Coversheet: BEPS – strengthening our interest limitation rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*The analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The problem the proposals discussed in this impact statement seek to address is the use of debt financing by taxpayers to reduce their New Zealand income tax liability significantly.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The adoption of a restricted transfer pricing rule for determining the allowable interest rate (for tax purposes) on related-party loans from a non-resident to a New Zealand borrower will help ensure interest rates on such loans cannot be excessive. In addition, changing the way deductible debt levels are calculated under the thin capitalisation rules will ensure that taxpayers with little equity are unable to have large amounts of deductible debt. These changes will provide a solution that is sustainable, efficient and equitable, while minimising impacts on compliance and administration costs.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that the new interest limitation rules are forecast to produce approximately $80–90 million per year on an ongoing basis. There are also efficiency and fairness benefits to these proposals which cannot be assigned to particular beneficiaries.

Where do the costs fall?
The costs primarily fall on foreign-owned taxpayers operating in New Zealand (though there may be some minor impacts on New Zealand-owned taxpayers with international operations). Tax payments for affected parties are forecast to increase by approximately $80–90 million per year on an ongoing basis.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
As with all tax rules, there is some risk of taxpayer non-compliance. However, this is mitigated as the rules predominately apply to large companies – and the tax affairs of large companies are closely monitored by Inland Revenue.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is moderate evidence in relation to the problem of excessive interest rates on related-party debt, and good evidence in relation to allowable debt levels. Inland Revenue has some data on interest rates paid on related-party debts, as well as examples of structures that appear to have the effect of increasing the interest rate on such debt. However, this data is not comprehensive. Inland Revenue has data on the debt, asset and equity levels of significant foreign-owned enterprises, which allows an accurate estimation of the impact of the non-debt liability adjustment for those firms.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *BEPS – strengthening our interest limitation rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the Quality Assurance criteria.

Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – strengthening our interest limitation rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy changes to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire. This dataset includes debt levels, related-party debt levels, and related-party interest payments of large foreign-owned firms. However, there are still limitations to that data – for example, data on interest rates on related-party debt (and the interest rates facing a New Zealand subsidiary's parent company) is not captured in the Questionnaire. Where possible, this information was obtained from other sources (such as credit ratings of parent companies and disclosed related-party interest rates in financial statements) or estimated (for example, estimating interest rates based on related-party interest payments and related-party debt amounts). However, this other data is less comprehensive and accurate. **Consultation** The preferred option in relation to limiting interest rates on related-party interest rates has not been subject to consultation. This was because it was developed in response to submissions on the original proposals. However, it is similar in many respects to the original proposal, which was subject to consultation. In addition, to ensure the rule operates effectively and to mitigate the risk of unintended outcomes, it will be subject to consultation with submitters on the technical detail.

Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to tax planning strategies used by some multinational enterprises (MNEs) to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over MNEs not engaged in BEPS and domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter BEPS.

BEPS using interest deductions

The use of debt financing is one of the simplest ways of shifting taxable profits from one jurisdiction to another. For example, because interest payments are deductible, a related-party cross-border loan from a parent to a subsidiary can be used to reduce taxes payable in the jurisdiction that the subsidiary is located.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations. This includes developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4).

If no further action is taken, MNEs that currently have high levels of debt in New Zealand, or highly-priced related-party debt, will be able to continue paying little tax in New Zealand. There is also a risk that additional MNEs would adopt similar structures.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

New Zealand's tax system has been the subject of numerous broad-based reviews – most recently the Victoria University of Wellington Tax Working Group in 2010. It is well regarded and generally functions well.

No other government agencies have a direct interest in the tax system. However, a good tax system is important for a well-functioning economy – many government agencies therefore have an indirect interest in the tax system.

Foreign investment in New Zealand is generally taxed under our company tax at 28 percent. New Zealand's tax system has rules that limit the deductible debt levels and interest rates for taxpayers with foreign connections. These rules affect only foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Thin capitalisation rules

New Zealand has "thin capitalisation" rules to limit tax deductions for interests that non-residents are allowed. These rules generally require an investment owned by a non-resident to have a debt-to-asset ratio of no more than 60 percent (interest deductions are denied to the extent the allowable debt-to-asset ratio is exceeded).

Thin capitalisation rules also apply to New Zealand-owned firms (frequently referred to as the "outbound thin capitalisation rules"). These rules generally require a debt-to-asset ratio of no more than 75 percent. They are designed to prevent a disproportionate portion of a New Zealand company's debt being placed in New Zealand.

Like the tax system as a whole, we consider that the thin capitalisation rules are serving us well. The rules are well understood and taxpayers subject to the rules generally have conservative debt levels and, for those with related-party debt, the debt is at conservative interest rates – as evidenced by the significant amount of tax paid by foreign-owned firms operating in New Zealand (foreign controlled firms paid 39 percent of company tax in the 2015 tax year).

Transfer pricing rules

It is important to limit not just the quantum of debt in New Zealand, but also the interest rate on that debt. For third-party debt, commercial pressures will drive the borrower to obtain as low an interest rate as possible. However, these pressures do not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates. Broadly speaking (and as they apply to related-party debt), these rules seek to ensure that the interest rate on a given loan contract is in line with what would have been agreed between unrelated parties.

NRWT

While payments of interest to related parties are deductible, they are subject to non-resident withholding tax (NRWT). NRWT applies at either 15 percent or 10 percent, depending on whether New Zealand has a Double Taxation Treaty with the interest recipient's home jurisdiction. This means that, while the use of debt can reduce tax payable in New Zealand, it does not completely eliminate it.

2.3 What is the policy problem or opportunity?

A simple way that non-residents can reduce their New Zealand tax liability significantly is by capitalising a New Zealand investment with debt instead of equity, because they can then take interest deductions in New Zealand. This is shown in the example below.

> ***Example***
> *Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.*
>
> *Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.*

Having a generally well regarded tax system does not mean that tax changes are unnecessary. An on-going policy challenge is to ensure that our tax rules are up to date and ensure that MNEs are paying a fair amount of tax in New Zealand. Base protection measures – such as rules for limiting the amount of debt allowable in New Zealand, and the interest rate on that debt – are therefore important.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

This impact statement considers two related policy opportunities:

- ensuring the rules for setting the allowable interest rates on related-party debt are sufficiently robust; and
- ensuring the basis for setting the allowable debt level in the thin capitalisation rules is appropriate.

Scale of the problem

The OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan) included developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4). We consider the fact that the OECD has included profit shifting using interest in its BEPS Action Plan as evidence that this is a significant policy issue internationally.

As mentioned above, most MNEs operating here have relatively low levels of debt and do not have interest rates considered to be excessive. However, there are a small number of taxpayers with either debt levels that are too high, or interest rates that are excessive. While small in number, the fiscal impact of these arrangements is significant – we estimate the tax revenue lost is $80–90 million per year.

2.4 Are there any constraints on the scope for decision making?

There are no constraints on scope.

2.5 What do stakeholders think?

Stakeholders

The stakeholders are primarily taxpayers (in particular, MNEs) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules.

Consultation already undertaken

In March 2017, the Government released the discussion document *BEPS – strengthening our interest limitation rules*. The discussion document consulted on two key proposals which are considered in this impact statement – new interest limitation rules and a non-debt liabilities adjustment to the thin capitalisation rules.

The Government received 27 submissions on the discussion document. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

In general, submitters acknowledged the need to respond to BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, many submitters did not support the specific proposals put forward.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Interest limitation

The discussion document proposed moving away from a transfer pricing approach for pricing inbound related-party loans. Instead, the allowable interest rate for such a loan would – in most instances – be set with reference to the New Zealand borrower's parent's borrowing costs (referred to as an "interest rate cap").

General reaction

Most submitters argued that the interest rate cap proposal was not necessary and should not proceed. They noted that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

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

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

Only two submitters wrote in favour of the proposed cap. However, the proposal did attract positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.

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

Allowable debt levels

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

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

General reaction

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

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

Stakeholders' views displayed no clear pattern. Two big accounting firms agreed with the proposal while two others disagreed. Similarly, of the three major stakeholder groups who submitted on the proposal, one supported and two opposed the change.

Deferred tax

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

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

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

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

Further consultation

Following Cabinet decisions in July 2017, officials are planning to undertake further public consultation on outstanding policy issues, technical design details and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Related-party interest rates

We have identified five mutually exclusive options to the address the problem of excessive interest rates on related-party debts.

Option 4 (administrative guidance) is a non-regulatory option. The other options for change involve changing New Zealand's tax legislation.

Option 1: Interest rate cap (discussion document proposal)

As described in section 2.5.

Option 2: Restricted transfer pricing

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

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

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

This restricted transfer pricing rule would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable.

This option was developed following consultation to address some of the concerns raised by submitters; however, it has not itself been subject to consultation.

Option 3: Adopt EBITDA-based rule (OECD recommended approach)

This option would involve limiting the amount of interest deductions a taxpayer is allowed with reference to their earnings (specifically, their profits before deductions for interest, depreciation and amortisation are taken into account, also known as their EBITDA). This new approach would completely replace the thin capitalisation rules, becoming the new method for limiting interest deductions for taxpayers with international connections.

This approach would constrain the tax effectiveness of highly priced debt, since it directly limits interest deductions rather than limiting the amount of debt; a taxpayer with highly priced debt would be more likely to exceed their EBITDA limit and face interest denial.

Almost all submitters did not support the adoption of an EBITDA-based rule.

Option 4: Administrative guidance

This option would involve Inland Revenue issuing administrative guidance on how it will assess the risk of related-party lending transactions – similar to what has recently been released by the Australian Taxation Office (ATO) (discussed below).

Under this option, related-party loans with certain features (such as having an interest rate in line with the interest rate facing the borrower's foreign parent) would be given a low risk rating and be unlikely to be challenged by Inland Revenue. Taxpayers with higher interest rates would be more likely to have their related-party loan investigated.

Several submitters suggested this option be adopted in place of the interest rate cap. They argued that it would provide certainty for taxpayers who desired it, but taxpayers who value certainty less would be free to breach the guidelines.

Option 5: Status quo (ordinary transfer pricing)

This option would involve continuing to price related-party debt under the transfer pricing rules. As discussed above, the Government proposed strengthening these rules in the discussion document *BEPS – transfer pricing and permanent establishment avoidance.* Many submitters argued that this should be sufficient to address any concerns over related-party interest rates.

Relevant experience from other countries

The ATO has released draft guidelines regarding the interest rates of cross-border related-party loans.[1] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

Allowable debt levels

We have identified three mutually exclusive options relating to setting the allowable debt level under the thin capitalisation rules.

The options (other than the status quo) involve changing New Zealand's tax legislation.

Option 1: Proceed with non-debt liabilities adjustment (as proposed in the discussion document)

As described in section 2.5.

Option 2: Proceed with non-debt liabilities proposal excluding deferred tax

Under this option, a taxpayer's deferred tax would be ignored for the purposes of the non-debt liability adjustment. That is, a taxpayer's allowable debt level would be set with reference to the result of the formula: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Of submitters who supported the proposed non-debt liability adjustment in principle, this was the preferred option.

Option 3: Status quo (do not proceed with non-debt liabilities adjustment)

Under this option, maximum deductible debt levels would continue to be calculated under the thin capitalisation rules with reference to assets, ignoring non-debt liabilities.

As mentioned in section 2.5, this was the preferred option of some submitters.

Relevant experience from other countries

Australia has thin capitalisation rules that are broadly similar to New Zealand's. Australia's rules currently require a non-debt liability adjustment, but deferred tax is carved-out. That is, Australia's rules are consistent with option 2.

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

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?
The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria: • *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible; • *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way; • *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible; • *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible; and • *Sustainability* – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved Efficiency, fairness and sustainability are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these three criteria.

3.3 What other options have been ruled out of scope, or not considered, and why?
No options were ruled out of scope.

Section 4: Impact Analysis

	Option 1 (interest rate cap)	Option 2 (restricted transfer pricing)	Option 3 (EBITDA-based rule)	Option 4 (administrative guidance)	Status quo
Efficiency and neutrality	+ Option 1 will provide a strong limit on related-party interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains. However, for some firms the interest rate allowed under the cap may be too low, which lowers the efficiency benefits.	++ Option 2 will provide a reasonably strong limit on related-party debt interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains.	**0** Option 3 will provide an effective limit on all interest expenses (including related-party interest expenses). However, it also increases the uncertainty of returns on New Zealand investment, since whether or not interest is deductible turns on a taxpayer's EBITDA, which can be very variable.	+ Some taxpayers would benefit from the certainty provided by the administrative safe harbour. However, for taxpayers willing to exceed the safe harbour, this option is no different than the status quo – excessive interest rates on related-party debt would still be possible.	**0**
Fairness and equity	++ Option 1 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	++ Option 2 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	**0** On the one hand, option 3 would be somewhat effective at preventing excessive interest rates. On the other hand, it could result in interest denial for firms with very conservative interest rates and debt positions (say, for example, if a taxpayer is in loss).	**0** Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. For taxpayers willing to exceed the administrative safe, harbour this option is no different to the status quo.	**0**
Efficiency of compliance	++ Option 1 would reduce compliance costs for many taxpayers – the allowable interest rate on related-party debt would be set on a clear objective factor (the credit rating of the foreign parent). However, in some cases – where the non-resident parent has no credit rating – compliance costs will stay the same or could potentially increase.	+ Option 2 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo)	**0** Compliance costs in some instances would reduce under option 3, as there would be fewer transfer pricing disputes about related-party debt. However, an EBITDA-based rule would be a fundamental shift in our interest limitation rules – taxpayers and agents would have to come to grips with an entirely new regime.	+ Option 4 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo).	**0**

Efficiency of administration	++ Option 1 would avoid the need for potentially complex and expensive disputes over whether the interest rate on related-party debt is set appropriate.	++ Option 2 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. For the remaining taxpayers, the restrictions (e.g. striking out exotic terms) would simplify the transfer pricing analysis.	+ Option 3 would reduce administration costs because there would be less need to review and challenge related-party loans under transfer pricing.	+ Option 4 would reduce the need to review the interest rates of taxpayers utilising the safe harbour.	**0**
Sustainability	+ Option 1 would apply to taxpayers that have structured their affairs to strip the maximum profits out of New Zealand; however, it could also affect the interest rates of less aggressive taxpayers.	++ Option 2 should generally only affect taxpayers with more aggressive debt structures.	**0** Option 3 could result in interest deduction denial even if a taxpayer has conservative debt levels.	+ Option 4 would not prevent firms from achieving excessive interest rates on related-party debt.	**0**
Overall assessment	+	++ **Recommended option**	**0**	+	**0**

Key:

++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Allowable debt levels

	Option 1 (non-debt liability adjustment)	Option 2 (adjustment with no deferred tax)	Status quo
Efficiency and neutrality	+ Option 1 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, submitters have argued that in some instances deferred tax (a type of non-debt liability) does not represent real liabilities; to the extent this is correct, reducing allowable debt levels in relation to these liabilities could hamper efficiency.	+ Option 2 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, this option carves out all types of deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option would allow some taxpayers to have too high a debt level.	**0**
Fairness and equity	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, submitters have argued that in some instances deferred tax does not represent a real liability. To the extent this is correct, including deferred tax in the non-debt liability adjustment could be seen as unfair.	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, this option excludes all deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option will not treat taxpayers in the same situation the same.	**0**
Efficiency of compliance	**0** Neither option will have a significant impact on compliance costs. The result of both options is just a change to how the existing thin capitalisation calculations are carried out. However, there may be some one-off compliance costs if the changes mean taxpayers breach their thin capitalisation limits and, as a result, decide to restructure their borrowing.		**0**
Efficiency of administration	**0** Neither option has a significant impact on administrative costs. Thin capitalisation calculations are carried out by taxpayers – this change has no substantive impact on Inland Revenue.		**0**
Sustainability	+ Both options similarly target firms with debt levels that are too high relative to their levels of equity and are therefore well targeted. Firms with low levels of debt, or with reasonable levels of debt relative to equity, will be largely unaffected by either option.		**0**
Overall assessment	+	+	**0**

Key: ++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Interest limitation

We consider that option 2 – developing a restricted transfer pricing approach – is the best option to limit interest expenses in relation to inbound related-party debt.

Following consultation and further analysis, we consider that if the Government pursued the interest rate cap (option 1), adjustments would be needed to the original discussion document proposal which would make it more complex. For example, to address some of the concerns expressed by submitters, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

The difficulty is, however, that simply relying on transfer pricing, as suggested by some submitters, will not achieve the desired policy outcomes. It is clear that the international consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. In addition, as noted in section 2.5, commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

Accordingly, we consider that the restricted transfer pricing rule is the best approach. Like the interest rate cap, it will ensure the policy objective – ensuring there is a robust mechanism for determining the interest rates for inbound related-party debt; however, since the restricted transfer pricing rule has more flexibility (compared to the interest rate cap – the other option that would most effectively achieve the policy objective) it is both more efficient and fairer.

Owing to the time available (and since it was developed subsequent to the initial consultation), this option has not been subject to consultation with stakeholders. This modification will address many, but not all of, submitters' concerns – it is still a departure from using ordinary transfer pricing. Nevertheless, we expect that it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur frequently because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

Allowable debt levels

At this stage, we do not have a preference between option 1 (non-debt liability adjustment as originally proposed) and option 2 (non-debt liability adjustment with deferred tax carve-out). Option 3 (status quo) is not preferred.

Both options 1 and 2 have similar impacts in terms of efficiency and fairness (and have no significant impacts in terms of compliance and administration costs). The non-debt liability adjustment in option 1 is potentially too extensive because of the inclusion of *all* types of deferred tax, but, on the other hand, the adjustment in option 2 is too narrow because of the exclusion of all deferred tax.

We consider that the best approach is to recommend neither options 1 or 2 at this stage, but instead consult further with stakeholders on whether there is another feasible option (since this is a minor technical detail, more consultation on this matter is feasible). For example, it might be possible to identify deferred tax liabilities that are the least likely to result in a future tax payment, and restrict the carve-out of deferred tax to just that identified group.

5.2 Summary table of costs and benefits of the preferred approach

Related-party interest rates

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40m per year	Medium
Regulators	Administration costs: There will be a one-off cost to Inland Revenue in developing guidance on how the new rules will operate.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40m per year	Medium
Non-monetised costs	Administration costs	Low	High
Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Reduction in compliance costs for firms that utilise safe harbour.	Medium	High
Regulators	Revenue: Tax collected will increase. Administration costs: Reduction in costs for ensuring related-party interest rates are appropriate.	Approximately $40m per year Medium	Medium High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40m per year	Medium
Non-monetised benefits	Compliance and administration cost reduction	Medium	High

Allowable debt levels

While a preferred option is not recommended, the costs and benefits of any option that is selected will be similar

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40–50m per year (depending on option)	High
Regulators			
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40–50m per year	High
Non-monetised costs			

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Tax collected will increase.	Approximately $40–50m per year (depending on option)	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40–50m per year	High
Non-monetised benefits			

5.3 What other impacts is this approach likely to have?
As discussed above, allowing BEPS through interest deductions is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take use interest deductions to reduce their New Zealand (and possibly worldwide) tax liability is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders. It is something that is fundamental to the tax system itself, which all of the stakeholders already discussed have an interest in preserving.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?
Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Implementation of both reforms (relating to related-party interest rates and allowable debt level) will be given effect through a combination of legislation and Inland Revenue administrative guidance. The legislative changes proposed will be progressed (subject to Cabinet approval) as part of a BEPS taxation bill to be introduced in late 2017. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin*.

In relation to the allowable debt level proposal, we will consult further with stakeholders on whether a preferred option can be identified. The Minister of Finance and Minister of Revenue will make the final decision on which option should be progressed (option 1, option 2, or a potential new option) following this consultation.

These reforms are expected to apply from income years beginning on or after 1 July 2018, subject to legislation progressing to enactment before this date.

Some submitters on the discussion document argued that transitional relief or grandparenting should be provided to give taxpayers sufficient lead-in time to restructure their affairs if necessary. We consider that the planned application date of 1 July 2018 is sufficiently prospective because:

- the interest rate proposal applies only to related-party transactions (which are more easily altered compared to transactions with third-parties); and
- in relation to the allowable debt level proposal, debt and asset levels under the thin capitalisation rules can be measured as at the end of the relevant income year, meaning taxpayers would have until at least 30 June 2019 to rearrange their affairs.

In addition, in response to consultation, we propose that advanced pricing agreements

(APAs) existing prior to the application date of these changes will be grandparented.

Once the proposals are implemented, Inland Revenue will be responsible for the ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

6.2 What are the implementation risks?

There is the risk that the relevant transfer pricing legislation could contain unintended errors or have unintended consequences. However, this risk can be efficiently managed by way of remedial amendments.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. Inland Revenue closely monitors the tax affairs of New Zealand's largest companies (which are, in general, the affected population of these proposals). For example, Inland Revenue currently collects data from these firms on their debt levels (including levels of related-party debt) through its International Questionnaire. This will allow how the proposals have impacted debt levels and related-party interest payments to be analysed.

More generally, Inland Revenue is considering the appropriate level of information that should be collected to support the proposed rules for all the BEPS measures being implemented. Any additional information may be collected via a disclosure statement that must be provided to Inland Revenue or it may be collected using existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTTP involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, following enactment, any changes identified as necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.