 1 (**AT1**) and Tier 2 (**T2**) capital, provided such capital complies with the prudential regulations. These regulatory requirements include subordination, permanence, flexibility of payment and loss absorbency measures. These are mandatory requirements. From a cost of capital perspective, CET1 is the most expensive, followed by AT1 and then T2. As such, ANZ holds a mix of such bank regulatory capital for economic cost of capital reasons. ANZ has issued AT1 instruments ranging in tenor from 5 to 10 years before any redemption can be made, subject to RBNZ (and where relevant APRA) approval. As a consequence of the mandatory regulatory features, AT1 and T2 instruments are priced above senior unsecured debt.

1.10 While ANZ has issued regulatory capital instruments to the New Zealand market, the New Zealand market is not sufficiently deep or liquid to absorb the regulatory capital needs of all New Zealand banks (including ANZ). Consequently, it is necessary that regulatory capital funding is obtained from international markets. It is often preferable for ANZ to access offshore markets for regulatory capital through its foreign parent rather than doing so directly for the following reasons:

i. ANZ would not issue direct into the Australian market as doing so places ANZ in direct competition with its parent (who also regularly accesses the Australian market for its regulatory capital requirements).

ii. Bank regulatory capital issued directly by ANZ into the market will not count as Level 1 capital for our ultimate Australian parent (Level 1 capital is preferable). Further, our parent bank incurs a haircut or reduction in the amount of regulatory capital it can recognise for any regulatory capital externally issued by ANZ.

iii. If our parent issues regulatory capital externally and provides regulatory capital to ANZ, only one set of regulatory rules applies to each capital instrument (i.e. APRA for the parent issued instrument and RBNZ for the ANZ issued instrument). By comparison, if ANZ issues regulatory capital externally both APRA and RBNZ rules apply to that single instrument creating significant complexity and cost in applying 2 sets of regulatory rules which are not perfectly aligned.

iv. It is more economic for ANZ's foreign parent to raise regulatory capital in the international markets and then provide that regulatory capital to ANZ than it is for ANZ to issue regulatory capital direct into international markets. For completeness and as noted above, the Board of the New Zealand registered bank would only issue bank regulatory capital to its parent an arm's length to ensure the Board is acting in the best interest of the New Zealand registered bank.

1.11 At this point, it is worth noting that ANZ is owned 100% by a New Zealand holding company which, in turn, is ultimately 100% owned by our Australian parent ADI. Where ANZ's foreign parent provides regulatory capital to ANZ, this could occur by providing non-regulatory debt funding to the New Zealand holding company which then provides the regulatory capital funding to ANZ. The debt funding to the New Zealand holding company cannot be regulatory capital as the New Zealand holding company is not a registered bank. However, such debt should closely mirror the terms, and therefore pricing, of the regulatory capital issuances. If this was not the case (for example if the debt from the offshore parent to the New Zealand holding company was senior unsecured debt) the New Zealand Holding company could be left in a position that if interest is not paid on the regulatory capital it holds in ANZ (as noted above, interest on regulatory capital is subject to flexibility of payment and must be non-cumulative) it would still have interest payable on the debt it has issued to the offshore parent. This would present a non-commercial outcome and present risks of insolvency for the Board of the New Zealand holding company. Equally the offshore parent holding the debt in the New Zealand holding company would end up in a position of having borrowed at a higher interest rate but having on-lent at a lower interest rate, creating an uneconomic and uncommercial outcome, again presenting issues for the Board of the offshore parent company. The use of a New Zealand holding company, as above, should result in a similar position, economically and tax wise, as if our Australian parent ADI provided regulatory capital direct into ANZ (and not through the New Zealand holding company). Further, we note that the foreign parent's holding of debt in the New Zealand holding company remains subject to APS 222.

1.12 Due to the unique requirements of bank regulatory capital and the reliance on offshore parent banks to provide such bank regulatory capital for the New Zealand banking system, ANZ submits that New Zealand banking groups should be excluded from the proposals in the Discussion Document. If New Zealand banking groups are not excluded from the proposals, an absurd tax policy outcome will arise in that, on a post-tax basis, it will become more economic for New Zealand banks to raise capital direct from international markets at higher interest rates than to obtain bank regulatory capital from our offshore parents at lower interest rates. The proposals would create a tax divergence from true economic positions resulting in inefficient capital raising for New Zealand banks.

1.13 It is not possible to restructure bank regulatory capital to have terms that are commensurate to senior unsecured debt. The terms of bank regulatory capital are mandatory and it is these mandatory requirements that result in such debt carrying a commercial but higher interest rate than that for senior unsecured debt. The proposals would, therefore, place New Zealand banks at a disadvantage (at least in a tax sense) to other New Zealand taxpayers that can change the terms of cross border related party debt.

1.14 Further, the proposals will result in double taxation on bank regulatory capital obtained from our parent. As above, bank regulatory capital carries an interest rate higher than our parent's senior unsecured rate. Therefore, a denial of a full deduction on the interest rate (i.e. actual interest paid) would arise in New Zealand. However, Australia (in ANZ's case) would not be bound by New Zealand's interest rate limitation and would require an arm's length price based on appropriate commercial terms reflecting the interest rate for bank regulatory capital for the tenor of the capital issued. It would not be possible to simply reduce the amount of interest paid on such instruments for regulatory reasons. In this regard, the proposed interest limitation rules appear to apply unilaterally from New Zealand's double tax treaty network such that it would not be possible to invoke the relevant Tax Treaty competent authority procedures.

1.15 Referring back to paragraphs 3.24 and 3.25 of the Discussion Document, the senior unsecured debt rate reflecting our parent's credit rating does not approximate the commercial requirement to access regulatory capital from our parent and the unique mandatory regulatory requirements of such capital which result in a commercial interest rate above a senior unsecured rate. This unique position in the banking industry was noted by the OECD in a public discussion draft on Action 4 that the "excessive leverage in a bank or insurance company has not been identified as a key risk"[4]. As such, ANZ considers that excluding New Zealand banking groups from the interest limitation proposals is not contrary to OECD guidance.

2. If our above submission is not accepted, we consider that the interest limitation proposals should apply as a safe harbour and not override application of the transfer pricing rules.

2.1 We understand from officials that the proposed interest limitation is a formulaic approach to interest limitation to reduce the time and effort required for taxpayers and the IRD to mutually agree on an arm's length price under the transfer pricing (**TP**) rules and, accordingly, may increase certainty for taxpayers. Assuming this will be the outcome, this should not come at the expense of accuracy, especially by imposing real tax costs on compliant industries and, as above, for industries that have regulatory requirements that would result in the broad formulaic approach diverging from accuracy and commercial reality. The proposal would inappropriately override commercial positions, being an interest rate that, under TP pricing rules would be considered arm's length.

2.2 Alongside the Discussion Document, officials have also proposed changes to strengthen the TP rules. The proposed changes in the Government Discussion Document on *BEPS – Transfer pricing and permanent establishment avoidance*, provide broad powers for the IRD to consider a company's debt raising and to restate the quality of debt instruments to reflect the economic substance. On application of the proposed TP rules, transactions with excessively priced debt that are artificial and based on uncommercial terms would be ineffective. The interest rate would then be revised to reflect economic reality. There is

[4] OECD, *BEPS Action 4: Approaches to address BEPS involving interest in the banking and insurance sectors*, p.10, available at: https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf

significant overlap between what the TP changes and the interest rate cap are intended to achieve. In our view, the core principle is, and must continue to be, that interest rates be set on an arm's length basis. It is critical that taxpayers retain the ability to establish, through the TP rules and subject to the IRD's review, an interest rate on cross-border debt that is based on appropriate commercial terms. The proposed interest limitation should not override genuine analysis of arm's length terms and conditions.

2.3 ANZ considers that the interest limitation proposal will not result in a significant easing of compliance. Taxpayers are, in a practical sense, required to ensure cross border prices are arm's length through assessment of their own credit position and considering comparable prices. The interest limitation proposal will still require such an obligation but merely shift the entity of focus from the New Zealand taxpayer to the offshore parent entity. Further, ANZ considers that any comparable pricing should not be limited to secondary markets (i.e. traded bonds). For example, secondary markets do not reflect the reality of costs of issuing new debt, including new issue premiums.

2.4 If the above submission to exclude banks from the scope of the proposed interest rate limitation is not accepted, ANZ submits that the interest rate limitation should act as a 'safe harbour' threshold. It should not override the TP rules or prevent an arm's length price from being established. Debt instruments with interest rates within the limitation threshold should not need to be reviewed against TP principles (i.e. are deemed to be TP compliant). This may still reduce compliance costs for taxpayers and administrative costs for the IRD. For instruments with interest rates greater than the proposed interest limitation (such as bank regulatory capital), taxpayers should continue to have the opportunity to apply the TP rules to establish an arm's length price. If such a position is not accepted for all cross border related party debt, it should apply, at least, to transactions relating to banking regulatory capital for the regulatory reasons outlined above which make bank regulatory capital unique.

3. If, contrary to the above submissions, the interest limitation proposals proceed, we submit that the cap should not apply to related party debt arrangements in existence at the date of enactment of the amending legislation.

3.1 The Discussion Document proposes that the interest rate cap will apply from the first income year beginning after enactment of the legislation (refer paragraph 5.36). Officials consider that this should give companies sufficient time to rearrange their affairs.

3.2 For the New Zealand banking industry, it is highly unlikely to be possible to rearrange such instruments due to their regulatory overlay. Further, in ANZ's context, we regularly seek IRD approval on the pricing of cross border funding. It would be inappropriate to over-ride such existing agreed positions.

3.3 Therefore, if the proposals proceed as drafted, we submit that the interest limitation should not apply to existing funding arrangements which have been reviewed, or are in the process of being reviewed, by the IRD under the TP rules to establish an arm's length price. The proposals should only apply to new arrangements entered into after the date of enactment.

4. ANZ submits that funding from offshore branches of New Zealand bank group entities are not caught within the proposed rules.

4.1 ANZ accesses debt by raising securities and commercial paper in international markets through a foreign branch of a subsidiary of ANZ. The foreign branch on-lends this debt into ANZ. The on-lending into ANZ is subject to TP rules.

4.2 The proposal for "related-party" debt in the Discussion Document at paragraph 3.43, however, may be sufficiently broad that it will include the on-lending from the offshore branch into ANZ within the interest limitation proposals. Such on-lending has no association to our parent's funding costs and therefore, should not fall within the interest limitation proposals.

4.3 ANZ understand from discussions with Officials that it is not intended for such funding from offshore branches to be included within the proposals. ANZ, therefore, submits that if our submission above at paragraph 1 is not accepted, any amending legislation is drafted to ensure such on-lending is not captured.

5. ANZ submits that ongoing consultation of the interest limitation proposals continue before a Bill is introduced into Parliament.

5.1 ANZ recommends and would welcome ongoing consultation on any further development of the interest limitation proposals prior to drafting of legislation. Given the complexity of this topic and its deviation from long standing tax principles, ANZ would also welcome the opportunity to consider any draft legislation of exposure draft prior to introduction to Parliament as a Bill.

#020

Response to

Inland Revenue

on the

Government discussion document:

BEPS – Strengthening our interest limitation rules

28 April 2017

1.0 INTRODUCTION

1.1 This submission has been prepared by Bank of New Zealand ("BNZ") in response to Inland Revenue's ("IR") discussion document, 'BEPS – Strengthening our interest limitation rules', released on 3 March 2017 ("Discussion Document").

1.2 BNZ welcomes this opportunity to provide a response to IR's Discussion Document. While BNZ is wholly supportive of actions to counter aggressive tax planning and tax avoidance, BNZ remains of the view that any legislative reform to counter aggressive tax planning must be appropriate for, and targeted at, the mischief it is intended to address. Many of the proposals contained in the discussion document have broad reach and are, in a number of cases, insufficiently targeted. A consequence of this is that compliant taxpayers who are currently paying a "fair amount of tax" will be affected, and in the case of the proposed interest rate cap, will be potentially exposed to double taxation.

1.3 BNZ is a member of the Corporate Taxpayers Group ("CTG") and the New Zealand Bankers' Association ("NZBA") and has been involved in the submissions each group has made on the discussion document. While BNZ is in total alignment with the submissions made by the CTG and the NZBA, BNZ wishes to make an additional submission on specific aspects of the proposals.

2.0 EXECUTIVE SUMMARY

2.1 The Discussion Document notes that it is a minority of firms that have borrowed from their foreign parents at high interest rates. If the issue is confined to a minority of firms, then a targeted response would be more appropriate. The introduction of the proposed reconstruction provision in the recently released discussion document on Transfer Pricing and Permanent Establishment Avoidance ("TP Discussion Document") should provide IR with sufficient tools to deal with those specific situations where excessive interest deductions are being claimed.

2.2 The proposed interest rate cap would significantly increase the potential for double taxation and does not allow for competent authority resolution when the other jurisdiction requires a higher rate of interest to be charged under its transfer pricing rules, based on the international standard arms-length principle.

2.3 If the interest rate cap proposal does proceed, banking regulatory capital should be excluded. The subordinated nature and longer terms for which regulatory capital debt is issued is a direct consequence of the rules mandated by the Reserve Bank of New Zealand ("RBNZ"), and/or the Australian Prudential Regulatory Authority ("APRA"). Debt that is issued for banking regulatory capital purposes is patently not issued so as to engineer excessive interest deductions and so should not be subject to the proposed interest rate cap. For banking regulatory capital, it is appropriate that the interest rate permitted for tax purposes is based on an arms-length rate of interest as that is what is required by RBNZ.

2.4 If the interest rate cap proposal proceeds, the definition of related party debt should be defined such that debt raised from third parties by a subsidiary of a New Zealand bank and then on-lent to the registered bank is not caught by the interest rate cap.

2.5 If the interest rate cap proposal proceeds, it should only operate as a safe-harbour, such that if a taxpayer chooses to be subject to the interest rate cap, full transfer pricing documentation supporting the arms-length price would not need to be prepared. However, the international standard arms-length principle should be retained for taxpayers who are prepared to carry out a transfer pricing exercise to establish an arms-length interest rate.

2.6 If the proposal proceeds, withholding tax should only apply to the extent that a tax deduction has been claimed. This would result in greater consistency with other recent legislative changes seeking to align the imposition of withholding tax with the deduction of interest costs by the borrower.

3.0 SUBMISSIONS

The proposed interest rate cap disregards the arms-length principle

3.1 BNZ does not support the proposed interest rate cap as it is a significant departure from the arms-length principle and will result in tax outcomes that are inconsistent with the real commercial and economic substance of the underlying arrangements.

3.2 The stated objective of the rule is to ensure pricing of related party debt is roughly in line with the interest rate the borrower would agree with a third party lender. In our view an interest rate cap does not necessarily achieve this. The proposal to base the interest rate on the senior unsecured corporate bonds rate assumes that all debt issued by the group would be senior unsecured debt, whereas there may be good commercial reasons for subordinated debt to be issued. Banking regulatory capital is a case in point.

3.3 The proposed interest rate cap also assumes that the interest rate a subsidiary would be able to agree with a third party financier is only marginally different from what the subsidiary's global parent could agree. This effectively treats a multinational group as a single commercial entity, and in doing so, any fundamental differences that exist between entities within a group, such as the nature of the businesses they conduct, the commercial risks faced and the markets in which they operate are disregarded. Under the proposal, the international standard arms-length approach to setting the interest rate on intragroup loans is abandoned in favour of a blunt approximation of the group's average cost of funds. BNZ considers that the arms-length principle should be preserved in setting interest rates on related party loans.

3.4 There is limited justification given in the Discussion Document for the departure from the arms-length principle. The primary reasons offered are that it can be difficult for IR to challenge uncommercial arrangements under the transfer pricing rules and that the highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply. While BNZ accepts that transfer pricing rules can sometimes be difficult to apply, that of itself is not good reason to abandon the arms-length principle which is a core concept in established transfer pricing and international taxation.

3.5 The OECD report "Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports" continues to support the arms-length approach to transfer pricing while acknowledging that application of the principle may be prone to manipulation. Rather than abandoning the principle, the OECD guidance authorises the disregarding of arrangements between associated enterprises for transfer pricing purposes when the transactions lack commercial rationality. This approach is included as a proposal in the recent Inland Revenue Discussion Document: "BEPS – Transfer pricing and permanent establishment avoidance", which proposes disregarding legal form if it does not align with the actual economic substance of the transaction.

3.6 In BNZ's view, the introduction of a reconstruction provision that enables the Commissioner to disregard transactions where the legal form does not align with economic substance ought to be sufficient to deal with the minority of multinationals setting excessive interest rates on related party loans. The proposed interest cap aims to counter the same mischief, only it is less targeted. BNZ does not consider there to be a compelling reason to have multiple tools to combat the same perceived mischief.

3.7 Finally, the fact that the Discussion Document excludes out-bound intercompany loans from the proposed interest rate cap serves to highlight that the interest rate cap is not a principled approach to setting interest rates on intercompany loans. If Government and the Commissioner are happy that the proposed interest rate cap ensures the interest rate on a related party loan is "roughly in line with the interest rate the borrower would agree to with a third-party lender"1, then the approach should apply to both inbound and outbound loans.

Reconstruction provisions for uncommercial arrangements is a more targeted approach

3.8 The base erosion and profit shifting behaviour that the proposed interest rate cap is targeting is, according to the Discussion Document, that there is a "minority that engages in more aggressive tax practices"2 where "some firms have borrowed from their parents at high interest rates, resulting in large interest deductions in New Zealand"3. The Discussion Document does not suggest this is a widespread problem, rather, that a minority of firms are taking excessive interest deductions.

3.9 If a minority of taxpayers are setting excessively high interest rates on intercompany loans, the most appropriate response is a targeted anti-avoidance measure. A targeted response should be preferred over a rule that applies broadly to all taxpayers as the broad approach will adversely affect valid, justifiable transactions as well. This is a particular concern due to the high potential for double taxation (see below) that will arise under the proposed interest rate cap.

3.10 A sufficiently targeted anti-avoidance measure has been proposed in the TP Discussion Document in the form of a reconstruction rule. The Discussion Document acknowledges that the proposed reconstruction rule strengthens the existing transfer pricing rules against aggressive tax practices. However, it goes on to argue that stronger transfer pricing rules are inadequate because sufficient commercial pressures do not exist in a related party context and that as a consequence, unnecessary and uncommercial terms feature in some related party loans.

3.11 The operation of the proposed reconstruction provisions in the TP Discussion Document is not dependent in anyway on there being a commercial tension within a related party funding transaction. Acknowledging that the reconstruction proposals are still only proposals, BNZ does not expect that the presence or absence of commercial pressures in a related party funding arrangement would have any bearing on the ability of IR to invoke a reconstruction provisions. Conversely, the reconstruction provisions would seem to be specifically targeted at those related party funding transactions where, through the absence of commercial pressures, the terms of the funding arrangement are unreasonable and uncommercial.

3.12 The fact IR is able to identify the features it considers are uncommercial and unnecessary means there should not be a concern with identifying those funding arrangements it considers result in excessive interest deductions.

Double taxation

3.13 The proposals do not address the double taxation that will result when the interest rate cap applies to deny an interest deduction in New Zealand but where the overseas jurisdiction requires the loan to be priced at an arms-length.

3.14 An example of this would be where banking regulatory capital is obtained from an Australian parent company and that capital is in the form of subordinated debt. The Australian transfer pricing rules would require standard arms-length principles to apply such that the interest rate on the debt is a market rate of interest, having regard to the credit rating of the New Zealand bank and the subordinated terms of the loan etc. In order to comply with the Australian transfer pricing rules, the loan would likely be priced at a rate higher than the interest rate allowed by the

[1] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 3.17
[2] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 1.4
[3] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 1.4

proposed interest rate cap. This means an interest deduction will be denied in New Zealand but that same interest will remain taxable in Australia.

3.15 In addition, there does not appear to be any ability for an affected taxpayer to engage the mutual agreement procedures contained in New Zealand's tax treaties when there is a tension between the interest rates that each jurisdiction deems to be appropriate. BNZ strongly recommends that this position is reviewed and that IR ensures mutual agreement procedures are available to mitigate the double taxation risks.

3.16 A consequence of the double taxation outcome that will result is that the hurdle rate for investment into New Zealand increases. In the context of the Australian owned banks operating in New Zealand, this will transpire as an increase in borrowing costs for New Zealand businesses and homeowners.

Withholding tax implications

3.17 As proposed, New Zealand withholding tax (or Approved Issuer Levy) would continue to apply to the actual interest payments made regardless of the amount of interest deemed to be deductible for New Zealand tax purposes.

3.18 BNZ expects IR will take the position that it is appropriate for withholding tax to apply as there is still a transfer of value from the subsidiary to the offshore parent, i.e. there is effectively a dividend. However, if that argument is to hold, the withholding implications should mirror what would occur if a dividend was declared and paid. Under many of New Zealand's double tax treaties such a dividend would not be subject to New Zealand withholding tax.

3.19 BNZ submits that withholding tax should only apply to the deductible interest amount. This is consistent with other recent legislative changes to align the deductibility of interest and the impost of withholding tax.

Banking regulatory capital

3.20 BNZ submits that banking regulatory capital should be excluded from the interest rate cap. Banking regulatory capital has many of the features it does (i.e. subordination, longer terms, convertibility) purely because of the regulation imposed on New Zealand registered banks under RBNZ's prudential supervision framework. This is in contrast to the Discussion Document's contention that such features are used primarily to drive up the interest rate on related party funding.

3.21 The capital adequacy framework in New Zealand is based upon the Basel capital framework developed by the Basel Committee on Banking Supervision. The framework incorporates minimum capital ratios, defines what qualifies as qualifying capital, includes internal capital adequacy assessment processes, and includes a disclosure regime. It is highly prescriptive.

3.22 A consequence of the highly prescriptive nature of the capital adequacy rules, along with a relatively shallow debt market in New Zealand means that New Zealand registered banks do, and will, have subordinated related party debt. The debt is typically deeply subordinated, may be for terms exceeding five years and may include conversion features however these are purely to meet the requirements of the prudential regulatory regime, and not for the purposes of obtaining an excessive interest deduction in New Zealand.

3.23 To highlight this point, the following is an extract from Subpart 2B of the Reserve Bank of New Zealand Capital Adequacy Framework (Standardised Approach) - Document BS2B, issued November 2015, which defines the criteria for classification as Additional Tier 1 capital:

To qualify as Additional Tier 1 capital, an instrument must satisfy the following criteria:

(a) ….

(b) The instrument represents, prior to any conversion or write-off (refer subpart 2E and subpart 2F), the most subordinated claim in the liquidation of the registered bank after Common Equity Tier 1 capital. Nothing in this provision shall prevent one Additional Tier 1 instrument being subordinated to another Additional Tier 1 instrument.

(c) The paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of any member of the banking group or a related entity, or subject to any other arrangement that legally or economically enhances the seniority of the holder's claim vis-a-vis bank creditors. The instrument may not be subject to netting or offset claims on behalf of the holder of the instrument.

(d) The principal amount of the instrument is perpetual (i.e. there is no maturity date). However, the instrument may be callable or redeemable at the initiative of the registered bank after a minimum of five years from the date on which the registered bank irrevocably receives payment for the instrument. Despite anything in this subpart, an instrument may:

(i) provide for the registered bank to have a right to call or redeem the instrument within the first five years of issuance as a result of a tax or regulatory event. Instruments issued after 1 January 2016 must include as a term of the instrument that the instrument may not be callable as a result of a tax or regulatory event if that event was anticipated at the time of the issue of the instrument or if the event is minor (or words to that effect) …

3.24 The requirements above mean that in order to qualify as Additional Tier 1 Capital, the debt must be, subordinated, unsecured and perpetual; all features the Discussion Document highlights as being used by multinational groups to artificially drive up interest rates on related party debt. In the context of banking regulatory capital, however, there is no real choice in the form of the debt that is being issued.

3.25 RBNZ also requires that related party debt that qualifies as regulatory capital is issued at an arms-length interest rate. As a rule, such debt would be priced based on the prevailing market interest rate on instruments with similar terms on the day the debt is issued. The proposed interest rate cap would put New Zealand registered banks in a position where two regulators impose directly competing rules in relation to the setting of interest rate on related party debt. It is therefore, not appropriate for banking regulatory capital to be captured by the proposed interest rate cap.

3.26 If the interest rate cap did apply, a consequence of disallowing interest deductions on banking regulatory capital would be an increase in the cost of funds to the New Zealand banks. Absent a change in the regulatory capital regulations, banks would still have limited choice in the types of regulatory capital they raise and would need to continue to issue related party debt that is subordinated, perpetual and/or convertible. The cost of the interest denial will inevitably flow on to the interest rates New Zealand registered banks charge to New Zealand businesses and homeowners.

3.27 Banks will typically hold a prudential buffer over and above the minimum capital requirements to ensure that the minimum capital ratios are not breached unexpectedly. It could be argued that in the absence of an interest rate cap banks would load-up on Additional Tier 1 capital issued to the Bank's parent company. However, Additional Tier 1 capital is more expensive than other forms of funding that does not qualify as regulatory capital. Holding excessive amounts of regulatory capital adversely impacts the New Zealand banks' financial performance as cheaper funding can be obtained. RBNZ imposes as a condition of registration on New Zealand banks the requirement for the board of directors of the New Zealand bank to act in the best interests of the New Zealand bank. This is outlined in the Reserve Bank of New Zealand Document BS14 – Corporate Governance:

Acting in best interests of the bank

(1) The aim of the conditions discussed above is to ensure as far as possible that the board collectively will, in practice, take decisions in the best interests of the bank, without undue influence from parties whose interests may diverge from the bank's. There is also a condition which prohibits the registered bank from having in its constitution a provision permitting a director, when exercising power or performing duties as a director, to act other than in what he or she believes is the best interests of the bank.

(2) Although a director of a company, when exercising powers or performing duties as a director, is normally required under the Companies Act 1993 to act in good faith and in what the director believes to be the best interests of the company, section 131(2) of the Companies Act allows a director of a subsidiary to act in a manner which he or she believes is in the best interests of its holding company even though it may not be in the best interests of the subsidiary, if expressly permitted by the subsidiary's constitution. Therefore this condition of registration prohibits the registered bank's constitution from allowing a director to act other than in the bank's best interests.

3.28 This requirement, to act in the best interests of the New Zealand bank, means that the board of directors could not agree to a course of action that involved a New Zealand bank having a preference to expensive related party debt where other alternative funding options are available.

3.29 Finally, as all the major retail banks in New Zealand are Australian owned, the argument that interest rates on intercompany regulatory capital might be set with a purpose of inflating interest deductions in New Zealand to the overall benefit of the worldwide group simply does not hold. The corporate tax rate in New Zealand is 28% while the corporate tax rate in Australia is 30%. Even if it were possible to inflate interest rates to achieve a tax advantage to the group (and it is not, given the regulatory conditions), it would not make economic sense to generate excessive interest deductions in the lower tax jurisdiction.

Related party definition

3.30 If the interest rate cap proposal proceeds, BNZ submits that the definition of related party debt should be amended to exclude debt raised from third parties by a subsidiary of a New Zealand registered bank and on-lent to the New Zealand bank. This is necessary because it is common for New Zealand banks to have a subsidiary that issues debt to the external market which is on-lent to the New Zealand bank. In these situations, there is a clear market interest rate for the debt (the rate on the debt issued to the external market) and it is that market interest rate that should be permitted for tax purposes.

3.31 Such an approach would be consistent with an underlying premise of the interest rate cap which is to treat the group of companies as a single economic entity rather than independent entities dealing at arms-length.

Interest rate cap should operate only as a safe-harbour

3.32 BNZ submits that the proposed interest rate cap should only operate as a safe harbour.

3.33 BNZ agrees with comments in the Discussion Document that it can be a complex and resource intensive exercise to establish what is an arms-length interest rate for an intercompany loan. This holds true for taxpayers and IR. Therefore, BNZ can see some merit in introducing an interest rate cap as a safe-harbour.

3.34 Under a safe-harbour approach, taxpayers who do not wish to undertake full transfer pricing analysis to determine an arm's length price would be free to apply a rate that meets the interest rate "cap". However, a taxpayer would be able to exceed this safe harbour if an arms-length interest rate (applying the transfer pricing rules) is higher than the interest rate cap.

3.35 The main benefit of this is approach is that the arms-length principle is preserved, and taxpayers would have a choice as to whether the benefits of undertaking a transfer pricing exercise to validate a higher arms-length interest rate exceeds the cost of doing so. It would also partially address the concerns BNZ has with the double taxation issues as a taxpayer would not be limited to the capped interest rate if there was a significant risk of double taxation under that approach (i.e. where the other jurisdiction required a higher interest rate under its standard arms-length based transfer pricing rules).

3.36 It would also mean that IR could focus its compliance / audit resources on those taxpayers who wish to use a rate over the safe-harbour but still allow taxpayers to use a greater interest rate where it is appropriate to do so on an arm's length analysis.

4.0 CONCLUSION

4.1 BNZ is pleased to provide this submission and the information it contains. BNZ is available to discuss any issues raised.

4.2 Should IR have any questions in relation to this submission, please contact:

Campbell Rapley
Head of Tax, BNZ

DDI: 9(2)(a) [redacted]
Mobile: [redacted]
Email: campbell_rapley@bnz.co.nz

#021

Level 3, 36 Kitchener Street
PO Box 4299, Shortland Street – 1140
Auckland, New Zealand

T: (09) 356 9300
F: (06) 356 9301

A RESPONSIBLE CARE® COMPANY

28 April 2017

Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

sent via email: policy.webmaster@ird.govt.nz

Dear Deputy Commissioner

BEPS – Strengthening our interest limitation rules

Thank you for the opportunity to comment on the Government's discussion document: BEPS – Strengthening our interest limitation rules (**Discussion Document**).

We would like to make the following submissions:

- the interest rate cap should not be introduced because it conflicts with the arm's length principle that is accepted globally for pricing related-party debt and has potential double tax implications (Chapter 3 of the Discussion Document); and
- the ability for taxpayers to use net current asset value for thin capitalisation calculations should be retained (Chapter 5 of the Discussion Document); and
- Grandparenting provisions should take into account existing Advance Pricing Agreements ('APA') and loan terms; and
- Gross assets should not be adjusted for non-debt liabilities.

We set out some background information about us, and our more detailed submissions, below.

1. About us

Methanex New Zealand Limited (MNZ) is ultimately owned by Methanex Corporation, a Canadian corporation which is listed on the Toronto Stock Exchange and the NASDAQ Global Market. Methanex Corporation, together with its global subsidiaries (the Group), produces and sells methanol globally. MNZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China. It's estimated methanol production adds $650 million to New Zealand's GDP each year, and sustains 1200 jobs directly and indirectly.[1]

Methanex Asia Pacific Limited, the immediate parent of MNZ, has advanced substantial intra-group funding to MNZ. MNZ has an APA with Inland Revenue in respect of this funding dated 23 December 2013.

[1] Economic Impact Analysis undertaken on behalf of Methanex by Business and Economic Research Limited ("BERL"), March 2013

Methanex Corporation subsidiaries operate in multiple jurisdictions globally and therefore it has considerable experience in operating within many legal and tax systems. In this context, Methanex Corporation has admired the stability of the NZ legal and tax systems and in particular the robustness of the tax policy/change process. We support the Government's desire to protect the tax base and ensure multinationals "pay a fair amount of tax". It has been on this basis that MNZ has for many years adopted an open and transparent dialogue with the Inland Revenue Department in relation to its tax profile and any proposed transactions/events. It is with this background that we respectfully express our surprise and concern about the proposed speed and novel approach being proposed in parts of the Discussion Document. The NZ economy is heavily reliant on inward investment with the associated benefits, economic and otherwise. There is some risk that the current proposed approach undermines the confidence of foreign investors in NZ.

2. An interest rate cap should not be introduced – debt should be priced on an arm's length basis

Intra-Group funding is priced on an arm's length basis in most of the other jurisdictions in which we operate. The arm's length principle may be applied slightly differently in different jurisdictions, with the result that interest income may not match interest deductions under domestic laws in all cases. However, double tax agreements override domestic laws to require such interest to be dealt with consistently between the two relevant jurisdictions (where the arm's-length approach is being followed) through corresponding adjustments and access to the mutual agreement procedure.

Our primary concern with the proposed interest rate cap is that it would be a fundamental shift away from pricing debt on this basis, giving rise to a risk of double taxation where interest income and interest deductions do not match, that cannot be mitigated through a double tax agreement. For this reason, the interest rate cap should not be introduced.

Pricing intra-group debt using arm's length principles (as strengthened by the Government's proposals in relation to transfer pricing) is consistent with the OECD's work under its BEPS project. Under Actions 8-10, the OECD concluded that the arm's length principle (based on economic reality rather than legal form) was the most effective and efficient way to price intra-group transactions. We understand that the OECD will be carrying out further work this year in relation to the transfer pricing aspects of financial transactions between related parties.

Pricing debt on this basis is also consistent with the OECD's work on BEPS involving interest deductions (Action 4). The OECD recognised that thin capitalisation rules which limit the level of debt (as New Zealand's rules do) do not address BEPS concerns where an excessive rate of interest is applied to a loan, and suggested that a further mechanism, such as an arm's length test, would be needed to address this particular concern.[2]

Lastly, imposing the Methanex Corporation credit rating on the NZ subsidiary is a blunt approach that ignores the significant difference in risk profiles between a global parent and a manufacturing subsidiary. Throughout our APA process in 2013 undertaken with Inland Revenue staff, it was clearly understood that the parent credit rating could never be achieved by the stand-alone subsidiary. It is a significant shift to now propose that the parent credit rating determines the interest rate cap – we are not aware of this approach being applied in any of the other jurisdictions we operate in.

[2] OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, paragraphs 58 & 59. In paragraphs 12-15 of that paper, the OECD commented that an arm's length amount of debt (and similar tests) on its own would not address all of the OECD aims of Action 4, but that it might still have a role to play alongside other tax policy goals. These comments do not indicate that arm's length principles should not be used to price debt.

3. Ability to use market values should be retained

The Discussion Document, at paragraph 5.25 states "…we consider that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets". This is not correct. Your Tax Information Bulletin: Volume Seven, No.11, Page 19 (March 1996) correctly said (when the thin capitalisation rules were first introduced) – "…it is recognised that the valuations for financial reporting purposes are likely to have been adopted for other than tax reasons". Consequently it was concluded that a taxpayer should be able to use net current value/market value if that taxpayer could have adopted it for assets under GAAP (now IFRS) but has chosen not to.

MNZ values its assets at historical cost for NZ financial reporting purposes. We are permitted to use market value under IFRS (IAS 16 and IAS 8). However, we choose not to do so, because there is no benefit to the Group or its shareholders in incurring the additional expense of preparing NZ financial statements on this basis. The group's published financial statements are prepared by Methanex Corporation on a consolidated basis, and these are the financial statements that are generally used to report to shareholders and for other purposes. MNZ's individual entity accounts effectively serve only to meet NZ Companies Office obligations.

The ability to use net current value/market value where permitted by IFRS should be retained. We understand that the Government's concern is that valuations used for thin capitalisation purposes but not for financial reporting purposes may not be subject to a sufficient level of independent scrutiny. We don't believe this should be a concern for MNZ because MNZ use asset valuations undertaken by a qualified valuer for thin capitalisation purposes.

If the ability to use net current value is not retained, taxpayers will, for tax reasons, adopt net current value for financial reporting purposes despite it making no sense for commercial reasons. This change of accounting policy in financial statements under IAS 8 can be made (ie. it is elective) if the result is more reliable or relevant. This will particularly be the case when there is a significant difference between the historical cost and market value of assets.

We strongly submit that the ability to use net current values/market value for thin capitalisation purposes needs to be retained.

Concerns could be addressed by requiring valuations being adopted for thin capitalisation purposes to be supported by a valuation from a registered valuer, or a similarly qualified independent person. As noted above, this is our current approach (which has been fully disclosed to Inland Revenue).

4. Grandparenting

The Discussion Document states that the proposals will apply from the beginning of the first income year after enactment. Assuming that the proposals proceed, we consider that this application date is too soon in the context of the significance of the changes being implemented. It does not allow sufficient time for us to model the impact and plan a potential restructure or refinancing in response. We submit that the application date for any new policy should be at least one income year post enactment.

There should also be grandparenting for existing APAs until the end of the currently agreed term of the APA or the term of the relevant loan, whichever is the longer. Any proposal to not respect existing APAs undermines the credibility of the tax system. We went to significant time (our global treasurer travelled to NZ to engage in the APA process) and cost to agree the APA and strongly believe APAs should remain in place. We also consider that existing financing arrangements covered by an APA should be grandparented to their original/current term where that exceeds the current APA term. This provides certainty for the multinational and allows time to refinance.

5. Treatment of non-debt liabilities

We do not consider that requiring gross assets to be adjusted for non-debt liabilities is consistent with the core objectives of a thin capitalisation regime. It arbitrarily distorts the thin capitalisation percentage depending on the timing and the make-up/nature of liabilities recorded for accounting purposes under IFRS.

We also consider that if there is a change to net assets (ie. deducting non-debt liabilities most of which will be disclosed at market value), that to ensure consistency, asset values should also be able to be expressed at market value (net current value). Finally, liabilities not funding a taxpayer's balance sheet should be excluded eg. deferred tax liabilities (as per the Australian rules).

Conclusion

We trust you find our submissions useful. Please contact me if you would like to discuss any aspect further.

Yours sincerely

Kevin Maloney
Managing Director
Methanex NZ Limited

#022

Submission

to the

Inland Revenue Department

on

BEPS – Strengthening our interest limitation rules: A Government Discussion Document

NEW ZEALAND BANKERS ASSOCIATION
Level 15, 80 The Terrace, PO Box 3043, Wellington 6140, New Zealand
TELEPHONE +64 4 802 3358 FACSIMILE +64 4 473 1698 EMAIL nzba@nzba.org.nz WEB www.nzba.org.nz

28 April 2017

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fifteen registered banks in New Zealand are members of NZBA:

    - ANZ Bank New Zealand Limited
    - ASB Bank Limited
    - Bank of China (NZ) Limited
    - Bank of New Zealand
    - Bank of Tokyo-Mitsubishi, UFJ
    - Citibank, N.A.
    - The Co-operative Bank Limited
    - Heartland Bank Limited
    - The Hongkong and Shanghai Banking Corporation Limited
    - JPMorgan Chase Bank, N.A.
    - Kiwibank Limited
    - Rabobank New Zealand Limited
    - SBS Bank
    - TSB Bank Limited
    - Westpac New Zealand Limited.

Background

3. NZBA welcomes the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on "BEPS – Strengthening our interest limitation rules: A Government Discussion Document" (**Discussion Document**).

4. NZBA appreciates the opportunity to have discussed the Discussion Document with IRD Officials to date and welcomes the opportunity to discuss any of our feedback directly with IRD Officials. As outlined in our feedback, we recommend ongoing discussions with IRD Officials on this topic as the proposals develop. In this regard, please contact:

Philip Leath
Chair of NZBA Tax Working Group
GM, Tax – ANZ
04 436 6493 / 021 280 4717

General Comments

5. As a general comment, NZBA supports the ongoing work of the OECD and IRD to address valid concerns over base erosion and profit shifting (**BEPS**), including shifting taxable income out of New Zealand through aggressively priced related party debt. However, addressing valid concerns should be targeted at the minority that engage in aggressive tax practices and not be applied across the board to all related party debt, the majority of whom represent legitimate commercial behaviour, which will impose an unwarranted cost on the New Zealand economy. This is particularly pertinent for the New Zealand banking industry as the primary financial intermediary for New Zealand individuals and businesses. The New Zealand banking industry is subject to significant prudential regulation in respect of the manner and source of its funding in order to ensure stability of the New Zealand financial system. The regulation already imposed on the New Zealand banking industry means the concerns stated in paragraphs 3.3 to 3.14 of the Discussion Document do not arise in the case on the New Zealand banking industry.

6. This submission centres upon the interest limitation proposals in chapter 3 of the Discussion Document.

Submissions

7. NZBA outlines below key submission points in respect of the potential outcomes from the interest limitation proposals on bank funding and also bank regulatory capital.

   a. NZBA submits that New Zealand banking groups should be excluded from the interest limitation proposals.

      i. New Zealand banking groups obtain the majority of their funding from various non-related party sources. The Reserve Bank of New Zealand (**RBNZ**) requires diversity in the funding utilised by New Zealand registered banks to ensure liquidity of inwards and outwards funding flows (often referred to as the minimum core funding ratio).[1] The calculation of the core funding ratio provides a preference for deposit funding compared to wholesale funding (which includes related party funding in the core funding ratio calculation). As such, New Zealand registered banks are unable to obtain a significant portion of funding from related parties.

      ii. New Zealand registered banks are subject to the RBNZ's conditions of registration which require New Zealand registered banks to act independently and in their own best interests. It follows that aggressively priced related party funding would not be permissible. For regulatory, commercial and tax reasons, related party debt must bear arm's length terms and interest. Hence, in light of paragraph 3.11 of the Discussion Document, it is not correct that New Zealand banking groups are indifferent to or accept "unnecessary or uncommercial terms".

      iii. Further, the Australian owned New Zealand banks face limits on exposures their parent can have to New Zealand banks by the Australian Prudential regulator (APRA). APRA restricts the exposure of an Australian Deposit Taking Institution (**ADI**) in their New Zealand subsidiaries to 50% of the

[1] Refer RBNZ Document BS13 (Liquidity Policy)

amount of Level 1 Capital of the ADI[2]. Therefore, existing prudential regulation precludes the exact type of behaviour the IRD are seeking to address through the proposals. New Zealand banking groups are not the target of the interest limitation proposals such that their exclusion is justified.

iv. The proposals seek to apply an offshore parent's senior unsecured debt interest rate as an approximation for the worldwide group's cost of funding and any interest paid to offshore related parties at a rate above this (plus a margin) will be disallowed as a deduction. Economically, this axiomatically assumes that a majority of the New Zealand foreign owned subsidiary's debt is sourced from their offshore parent and that the New Zealand subsidiary would only seek, in a commercial sense, senior unsecured debt from the market. However, this is not the case in the New Zealand banking industry. As above, the New Zealand banking industry primarily sources funding from unrelated parties. Further, New Zealand banks are required to hold, at least, 10.5% regulatory capital over risk weighted exposures, of which 7.0% must comprise Common Equity Tier 1 Capital (ordinary shares and retained earnings; not debt). The balance of regulatory capital, over and above Common Equity Tier 1, takes the form of Additional Tier 1 (**AT1**) or Tier 2 (**T2**) capital. RBNZ (in applying the Basel III framework) requires AT1 and T2 to include specific features, including subordination, permanence (with a minimum 5 year term), flexibility of payment (e.g. AT1 must include terms whereby interest is payable at the option of the issuer and be non-cumulative) and loss absorbency measures. These features are mandatory and, as a consequence of these features, regulatory capital is priced well above senior unsecured debt.

v. While it is necessary that New Zealand banks have diversity of funding sources and can be restricted as to the level of funding available from their parent, it is logical for New Zealand banks to apply such restriction primarily to source regulatory capital from their offshore parent. This is because:

- the New Zealand market is not sufficiently liquid to fund all the New Zealand bank's regulatory capital needs (particularly given the idiosyncratic complexity and cost of issuing such capital);
- of the regulatory benefits of a parent raising such capital (i.e. a parent bank may not be able to recognise 100% value of regulatory capital externally issued by its New Zealand subsidiary bank);
- it reduces the complexities of multiple prudential regulatory rules applying to the same capital issuance (which is the case when the New Zealand bank issues regulatory capital externally);
- the commercial undesirability for a New Zealand bank to issue regulatory capital into its parents' home market; and
- generally, the offshore parent bank can raise regulatory capital more cheaply than the New Zealand bank (particularly in international markets).

[2] Refer APRA's Prudent Standard APS 222 (Associations with related Entities). The ADI parents of the 4 major New Zealand banks are subject to additional tighter related party exposures which require that, by 1 January 2021, no more than 5% of the Australian ADI's Level 1 Tier 1 Capital comprise non-equity exposures to its New Zealand operations, including New Zealand holding companies (excluding regulatory capital instruments).

vi. Consequently, a significant source of funding of New Zealand banks' regulatory capital is from their offshore parent. This is due to commercial and regulatory reasons and is not driven by tax considerations. As such, applying an offshore parent bank's senior unsecured rate to such funding is inappropriate as it does not reflect the predominant type of debt sourced from offshore parents in terms of both the legal and economic substance of such debt. As above, such debt is obtained from offshore parent banks for commercial and regulatory reasons.

vii. NZBA considers the above position is not altered if the New Zealand registered bank is owned by an offshore parent bank via a New Zealand holding company (which is not a registered bank). It is possible that a foreign parent provides regulatory capital to its New Zealand subsidiary bank by providing non-regulatory debt funding to the New Zealand holding company which, in turn, provides the regulatory capital funding to the New Zealand registered bank. While the debt funding to the New Zealand holding company cannot be regulatory capital, such debt does need to closely mirror the terms, and therefore pricing, of the regulatory capital issued to the New Zealand registered bank. This mirroring is important for commercial reasons to ensure the New Zealand holding company can "pass through" the risk of the regulatory capital instrument to the debt it has issued to ensure, amongst other things, the solvency of the New Zealand holding company. For example, the New Zealand holding company faces a risk of non-payment of interest on the regulatory capital funding to the New Zealand bank. If this risk is not passed on, it could become insolvent. Further, the use of a New Zealand holding company results in a similar position, economically and tax wise, as if the offshore parent bank provided regulatory capital direct into the New Zealand bank (and not through the New Zealand holding company).

viii. If New Zealand banking groups are not excluded from the proposals, foreign owned New Zealand banking groups would suffer adverse funding and inconsistent tax outcomes compared to other industries. Foreign owned New Zealand banking groups must hold regulatory capital and do not have the flexibility that many other industries have of restructuring related party debt. As such, foreign owned New Zealand banking groups will be required to pay interest, at commercial rates (as required under the RBNZ conditions of registration as well as for tax transfer pricing purposes), on bank regulatory capital to their parent but be denied a full interest deduction for doing so.

ix. The proposals, if they did apply to New Zealand banking groups, may drive a perverse economic position in that New Zealand banking groups may be forced to directly issue regulatory capital in international markets at a higher pre-tax cost (than if the regulatory capital was sourced from its parent) to obtain a lower post tax outcome (than if the regulatory capital was sourced from its parent). Such a position appears contrary to good tax policy.

x. NZBA considers that excluding New Zealand banking groups from the interest limitation proposals may not be contrary to OECD recommendations. The OECD public discussion document on Action 4[3]

[3] OECD, BEPS Action Item 4: Approaches to address BEPS involving interest in the banking and insurance sectors

highlighted the difficulty on applying interest limitation rules in the banking industry, in particular noting that *"…excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low …"*. In this regard we also refer to the submissions from the Australian Banker's Association (**ABA**) and the International Banking Federation (**IB Fed**) on the OECD's Action 4[4].

b. If our submission that New Zealand registered banks should be excluded from the interest limitation proposals is not accepted, NZBA submits that bank regulatory capital should be excluded from the proposals, for the same reasons outlined above. NZBA considers that the combination of the existing prudential regulation and the New Zealand transfer pricing rules provides sufficient comfort and power to the IRD to ensure arm's length pricing is applied. This is particularly the case in light of the proposed enhanced powers for the IRD in respect of transfer pricing as outlined in the *"BEPS – Transfer pricing and permanent establishment avoidance: Government Discussion Document"*.

c. If our submissions above are not accepted, NZBA submits that the interest limitation proposals should apply as a safe harbour only and not over ride application of the transfer pricing rules or prevent use of a true commercial arm's length arrangement. NZBA considers that such an approach would minimise the compliance burden for both taxpayers and the IRD by allowing taxpayers to fall within the interest limitation rule and, therefore, not be required to apply transfer pricing rules. It would also provide flexibility for taxpayers to apply the arm's length principle in respect of instruments where the interest limitation proposal would not reflect arm's length commercial terms and price (such as bank regulatory capital).

   Further, NZBA is concerned that as a domestic anti-avoidance measure, the interest limitation proposals would unilaterally apply outside New Zealand's Tax treaty network. As it is necessary for New Zealand banking groups to pay arm's length interest rates to related parties (refer 7a ii above), the interest limitation proposals would result in a unilateral tax impost (i.e. the double tax outcome referred to above) that could not be corrected via Tax Treaty competent authority procedures.

d. If none of the above submissions are accepted, NZBA submits that the interest limitation rules should not apply to existing related party debt instruments, or at least not to existing related-party bank regulatory capital issuances. Contrary to the statement in the Discussion Document that the proposed implementation timeframe of the proposals will provide sufficient time to companies to rearrange their affairs, New Zealand banks will not have this option. It is not possible to restructure bank regulatory capital with a different instrument predominantly due to the inability to call such instruments. Further, if the New Zealand banks were forced to call and re-issue such instruments, significant liquidity pressures would arise which may result in very highly priced capital being raised in international markets and place a significant strain on the security of the New Zealand banking system.

[4] Refer to pages 36-48 (for the ABA submission) and pages 179-182 (IB Fed) of the "Comments received on Public Discussion Draft BEPS Action 4 – available at http://www.oecd.org/ctp/aggressive/public-comments-received-on-the-discussion-draft-on-approaches-to-address-beps-involving-interest-in-the-banking-and-insurance-sectors-under-action-4.htm

e. NZBA understands from discussions with Officials that the proposed “related-party” debt definition at paragraph 3.43 of the Discussion Document should not extend to capture debt raised by offshore branches of subsidiaries in the New Zealand banking group for the purposes of funding the New Zealand banking group. NZBA supports this approach as such funding is raised by the New Zealand banking group, for the New Zealand banking group.

f. NZBA recommends extensive consultation occurs on any further development of the interest limitation proposals, importantly before legislation is drafted, and that any draft legislation/exposure draft is made available to interested parties for comment prior to introduction to Parliament as a Bill. We would be very happy to set up working group meetings with appropriate representatives from members of the NZBA in this regard.

The American Chamber of Commerce in New Zealand Inc
PO Box 106 002, Auckland Central 1143, New Zealand | t: (09) 309 9140 | m: (021) 707 506 | f: (09) 309 1090 | e: amcham@amcham.co.nz | www.amcham.co.nz

28 April 2017

Interest limitation #023
TP +PE #012

BEPS – Transfer pricing, PE avoidance & Interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

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

Dear Cath

BEPS – Transfer pricing, PE avoidance and proposed interest limitation rules

The American Chamber of Commerce in New Zealand Inc appreciates the opportunity to comment on New Zealand's proposals for international tax reform released on 3 March 2017.

The American Chamber of Commerce in New Zealand Inc – better known as AmCham – has been New Zealand's number one business organisation for the promotion of trade and investment between the United States and New Zealand and the Asia Pacific region for over 50 years. We are "The Voice of American Business in New Zealand". Our members represent turnover in excess of NZ$50 billion and over 100,000 employees.

Our submission covers two Government discussion documents – BEPS – Transfer pricing and permanent establishment avoidance and BEPS – Strengthening our interest limitation rules.

We provide comments on the overall approach which we recommend should be adopted by the Government, supplemented by our recommendations for changes to the specific proposals regarding permanent establishments ("PEs"), interest limitation rules and transfer pricing.

1. Executive Summary

Inbound investment from the United States is important to New Zealand – both in absolute dollars (at least 8% of total foreign direct investment ["FDI"]) and through wider contributions to the economy and society. Tax policy should recognise the importance of inbound FDI while ensuring that inbound investors, including our members, pay their "fair share".

Fairness and certainty considerations lead us to supporting implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem. However, there is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

With regards to the proposals concerning PE avoidance:

- *We support enforcement of the accepted international definition of a PE. This is best done by way of implementing the Multilateral convention to implement tax treaty related measures to prevent BEPS rather than a unilateral PE anti-avoidance rule.*

- *Should New Zealand proceed with the PE anti-avoidance rule, clarity of scope and application is essential, there should be a transitional rule to allow our members the time to restructure and guidance from Inland Revenue regarding profit attribution would be welcome.*

We agree with aspects of the proposed reforms to interest limitation rules but wonder if the Government has lost sight of the strength of New Zealand's existing thin capitalisation rules. Members have major concerns regarding the proposed limit on interest rates on related party loans, as it will lead to double taxation in many cases and is incompatible with the arm's length principle.

We agree in principle with the change to require total assets to be calculated net of non-debt liabilities, but our members should be given time to adjust their existing arrangements. Other conditions for our support include that the ability to use net current asset values is retained, deferred tax liabilities are excluded from the definition of non-debt liabilities and existing financing arrangements are grandparented for an extended period.

With respect to transfer pricing, we support aligning New Zealand's transfer pricing rules to OECD Guidelines. Better alignment with the Australian transfer pricing rules is also appropriate, but only to the extent that those rules remain consistent with the principles set down by the OECD and do not seek to target a greater than arm's length proportion of profit.

Members do have concerns regarding the references to limited risk distribution ("LRD") structures. LRD structures commonly reflect commercial substance and are frequently embedded within a global group's worldwide framework. The LRD structure is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken is often relatively low in terms of value-add.

Members also see a number of the administrative measures proposed as inappropriate. We have concerns regarding penalties for not providing information, the factors leading to a finding that a taxpayer is non-cooperative, Inland Revenue's additional information gathering powers and the enforced early payment of tax in dispute.

We expand on these issues below.

2. Importance of New Zealand/United States relationship

The United States is New Zealand's second largest source of foreign direct investment, representing at least 8% of total FDI.

Many American inbound investors create substantial value through their business activity here, over and above the tax paid, in ways not visible through financial statements alone.

Tax policy should take account of these hard to measure spillover effects while ensuring that inbound investors continue to pay their fair share.

As the world has become more interconnected FDI has increasingly become a hot topic. For New Zealand how we connect with the world is a major issue since we import most of our technology and have a relatively shallow domestic capital base.

New Zealand–United States trade and investment has a considerable impact on the New Zealand economy. The Government has acknowledged our tax settings must "be consistent with maintaining New Zealand's position as an attractive location to base a business." There is a broad consensus that taxation is a significant factor in location decisions regarding inbound investment.

United States companies operating in New Zealand account for investment totalling in excess of NZD 12.6 billion and thousands of jobs. Direct investment in New Zealand is mostly in the finance/insurance and manufacturing sectors, with many investments having some degree of mobility. The United States accounts for at least 8.0% of foreign direct investment into New Zealand. This figure is likely to be materially understated as it excludes investment ultimately sourced from the United States but routed via third countries such as Australia and Singapore. Inland Revenue's own statistics show that, of the 314 foreign owned groups completing its international tax questionnaire, some 59 (or 19%) have ultimate American ownership.

The United States has become New Zealand's third largest trading partner, with trade totalling in excess of NZD 11 billion. In particular, New Zealand's largest imports of tangible goods from the United States include aircraft, jets, motor vehicles, medical instruments, food and appliances.

Our members' businesses have a positive impact on New Zealand society in many ways. Technology companies among our membership are commonly singled out during tax debates due to their digital nature. Yet these members belong to a sector having a transformative effect on the New Zealand economy, with the benefits from their presence extending well beyond New Zealand's receipt of corporate income tax.

Traditional economic and accounting indicators can underplay this effect and lead to the importance of inbound investment being underplayed. The digital economy in particular has the potential to drive future economic growth and productivity when it is adopted by businesses and consumed by users, whereas a large portion of the value of the digital economy goes unmeasured in today's economic indicators. For example:

- *In terms of economic development, the digital economy can help alleviate the "double tyranny" of New Zealand's relative size and distance that affects businesses;*

- *Consumer benefits of digital communication are seen in increased convenience, better access to information, well informed decisions and more time saved in our daily lives; and*

- *With respect to transport, better mapping technology enables improved navigation and helps people find local businesses and tourist destinations.*

AmCham consider that it is legitimate for the Government to take into account the wider spillover effects of our members' inbound investment when setting tax policy. We emphasise that we are not seeking any form of tax break or incentive: it is important that taxes are fair and seen to be fair. Our members are happy to pay their "fair share" in accordance with legislation.

3. Overall comments on the approach taken in the discussion documents

AmCham supports implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem.

Our members do not accept that aggressive tax practices are commonplace in New Zealand.

There is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

Today's business structures have evolved within a dated tax system and everyone will benefit from a simpler, more transparent, tax system.

The members of AmCham support the work of the Organisation for Economic Co-operation and Development ("OECD") and the G20 towards coordinated tax reform to ensure that global tax rules keep pace with business evolution. We recognise that consistent and fair taxation of multinationals has become more difficult in recent years. We also note the Government's consistent support for, and major policy contribution to, the OECD's work.

AmCham therefore agrees a proportionate implementation of the OECD recommendations is the right tax policy for New Zealand.

Keeping the Government's response proportionate to the size of the problem, while not deterring inbound investment, will be crucial. To this end, we agree with the Government that the majority of multinational companies operating in New Zealand comply with their tax obligations and with the

Minister of Revenue that "most foreign-owned firms operating here have relatively conservative debt positions and pay significant amounts of tax." We note further recent research conducted by EY which supports the conclusion that the majority of multinationals are not loading their New Zealand subsidiaries with excessive interest-bearing debt and that the majority have an effective tax rate close to, or equal to, the New Zealand corporate tax rate. While the evidence is not fully conclusive, AmCham does not accept that aggressive tax practices are prevalent in New Zealand.

We are further concerned that measures enacted unilaterally in New Zealand will over time have a similar impact on our New Zealand members operating in overseas jurisdictions. Should all countries implement the full package of measures proposed in New Zealand, such as the interest rate cap or anti-avoidance source rule, double taxation appears inevitable.

AmCham therefore considers it essential for New Zealand to take a measured approach and to stay within international norms. Governments should harmonise tax rules so that businesses can continue to create value. Fragmentation along country lines puts this value at risk. Unilateral action by New Zealand in addressing perceived base erosion and profit shifting ("BEPS") will be harmful if it also creates double taxation. A coordinated approach to BEPS will lead to more certainty for businesses, more efficient economic outcomes and growth, fewer cross-border tax disputes between revenue authorities and a higher global tax-take.

AmCham also endorses New Zealand's international tax framework. We consider the Government needs to confirm that it is open for business, consistent with New Zealand's taxation framework for inbound investment. Foreign businesses will respond favourably to certain and predictable tax laws in New Zealand. The benefits of foreign direct investment are endorsed in the discussion documents.

We note that the package is a powerful combination. It has gained international attention, and will put New Zealand at the forefront of BEPS implementation worldwide.

Given the substantial impact that some components of the package will have, we suggest that the Government consider whether any measures can be targeted at highly geared companies which have sought aggressively to minimise their New Zealand tax liability.

Finally, we support the consultative process adopted by the New Zealand Government.

4. Permanent establishment avoidance

Support for rule which enforces the accepted international definition of a permanent establishment

We agree that economic activities which should result in a PE in New Zealand should be subject to tax here. We therefore support a rule which enforces but does not widen the accepted international definition of a PE in substance.

We further agree that there is no need for a separate diverted profits tax. That said, the proposed PE anti-avoidance rule does replicate elements of the United Kingdom diverted profits tax, notably sharing many features with Australia's multinational anti-avoidance law.

We highlight, however, that New Zealand's implementation of the Multilateral convention to implement tax treaty related measures to prevent BEPS has the potential to address most, if not all, of the attempts to flout PE rules. That approach, being the coordinated international response, is the appropriate mechanism by which to enforce New Zealand's PE rules.

The introduction of more robust transfer pricing rules as proposed in the discussion document will also counteract the need for a specific PE avoidance rule. In particular, the discussion document indicates that the existence of a "number of well paid employees" would be an indicator of the existence of a PE. This could be addressed through the transfer pricing regime, and strengthened transfer pricing rules will assist Inland Revenue in relation to enforcement.

We are concerned that implementation of a unilateral response such as the new PE avoidance rule will impede the coordinated global response to BEPS. We therefore do not support its introduction at this time.

Uncertainty will not lead to good tax administration

There is a risk that vague and uncertain wording within the legislation could lead to disputes about the nature of activities being performed by taxpayers in New Zealand. In particular, a number of phrases and concepts central to the operation of the rule ought to be defined, including "commercially dependent", "in connection with", "low tax jurisdiction", "high paid employee" and "specialised services".

As an example of uncertainty, consider the proposal that an "arrangement involving third party channel providers" should necessarily result in a PE. Any such investigation would be a fact-specific enquiry and would depend on the activities provided by related party and third party channel providers. It will not always be clear whether the related party is performing "sales promotion and services", and there will inevitably be cases where the activities in New Zealand are in reality something less than this, or where the non-resident and the third party are in fact not working together to sell the goods or services to the end customer. The legislation, or guidance supporting the legislation, should be clear as to what kinds of specific arrangements give rise to a deemed PE.

If PE anti-avoidance rules are uncertain or difficult to apply, then the corresponding compliance costs could potentially outweigh the gains to the Government from more tax being paid here. Uncertainty in the rules could dissuade investment into New Zealand. Further, we highlight Inland Revenue's expectations regarding initiatives to tackle complex technical issues (such as PE anti-avoidance). The Commissioner of Inland Revenue is required to collect over time the highest net revenue practicable within the law having regard to the compliance costs incurred by taxpayers. Inland Revenue's *unaudited target return on income for additional funding voted by the Government in 2015/16 was $13.00 per dollar spent, on the basis of the economic inefficiencies involved in chasing down the last dollar of revenue. There is risk that attempted enforcement of the PE anti-avoidance rule will fall short of Inland Revenue's targets.*

An ambiguous rule, combined with the proposed 100% penalty, could dissuade investment in a legitimate PE structure, within New Zealand's double tax agreements, on the mere potential that New Zealand would take unilateral action. This would not benefit tax enforcement, the New Zealand economy or our members.

We submit that taxpayers should be able to obtain confirmation from Inland Revenue that the PE avoidance rule would not apply in respect of a particular business structure. The process should operate similarly to an Advance Pricing Agreement ("APA") for transfer pricing purposes, and would add clarity for business with unique circumstances that risk breaching the proposed rule.

Changes to group structure will take time

Reorganising a global supply chain can be a complex business taking a substantial amount of time. New Zealand will often be a small component of a much larger supply chain. The effect of reorganising a global supply chain in a short period of time would be exacerbated for our multinational members operating in a larger number of countries.

We are also concerned that the proposed PE anti-avoidance rule could apply to members whose existing investment structures have previously been reviewed by Inland Revenue by way of a ruling, tax audit sign-off or an APA.

Further, the proposed 100% penalty applicable would present a punitive outcome for such taxpayers with a history of complying with New Zealand tax law if it is not possible for a multinational to reorganise its supply chain before the PE avoidance rule is implemented.

Additional guidance required on profit attribution

We anticipate that multinationals will engage more frequently in disputes with revenue authorities regarding the attribution of profits across jurisdictions.

It is important that the New Zealand Government consider the risk of double taxation where its preferred method of profit attribution differs from that applied in the jurisdiction of the foreign entity.

In light of these substantial proposed changes to the rules around PEs, it would be timely for Inland Revenue to provide additional guidance around the attribution of profit to a New Zealand PE.

5. Interest limitation rules

No case for interest rate cap

Limiting interest deductions based on credit rating within wider group is uncommercial, a departure from the arm's length principle and is likely to lead to cross-border disputes and double tax.

Our members find that there are many circumstances in which a foreign investor might want to invest in New Zealand through debt funding which should appropriately be priced at an interest rate higher than its group cost of funds. The New Zealand entity might be a high credit risk, for example a start-up or different industry. New Zealand is also a small, isolated, market and presents more risk to a (say) United States investor for which the next best alternative would be to expand its existing operations in the United States.

In such circumstances, a third party bank would conceivably lend to the New Zealand subsidiary at an interest rate much higher than the parent company's cost of funds. It will therefore often be more cost-effective for the parent company to provide funding directly to New Zealand. We anticipate that for our members providing finance into New Zealand, double taxation is a likely outcome. The lender will be required by its home tax authority to charge interest at arm's length rates, whereas New Zealand would apply its interest rate cap. In such a case, more disputes between tax authorities would result, most likely leading to additional mutual agreement procedures. Additional compliance costs would be inevitable, and it is not clear that the New Zealand Government would prevail.

An alternative approach would be for the US parent to provide a guarantee to the New Zealand subsidiary to reduce the cost of borrowing. In such circumstances, OECD guidance suggests that a guarantee fee should be paid to the parent company. The fact that OECD endorses the payment (and therefore deduction) of a guarantee fee reflects the fact that an interest rate anchored to the parent's cost of funds is not arm's length.

Agreement in principle to change in treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities for consistency with the test employed in other jurisdictions, but we note that this would result in a material increase in gearing levels for some members, particularly those with large provisions, trade creditors or deferred tax liabilities.

The ability to use net current assets should be retained.

The Government is correct to highlight that current thin capitalisation rules work well given their aim of ensuring that excessive interest deductions are not used to shelter New Zealand sourced profits.

Most multinationals operating in New Zealand have relatively modest debt levels. EY's recent research (cited above) supports that conclusion. Members have seen no evidence to suggest that the *majority of multinationals are sheltering New Zealand sourced profits using excessive levels of related-party debt.*

Members do however note that the changes to the treatment of non-debt liabilities will significantly increase calculated gearing levels, particularly for members with large provisions, trade creditors or deferred tax liabilities. That makes it more important for calculations to give fair value to assets and for the definition of non-debt liabilities to be well designed.

The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.

The non-debt liabilities definition is based on the Australian definition, and – as in Australia - deferred tax should be excluded.

For some of our members, deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS. Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

Compliance costs will increase

The ability for taxpayers to carry out a thin capitalisation calculation once each year should be retained.

We note that the changes to the thin capitalisation test will increase the burden of compliance for multinational taxpayers. An example is the proposal that only quarterly or daily calculations should be acceptable for the purposes of the measurement date of the thin capitalisation test. Absent any evidence that multinationals are abusing the annual method, we see no reason to change the rules. To do so would add a compliance burden to the majority in order to address a problem which has not been seen by our members and must be very rare in practice.

Existing financing arrangements should be grandparented

We are concerned that companies will not have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time. This logic applies equally to all multinationals.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return. It would not be reasonable to expect borrowers to refinance based on a proposal in a discussion document which may be subject to significant amendment prior to enactment.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature.

6. Transfer pricing

Support for alignment with OECD Guidelines and appropriate Australian rules

We agree that New Zealand's transfer pricing regime should be aligned to international best practice. Consistency with the regimes applied in other jurisdictions will also help avoid the incidence of double taxation.

In our members' experience, since reform in 2012, the Australian transfer pricing rules have led to additional disputes between multinationals, the Australian Tax Office and overseas tax administrations. We expect that the proposals to reform the transfer pricing regime in New Zealand will result in a similar increase in the number of disputes, and we note the compliance costs associated with this.

Limited risk distributors commonly reflect commercial substance

The LRD model is one commonly used throughout the world. It is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken in New Zealand happens at the end of the supply chain and is often relatively low in terms of the value-adding functions contributing to the system profits of the enterprise.

The implication of the discussion document seems to be that, in most cases, LRDs structures lack commercial reality and most risks are controlled by the New Zealand entity. More often, for these businesses the global marketing strategy is conducted offshore and tight control maintained over marketing spend, inventory levels and major business decisions of the LRD. The New Zealand subsidiary will have substantially smaller resources at its disposal and will often undertake market activation activity rather than development.

This point has previously been accepted by Inland Revenue. In one recent example, John Nash, Manager (International Revenue Strategy) was commented:

"In terms of the way we tax, is you tax the value-add. I wish it wasn't like this. But you can only tax what gets added in New Zealand and we're right at the end of the value chain. Unfortunately, that's the state of the industry in New Zealand; it's not necessarily a reflection of profit-shifting."

Applying the arm's length standard

We note that, in assessing the transfer prices employed by taxpayers and determining whether adjustment is appropriate, the Commissioner has the advantage of hindsight which our members will not have when entering into the transaction. Shifting the burden of proof onto our members in relation to transfer pricing matters could be problematic, if we are later required to show that the arrangement was arm's length based on an outcome we could not have predicted. The Commissioner should take care not to impose unrealistic requirements on members in relation to genuine, but underperforming, business ventures.

Opposition to time bar extension

Tax positions assessed in the year ended 31 March 2013 are now time barred, but under the proposals could be reopened for a further three years. Members consider that this is inappropriate; any changes should be prospective in their application only.

Some members have invested considerable time and money in negotiating APAs with Inland Revenue. It is possible that legislative changes could override the effect of these APAs, effectively penalising taxpayers whose intention it was to be proactive in managing transfer pricing risk in a constructive way with Inland Revenue. The agreements should be honoured given their lower risk to the New Zealand revenue base and the inequity that would be created should taxpayers need to renegotiate such agreements.

We consider that any need for the extension of the time bar is limited should the proposal to shift the burden of proof to the taxpayer be adopted. This is because, should the taxpayer have the burden of proof, the Commissioner's concerns in relation to accessing relevant information are mitigated by an ability to more readily adjust transfer pricing outcomes where the taxpayer is non-compliant.

In addition, the Government will already have access to improved information flows through country-by-country reporting and automatic exchanges of information between Revenue Authorities.

Further, although the proposed extension of the time bar is limited to transfer pricing matters, there are complications associated with an adjustment for the interactions between transfer pricing and other matters, including income tax and withholding tax. If an extension of the transfer pricing time *bar is pursued, it should be clear what delimits a "transfer pricing matter" from another, to avoid the Commissioner pursuing something as a transfer pricing matter to "get around" a more restrictive time bar for another regime.*

Evidence and documentation requirements

Given that the revised transfer pricing rules would place a burden of proof on our members to show that their transfer pricing is arm's length, it is important that it is clear to members what is required. In other jurisdictions around the world, the legislation is notably more prescriptive and sets out clearly what is required in documentation.

In New Zealand, Inland Revenue does not habitually set out its requirements in a formal way which creates difficulty for multinationals attempting to assess their documentation requirements (in many cases, by centralised tax functions overseas). Inland Revenue should set out unambiguously what is required of taxpayers. Mere endorsement of the OECD Guidelines does not assist taxpayers with little understanding of the particular risks to the New Zealand revenue base to which Inland Revenue's concerns more specifically relate.

7. Administrative measures

Penalties for not providing information

Penalties for failure to provide transfer pricing information should not be imposed on New Zealand business officers and/or directors.

It is proposed that changes be made to allow a person to be convicted of an offence if they fail to provide information held by an associated offshore group member. The New Zealand subsidiary of a multinational tends to be small in the context of the group's global operations. Our members note that officers and/or directors of New Zealand subsidiaries will often have little or no ability to compel offshore parents to provide information. We submit that it is not appropriate to impose penalties on New Zealand officers and/or directors for this reason.

Non-cooperation

Obtaining information can be difficult for a small subsidiary of a multinational.

We note that some of the factors proposed in the discussion document that lead to a finding that a taxpayer is "non-cooperative" are wide in scope (e.g. failure to respond to Inland Revenue correspondence). We submit that there should be some acknowledgement that on occasion delays in *obtaining information are not driven by an unwillingness to provide information, but rather by the difficulties in obtaining information from within large organisations generally.*

Collection of information

Additional information gathering powers are unlikely to be effective and should not proceed.

We submit that Inland Revenue is likely to have sufficient ability to collect information from large multinationals under existing rules by virtue of country-by-country reporting and automatic exchange of information.

As noted previously, the introduction of specific provisions that enable Inland Revenue to directly request information or documents offshore may be unlikely to result in Inland Revenue receiving information in a timelier manner, on the basis that delays in obtaining information tend to be attributable to the internal workings of large organisations rather than deliberate non-cooperation. This is particularly so in light of the size of New Zealand relative to other jurisdictions that multinationals operate in, rather than a result of unwillingness by large multinationals to provide information. Country-by-country reporting and automatic exchange of information arguably provides Inland Revenue with a better method of collecting information than the specific provisions proposed in the discussion documents.

Early payment of disputed tax

Payment of tax in dispute at an earlier stage of the disputes process is not appropriate. Large multinationals are unlikely to default on the tax due, with use of money interest being an inadequate form of recompense for taxpayers.

Taxpayers generally do not enter into a dispute with Inland Revenue to delay the payment of tax. Rather, there is a genuine dispute over the tax position taken and amount of tax payable. In this respect, large multinationals in dispute with Inland Revenue should not be treated differently from any other New Zealand taxpayer.

The use of money interest and late payment penalties regime should be a strong enough disincentive not to prolong a dispute. The power of use of money interest is further evidenced by taxpayers using tax pooling services to mitigate its effects.

8. Conclusion

AmCham believes that New Zealand's tax laws are currently among the best in the world. New Zealand has a strong tax treaty network, a proven and effective thin capitalisation regime and a well-established transfer pricing regime.

AmCham supports a coordinated global response to BEPS, and endorses the work of the G20 and OECD. To the extent that the New Zealand Government proposes implementing the OECD's recommendations, our members broadly support the Government's intentions. However, where the proposals extend beyond implementing OECD recommendations, we do not see the Government has sufficient justification to take unilateral action.

A coordinated global approach will lead to better outcomes for tax authorities and for taxpayers.

We understand these submissions may be the subject of a request under the Official Information Act 1982 and consent to their release.

Yours sincerely

Mike Hearn
Executive Director

American Chamber of Commerce in New Zealand Inc.
mike@amcham.co.nz
Mob: 021-707-506

#024

Westpac New Zealand Limited
Westpac on Takutai Square
PO Box 934
Auckland 1010

30 April 2017

BEPS – Interest Limitation Rules
C/- Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath,

Submission
BEPS – Strengthening our interest limitation rules: A Government discussion document

Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch (Westpac collectively) welcome the opportunity to submit on the Government discussion document "BEPS – Strengthening our interest limitation rules" (the Discussion Document) published in March 2017. Westpac appreciates both the opportunity to provide feedback on the Discussion Document and to continue to engage with officials in relation to the proposals.

Westpac is a member of the New Zealand Bankers Association (NZBA) and the Corporate Taxpayers Group (CTG) and supports the submissions provided by those bodies on behalf of their members. The following comments are intended to supplement the feedback provided by NZBA and CTG.

In summary we do not support the proposal outlined in the Discussion Document to limit the deductible interest rate on related party loans from a non-resident to a New Zealand borrower. We submit that at a minimum New Zealand banking groups should be excluded from the ambit of the proposals and that the rules should be refined so that they target the specific cases of abuse (as outlined in paragraph 1.4 of the Discussion Document, where it is acknowledged that only a minority engages in the behaviour these proposals are intended to target).

We have limited our comments to the proposals contained in Chapter 3 on the basis that most of the changes outlined in the Discussion Document do not apply to New Zealand banking groups given that the industry is already subject to a special thin capitalization regime.

We note the following in support of our submission:

Regulatory framework

The Discussion Document outlines the policy rationale for the proposals in paragraphs 3.3 to 3.14. In essence we understand that Inland Revenue Department (IRD) are concerned that the transfer pricing rules are ineffective to combat, in a related party scenario, tax aggressive behaviour and specifically the use of excessive and uncommercial interest rates for related party loans. The statements contained in these sections do not apply to Westpac and New Zealand banks more generally. This is due largely to the regulatory and commercial environment in which registered banks operate.

One of the primary tasks of the Reserve Bank of New Zealand (RBNZ) is to monitor and supervise registered banks in order to maintain the health and stability of the financial system. Under the RBNZ rules[1] a bank can only be registered where it meets criteria relating to its financial position, governance and ability to carry on business in a prudent manner (hereinafter referred to as conditions of registration) all of which preclude aggressive and uncommercial behavior including in respect of related party loan structuring.

---

[1] Further details of the extensive banking regulatory environment (based on Basel III principles) under which New Zealand registered banks operate are provided in the NZBA submission.

More specifically, a combination of the capital adequacy and liquidity frameworks in which New Zealand banks operate mean that the perceived behaviour used as justification for the proposals just do not exist in a banking context.

First, within the capital adequacy framework (BS2A and BS2B) a registered bank must maintain certain levels of regulatory capital. Currently the RBNZ prescribed minimum capital ratios for Common Equity Tier 1 (CET1), Tier 1 and Total Capital, are 7.0%, 8.5% and 10.5% respectively. CET1 must be made up of ordinary share capital and retained earnings (i.e. no debt element whatsoever). Ordinary share capital is universally accepted to be the most expensive form of funding, for any entity, predominately due to the risk of return given that ordinary shares rank last in the case of company liquidation. In respect of the other elements that can make up a banking groups regulatory capital (Additional Tier 1 and Tier 2 capital), while they can be debt in legal form, they must contain features in respect of subordination, tenor, discretion over interest payments and loss absorbency that mean from a regulatory perspective these instruments are more akin to share capital than ordinary debt funding. In such instruments, the interest rate will reflect the restricted rights of holders of an Additional Tier 1 or Tier 2 instrument and level of subordination in terms of ranking in liquidation. This is simply how the market operates from a commercial perspective, reflecting the balance between risk and return.

Secondly, the RBNZ's Liquidity Policy (BS13) impacts on the type and source of funding a New Zealand banking group can hold. The policy provides for a cap on any single party providing funding and for the purposes of the limits, related parties of a registered bank are treated as a single provider of that funding. BS13 therefore means that from a tax perspective the risk of excessive related party lending does not exist. Additionally, BS13 prescribes RBNZ disclosure requirements in respect of liquidity risk and liquidity risk management.

From both a capital efficiency and profitability perspective (noting that the weighted average cost of funding is a key driver of a banks net interest margin), it is in the New Zealand's banks interest to optimize its funding costs through diversification of funding sources. The features of regulatory capital and limits on related party funding create a natural bias for a bank to leverage its parent's ability to raise regulatory capital rather than "standard" unsubordinated debt not least because generally the offshore parent bank can raise regulatory capital at a much cheaper rate than a New Zealand bank could (we also refer you to the NZBA submission that outlines further reasons for the bias to utilising related party to meet a New Zealand banks regulatory capital requirements).

The New Zealand regulatory banking framework recognizes:

- the need for a bank to have an appropriate level of capital to cover its risks and maintain the health and stability of the financial system,
- that capital is expensive and that requiring too much capital will limit credit supply, and
- that different sources of capital are available which can reduce the overall cost of capital and thus allows (within prescribed limits) for different types of capital instruments to be issued.

Assuming rational economic behaviour, it can be expected that a New Zealand bank will optimize its capital structure to include Additional Tier 1 and Tier 2 capital. Further, that in sourcing such capital a New Zealand bank would look to leverage its offshore parents' market position. This reflects that the non-resident parent bank has deeper and greater access to capital markets than a New Zealand bank. This potentially reduces the cost of capital for a New Zealand bank. Accordingly, it is often the case that Additional Tier 1 and Tier 2 capital will be sourced from or through a related party entity (subject to BS13 liquidity requirements).

The Discussion Document proposes that the deductible interest rate be limited to the parent company's credit rating (plus a margin) as applied to unsubordinated debt with a maximum term of 5 years. If you accept the proposition that there is a preference for a bank to seek regulatory capital funding (which is heavily subordinated with an absolute minimum term of 5 years) from its offshore parent it then follows that the cap proposed will deny at least in part the interest expense on that instrument.

We do not agree with the comment at paragraph 3.17 that such an approach will ensure that the interest rate on related-party loans will therefore be roughly in line with the interest rate a borrower would agree with a third-party lender. As noted above, the features of regulatory capital required to be held by banks to the extent that this takes the form of debt (as Additional Tier 1 or Tier 2 capital) rather than pure equity mean that commercially such instruments will be priced accordingly. Any investor (whether it is a third party or related party) would seek a commensurate return to the level of risk inherent in such instruments.

The sourcing and allocation of funds of a bank are driven by factors that are not applicable to commercial and industrial companies. If the cap on related party interest rates proceeds as proposed, in our view it will inevitably increase the cost of capital in New Zealand (either as a result of the double taxation that will result from using Additional Tier 1 or Tier 2 instruments, or through such instruments no longer being viable and more expensive ordinary equity being required in their place to meet the RBNZ prescribed capital adequacy levels).

We understand that the concern that officials are seeking to address is the artificial weakening of a New Zealand entity's balance sheet that allows related party debt to be priced at a higher (contrived) rate. This issue does not and cannot exist given the regulatory banking framework (as the amount of related party funding is limited by BS13[2]) and the very nature of its business (being credit intermediation). Any artificial weakening of a bank's balance sheet would be value decretive as it would result in third party funders charging a higher cost. Therefore the perceived risk simply does not exist within the banking sector as the combination of regulatory constraints, market demands and the nature of business constraints mean that it would be counter-productive to the essence of a banking business to artificially weaken the balance sheet of a deposit taking entity.

As such, we do not believe that there is any basis for a general interest limitation rule to apply to the banking industry.

New Zealand banks are net deposit takers

The Discussion Document assumes that a group of companies will incur net third party interest expense, which may then be allocated around the various group entities. The allocation of group interest expense is meaningless in a banking context because banks are margin lenders and derive net interest income from a wide variety of external funding sources and markets. This point was specifically noted in the OECD's original discussion draft on BEPS Action 4:

> *"....taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore, a rule which caps net interest expense will have no direct impact on a bank or insurance company ..." (para 205)*

Further a New Zealand banks' ability to attract funding in both retail and wholesale markets is based on the strength of its balance sheet. Thus there is no rationale for a bank to weaken its balance sheet through excessive leverage. The premise, on which this proposal rests, of an artificially weakened balance sheet, is the antithesis of what occurs in the context of a bank which funds from the market.

The OECD has repeatedly acknowledged that there is a low risk in the banking sector in relation to excessive leverage. In this regard we refer you to the commentary in Chapter III of the OECD Report "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" published in December 2016, and in particular the comments at paragraph 510 in relation to a general limitation rule such as that proposed in the discussion document:

> *"In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a general risk at this point in time and so it is anticipated, in the majority of cases, countries will find this risk to be low. Excessive leverage in entities in a group with a banking or insurance company has been identified to be a greater risk. However because of differences in regulatory and tax rules between countries, there may be countries where this risk is adequately addressed. Where this is the case, there is no expectation that a country should apply a general interest limitation rule aimed at dealing with a risk that does not exist or is already addressed."*

As highlighted in this document and the NZBA's submission, there is no risk of excessive leverage in New Zealand banking groups due to the extensive and ongoing regulation of banks in Australia and New Zealand by the Australian Prudential Regulation Authority (APRA) and RBNZ.

Double Taxation

Westpac is concerned that in the case of bank debt, interest limitation represents a significant and unwarranted departure from accepted transfer pricing principles that apply across tax jurisdictions world-wide. Any rule that overrides the arm's length standard would give rise to a number of undesirable and

---

[2] For example as at 30 September 2016, total liabilities for the Westpac New Zealand Banking Group was NZD $86.3 billion, of which NZD $4.6 billion was related party. (See https://www.westpac.co.nz/assets/Who-we-are/About-Westpac-NZ/Disclosure-statements/Westpac-Banking-Corporation-Sept-2016.pdf)

arbitrary outcomes including double taxation. At a minimum this proposal is contrary to the transfer pricing principles espoused in New Zealand's extensive tax treaty network.

In this regard, we are concerned that it will not be possible to achieve mutual arbitration outcomes under a double tax agreement where, by way of example the IRD and Australian Taxation Office (ATO) disagree about the appropriate level of interest rate on related party loans.

Referring to the comments above in relation to the required nature of the type of arrangements that qualify as regulatory capital the interest rate cap will create artificial outcomes. The Australian parent bank will need to apply an arms length rate otherwise the ATO will reconstruct the terms of the arrangement to achieve this. Those terms will reflect market pricing for heavily subordinated, long term and in the case of Additional Tier 1, perpetual debt that will exceed the rate proposed by IRD. The tension between transfer pricing norms and the proposed interest limitation will lead not just to double taxation but also to greater uncertainty in pricing, more complexity in undertaking cross border transactions and additional compliance costs.

Conclusion

In summary we consider that the current tax and regulatory environment in which the New Zealand banking industry operates is more than sufficient to safeguard against the risk of excessive interest deductions by New Zealand banks. The extent of this regulation makes it unfeasible for Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch to manipulate related party loans in the manner that IRD are seeking to address. In point of fact, this has been acknowledged by OECD where in its Discussion Draft on BEPS Action 4 it was noted:

> *"existing regulatory requirements [might] act as an effective general interest limitation rule, and prevent excessive leverage in group entities…" (para 212)*

We believe that the proposal, if it were to proceed, will inevitably increase the cost of capital in New Zealand. Having regard to the conditions of registration, New Zealand banks do not have the options available to corporates in other industries to structure out of related party loans (and conversely these same rules prevent New Zealand banks from manipulating the terms of such loans). Tax rules should not interfere with normal banking commercial practice or run counter to the imperatives of banking regulation and the health and stability of the New Zealand financial system.

As such we consider the application of a general interest limitation rule to Westpac and the banking industry more generally as an unnecessary overreach.

As noted above we welcome the opportunity to discuss with you in more detail the comments raised in this submission.

Yours faithfully
Westpac New Zealand Limited

Jo Sawden
Head of Tax

Corporate Taxpayers Group
c/- Rebecca Osborn | Deloitte | PO Box 1990 | Wellington | +64 (0)4 470 3691
CTG

28 April 2017

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

Dear Cath

BEPS – STRENGTHENING OUR INTEREST LIMITATION RULES

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

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

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

Summary of our submission

The key points in our submission are:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We look forward to discussing this submission further with you.

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

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

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

Yours sincerely,

John Payne

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE: DETAILED SUBMISSION POINTS – GENERAL COMMENTS

1. General comments

Timeframes

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

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

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

Wider economic concerns

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Certainty, compliance costs and competitiveness

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

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

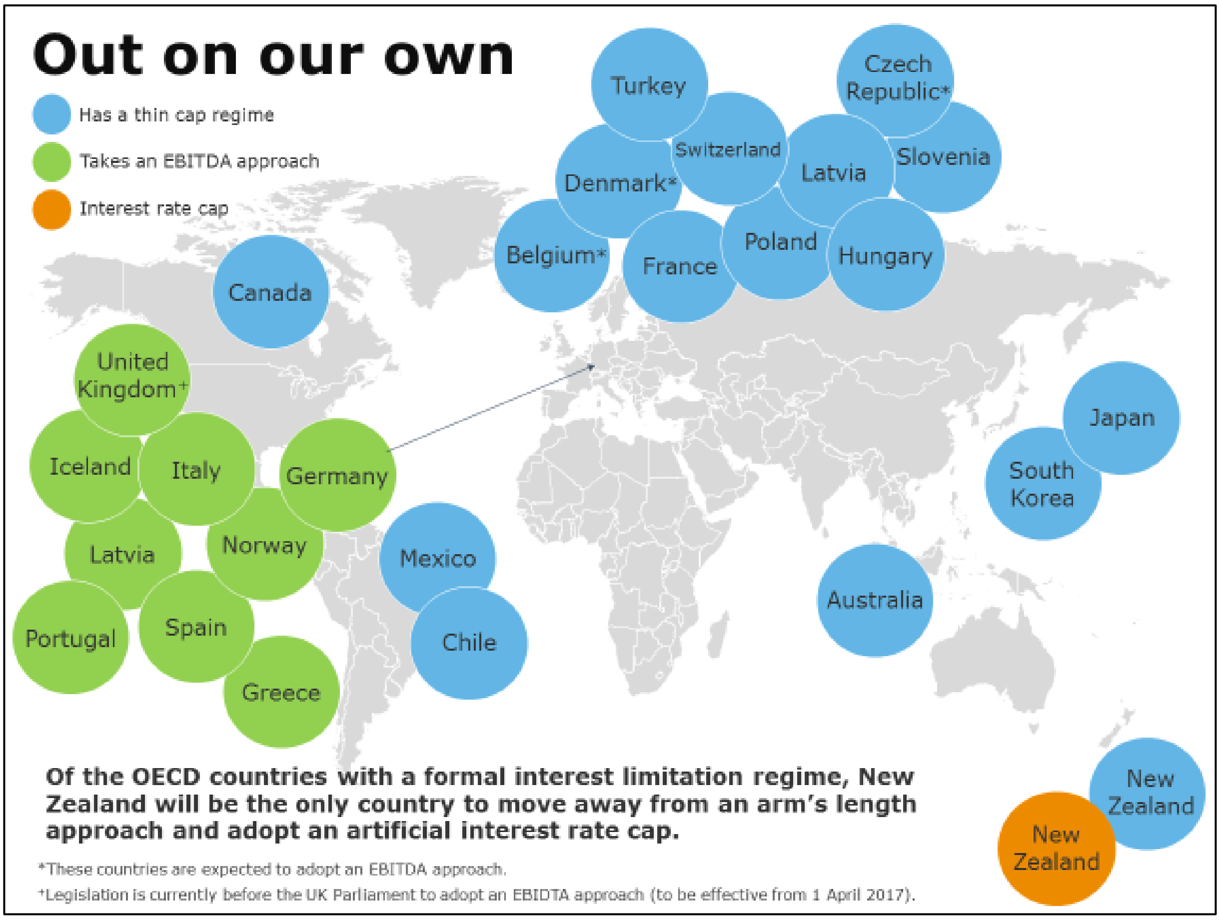
1.16 It is important to consider the changes occurring / that have occurred in Australia and the potential impact (whether negative or positive) of those changes. As New Zealand's largest inbound investor, Australia's approach to this issue is very important. The Australian Government has stated that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

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

[4] http://www.ird.govt.nz/resources/6/2/62414b82-6ab8-4017-b04d-cc5d950cab47/compliance-focus-2016.pdf, Page 1
[5] Do corporates pay their "fair Share" of tax in New Zealand?: Effective tax rates in corporate New Zealand – domestic corporates versus foreign multinationals. EY, March 2017.

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

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



Purpose of the thin capitalisation rules

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

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

---

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

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

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

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

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

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

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

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

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

[7] 2014 Commentary pages 183-184

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

Transfer Pricing / Arm's Length Tests

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

> ***Use of interest and payments economically equivalent to interest for base erosion and profit shifting***
>
> *11. Rules currently applied by countries fall into six broad groups, with some countries using a combined approach that includes more than one type of rule:*
>
> > *1. Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.*
> > *2. Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction.*
> > *3. Rules which disallow a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made.*
> > *4. Rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets.*
> > *5. Rules which limit the level of interest expense or debt in an entity with reference to the group's overall position.*
> > *6. Targeted anti-avoidance rules which disallow interest expense on specific transactions.*
>
> *12. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately after arrangements are entered into, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules (e.g. in pricing the interest income and expense of an entity before applying other interest limitation rules). In particular, countries have experience of groups structuring intragroup debt with equity-like features to justify interest payments significantly in excess of those the group actually incurs on its third party debt. Additionally, an arm's length test does not prevent an entity from claiming a deduction for interest expense which is used to fund investments in non-taxable assets or income streams, which is a base erosion risk specifically mentioned as a concern in the BEPS action plan (OECD, 2013).*

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

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

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

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

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

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

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

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

Interaction with our double tax agreements

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

- Allows a jurisdiction to adjust profits to those arising on an arm's length basis (in which case New Zealand would not be restricted to taxing profits in excess of those that would be calculated on an arm's length basis); or

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

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

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

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

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

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

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

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

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

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

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

- The discussion document argues that given the OECD has recommended countries adopt an interest limitation rule the interest rate cap is consistent with our DTA obligations regardless of the fact the OCED recommends an EBITDA based rule. Clearly the Discussion Document approach is not consistent with international practice given the interest rate cap is unique in the world. As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". Whether or not an interest rate cap is seen as equivalent to what OECD recommends is not determinative of whether or not the approach would be overridden by a DTA. In any case the OECD EBITDA approach explicitly does not limit interest deductions to situations where the lender is non-resident. Instead the OECD recommends that the EBITDA approach apply at a minimum to all entities that are part of any multinational group but the OECD also suggests it could usefully apply to all entities including stand-alone companies with purely domestic operations (OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – 2016 Update, page 37). The inconsistency with the provisions of the DTA thus does not arise with the OECD proposal. They do, however, arise with the Discussion Document proposal.

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

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

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

2. Limiting the interest rate on related-party loans

Summary

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

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

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

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

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

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

2.7 The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred over making some amendments to the existing thin capitalisation rules (but not necessarily to the extent of the proposals contained in the discussion document) as a first step.

Proposal

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

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

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

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

Concerns with an absolute cap

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

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

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

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

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

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

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

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

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

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

- The size and tenor or the loan/investment.

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

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

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

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

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

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

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

- In circumstances where there are two substantial shareholders, reliance on the majority shareholder's credit rating is inappropriate. For example in a scenario where you have two shareholders with 51% and 49% shareholdings respectively, reliance on the 51% shareholder's credit rating is inappropriate, particularly if that rating differs substantially from the 49% shareholder's credit rating.

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

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

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

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

EBITDA approach

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

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

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

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

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

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

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

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

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

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

Safe harbour[13]

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

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

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

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

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

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

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

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

3. Treatment of non-debt liabilities

Summary

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

Examples

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

International comparisons

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

Commercial approach to lending

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

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

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

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

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

Exclusions

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

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

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

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

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

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

Application date

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

---

[15] Income Tax Assessment Act 1997 – Section 820.682

APPENDIX FOUR: DETAILED SUBMISSION POINTS – OTHER MATTERS

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

4. Other matters

Summary

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

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

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

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

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

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

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

De minimis

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

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

4.10 There are a number of reasons as to why it may be necessary to have owner-linked funding. For example, a newly established entity or operations may not be able to borrow in New Zealand so the non-resident parent may need to advance some funds to get the business started. Alternatively, it may be that the only way that the New Zealand entity is able to obtain borrowed funds is by the parent guaranteeing the debt. For interest deductions of this level there is little scope to undertake profit shifting activities and it would not be worth Inland Revenue's time to review these deductions. In this context it would be appropriate to extend the de-minimis to inbound investment without the owner-linked debt restriction on compliance cost saving grounds.

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

Infrastructure projects

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

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

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

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

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

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

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

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

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

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

4.15 The Group does not agree that all related party debt should be non-deductible. In the Group's view equity investors should be able to take a debt interest in the project if it is at a level that a third party would bank. The tax system should not force investors to take bank debt and give debt margin away. There are legitimate reasons why an investor may want equity and debt returns. The Group submits that where related party debt is a substitute for third party debt (i.e. it would meet an arm's length debt test) it should remained deductible even with gearing levels above 60%.

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

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

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

Non-residents acting together: related party debt

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

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

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

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

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

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

Asset valuation

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

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

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

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

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

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

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

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

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

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

Measurement date for assets and liabilities

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

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

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

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

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

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

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

Australian thin capitalisation rules

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

Application date / grandparenting

4.40 The discussion document notes that, if implemented, the proposals will apply from the beginning of the first income year after enactment (except for the proposals relating to non-resident owning bodies). The Group submits that this application date is inappropriate for such fundamental proposals.

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

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

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

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

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

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

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

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

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

#026

NEW ZEALAND
LAW SOCIETY
NZLS EST 1869

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

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

1 May 2017

Policy and Strategy
Inland Revenue
PO Box 2198
Wellington

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

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

Introduction

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

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

Proposed interest deduction cap

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

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

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

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

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

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

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

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

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

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

7. This submission addresses:

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

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

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

Summary of proposed alternative regime

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

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

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

The justification for change

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

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

    (a) not unique to the transfer pricing rules;

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

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

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

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

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

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

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

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

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

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

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

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

> *"Applying this interest rate cap will likely require the engagement of financial analysts or other subject matter experts, who have access to bond yield data and are able to perform the required calculations. This is no different to the situation at present – firms borrowing from related-parties should be involving subject matter experts to perform comparability analysis and ensure that the interest rate (and the other terms and conditions) of the related-party loan is reasonable.*
>
> *We therefore believe this proposal will not result in increased compliance costs; indeed compliance costs may reduce in some circumstances."*

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

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

Inconsistency with the arm's length principle

19. The Government comments in general terms in the discussion document that the interest rate cap would ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would agree to with a third party (paragraphs 3.17 and 3.21).

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

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

21. Government reasons further at 3.58 that:

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

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

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

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

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

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

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

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

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

Significance of the departure from the arm's length principle

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

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

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

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

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

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

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

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

Summary and alternative proposal

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

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

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

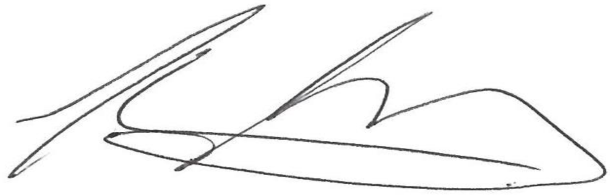
39. The Law Society submits that a balancing of Inland Revenue concerns and the importance of the arm's length principle could be achieved through adoption of an approach that incorporates the interest deduction cap as a safe-harbour adopted by election of taxpayers. Taxpayers would be permitted to deduct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

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

Conclusion

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

Yours faithfully



Kathryn Beck
President

InfraRed
Capital Partners

12 Charles II Street
London
SW1Y 4QU

T +44 (0)20 7484 1800
F +44 (0)20 7484 1801
www.ircp.com

Strictly private and confidential

BEPS – Interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

12 May 2017

To whom it may concern,

InfraRed Capital Partners Limited, via its local Adviser, InfraRed Capital Partners (Australia) Pty Limited (together "**InfraRed**"), makes the following submission in relation to the Government Discussion Document titled "BEPS – Strengthening our interest limitation rules". The primary focus of this submission is the operation of the thin capitalisation regime and the proposed changes discussed in Chapter 5 as applied to government infrastructure procurements (ie. PPPs).

InfraRed makes this submission as an active equity investor in the New Zealand PPP sector, currently holding interests in the SecureFuture Wiri Group and the Wellington Gateway Partnership Group, delivering the Auckland South Correctional Facility and Transmission Gully Motorway projects, respectively.

Current state of play

The current thin capitalisation regime applies to any foreign investor that holds an equity interest of 50% or more of an asset or a group of foreign investors which in aggregate (in certain circumstances) hold 50% or more of the equity . Once inside the thin cap regime, the regime provides that the foreign investor may utilise tax deductible gearing in the NZ Project up to the greater of: (a) the safe harbour threshold of 60%; and (b) a level that is 110% of the level of gearing currently held in its World Wide Group. We interpret that the policy objective of this is to ensure that foreign investors do not gear local NZ entities disproportionately higher than entities that they invest in in other jurisdictions.

If the foreign investor is unable to satisfy this test then the interest on the excess portion of the project level debt is treated as non-deductible.

As an investor bidding for projects in the New Zealand market, it is important that tax rules:

i) are clearly understood so that their impact can be priced into the economic analysis
ii) apply in a consistent way so that they do not favour certain types of investor or structures
iii) do not make New Zealand uncompetitive when compared to other international markets competing for inward investment

Observations on current framework

The following observations highlight situations in which the above points are not always met:

- Project finance structures used to finance infrastructure projects typically have higher gearing levels than other arrangements (eg. corporate) and commonly exceed the safe harbour threshold. There are a number of reasons for this which include revenue credit quality, cost predictability and the generally tightly controlled nature of the structure (ie ring fenced). It is on this basis that arms-length third-party lenders are comfortable to lend at higher levels (up to 90%) on a non-recourse basis, compared to other structures. This maximisation of the cheapest form of private capital is a key feature in driving affordability/feasibility of these projects.
- The first order impact of the thin capitalisation rules is that it can drive the make-up of consortiums (to manage under the 50% non-resident threshold). This results in tax driving the level of participation in consortium with a corresponding reduction in participation and competition. This is sub optimal.
- Secondly, it can also drive the chosen investment structure (e.g. a company) which results in additional tax risks being imposed on consortium participants (e.g. loss continuity) which would not be the case if thin cap constraint did not dictate the investment choice. Again, this is sub optimal.
- Unless the investment (and its participants make up) can be structured so as to effectively fall outside the ambit of the thin capitalisation rules, the resulting participation by non-residents is further constrained. This is because in those circumstances, limb (a) of the thin cap test is generally failed, and so the project entity needs to satisfy limb (b) in order to avoid an interest deduction restriction, however, application of this test is not always simple in practice in project finance situations.
- Entities that invest in project finance structures are usually corporates or investments funds. As such the current thin capitalisation test requires you to compare the gearing levels of the project company to the gearing level in the corporate group or fund structure which does not seem an appropriate test in the context of a ring-fenced project finance structure. It is highly unlikely that the investing entity will be able demonstrate the required gearing levels (80%+ and as prepared on an accounting basis) to allow the underlying project company to utilise c. 90% gearing levels.
- Further, because the different projects in which the corporates / funds have invested will be in different phases of their lifecycle, a comparison of the gearing level of the project company to the gearing level of the investing entity is not appropriate. The thin capitalisation regime requires a minimum of an annual testing of the debt:asset ratio. An annual test that compares the gearing of say, a project entity in a build phase to a portfolio of projects companies which are in the operation phase will give different views on the level of gearing depending on the maturity of the project profile. Over the life of similar projects, comparable levels of gearing could be expected. However, an annual “snap shot” will not reflect this.
- Even if the debt:asset profile of the investor could be managed at the outset, the life of the assets means it is not possible to commit to that being the case for the life of the project.
- The measure of gearing is an accounting construct (Debt:Assets) so does not represent the same economic picture as simply looking at the amount of debt versus the amount of equity. Accounting practices also vary between different jurisdictions and legal structures (eg. partnerships vs trusts vs companies), as do account preparation dates. Additionally, the accounting treatment varies depending

on the amount of equity ownership in the underlying project (eg. consolidate or equity account). This further clouds the economic reality of the group.

- Additionally, determination of what entities to include in the World Wide Group can be complicated as investment funds may not prepare consolidated accounts.
- The impact of the above is that limb (b) does not provide the safety valve it should.

Impact on InfraRed's investment activity in New Zealand

The impact of the above is that InfraRed considers it is very difficult to satisfy the current thin cap test when applied to project finance structures in which InfraRed will take a 50%+ stake. This means that a significant portion of the third-party senior debt has to be treated as non-deductible, resulting in more tax being paid overall and earlier and increasing the cost of capital significantly. . This places the bid at a significant cost disadvantage versus a bid where a foreign investor does not have a 50%+ stake. Tax may therefore be a key factor in determining which investor delivers the lowest cost bid, which, we suggest, is not in the interests of the public sector procuring body.

Accordingly, when investing in NZ PPPs InfraRed is constrained in that it needs to remain under 50% of the project equity. This reduces the attractiveness of the various projects by reducing the absolute investment amount whilst the significant cost and time required to bid these projects remains fixed. Predominantly for this reason, InfraRed has declined recent opportunities to participate in smaller NZ PPPs (eg. schools procurements). This constraint also has second order impacts in constraining the liquidity of the projects, which will become more relevant as the New Zealand project profiles mature, i.e. secondary investors will not want to take 50%+ stakes in projects that have reached their operations phase.

InfraRed manages funds that invest in similarly geared PPP projects in the region and other markets globally. These funds do not seek to gear the NZ project entities disproportionately to project entities in other countries, however, for the reasons given above, it finds that it cannot meet the thin cap tests. This appears at odds with our perception of the underlying commercial rationale of the regime.

Overall, when InfraRed looks to invest in NZ it compares the forecast investment returns to those of investment opportunities in other regions. However, the way the thin cap rules currently operate has a negative impact on the returns from NZ investment opportunities making it harder to allocate capital to those opportunities.

Application to the Government Discussion Document

InfraRed supports the proposal for the safe harbour threshold to be able to be exceeded for infrastructure projects as a solution to the problems outlined above. As PPP projects are Government procured and financed on a non-recourse basis, the debt in these projects represents no BEPS risk

However, InfraRed does not support the view that related party debt is by definition "not arms-length". There is legitimate commercial rationale as to why an investor would hold equity and debt interests in a project or would seek to fund a project using shareholder funds rather than seeking external finance. Provided that the overall level of debt remains in line with the level that a third-party would lend to, and at a comparable rate, then InfraRed is of the view that this should remain deductible.There are currently a number of investors both in New Zealand and internationally who participate in the provision of both equity and senior debt pari passu with third party banks. In these instances, it is common that the equity providers do not all participate in the debt, and the provision of the senior debt by an equity party is effectively taking the role of a third party lender. InfraRed is of the view that in these types of arrangements interest on the related party debt should remain deductible.

InfraRed firmly believes that the ability to use arms-length debt in excess of the safe harbour threshold should not depend on the specific legal structuring of the deal; the utilisation of limited partnership structures or alternatively company structures. Any change in the rules should ensure that this is the case.

Next Steps

InfraRed remains one of the larger foreign equity participants in NZ and has a great level of interest in continuing to invest significant funds in NZ projects over the foreseeable future. We would be happy to further engage with and discuss the Government's proposals to provide further perspective on how they relate to InfraRed's investment activity in New Zealand.