April 2019

A special report from
Policy and Strategy, Inland Revenue

Base erosion and profit shifting – interest limitation rules

Introduction

This is the final version of the special report on the interest limitation rules for base erosion and profit shifting (BEPS).

The rules were enacted on 27 June 2018 in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

This special report was also published in the April 2019 edition of the Tax Information Bulletin (Volume 31 Number 3).

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RESTRICTED TRANSFER PRICING FOR CROSS-BORDER RELATED BORROWING

Sections GC 6, GC 15 to GC 19 and YA 1 (cross-border related borrowing, and related-party debt) of the Income Tax Act 2007

New rules have been introduced requiring related-party loans between a non-resident lender and a New Zealand-resident borrower to be priced using a restricted transfer pricing approach. Under these rules, specific rules and parameters are applied to certain inbound related-party loans to:

- determine the credit rating of New Zealand borrowers at a high risk of BEPS; and
- remove any features not typically found in third party debt in order to calculate (in combination with the credit rating rule) the appropriate amount of interest that is deductible on the debt.

Separate rules apply to financial institutions such as banks and insurance companies.

Application date

The amendments apply to income years starting on or after 1 July 2018. The amendments will not apply to an arrangement that complies with an advance pricing agreement issued by the Commissioner before 1 July 2018.

Key features

Amendments to section GC 6, including the introduction of subsections GC 6(3B) to (3E), provide for the rules to restrict interest deductions on cross-border related borrowing.

The rules, where they apply, alter the terms and conditions of a borrower and/or an instrument considered before applying the general transfer pricing rules, including the amendments to transfer pricing also amended by the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 and discussed elsewhere in this special report.

The rules are contained in sections GC 15 to GC 19:

- Section GC 15 sets out how the rules operate and also defines an “insuring or lending person” as the rules operate differently for these persons.
- Section GC 16 calculates how the credit rating of a borrower, other than an insuring or lending person, may be adjusted.
- Section GC 17 calculates how the credit rating of an insuring or lending person may be adjusted.
- Section GC 18 disregards certain features of a financial arrangement for the purpose of calculating an interest rate.
• Section GC 19 confirms that for arrangements existing before the new rules apply the loan must be repriced at the last day before the new rules apply that the loan was priced or repriced.

Background

New Zealand’s thin capitalisation rules limit the amount of deductible debt a company can have, rather than directly limiting interest deductions. For the rules to be effective at actually limiting interest deductions in New Zealand to an appropriate level, allowable interest rates on debt also need to be limited.

Historically this limitation has been achieved through transfer pricing. However, this approach has not been wholly effective.

The transfer pricing rules require taxpayers to adjust the payments for cross-border related party transactions, so they align with the arm’s length conditions that would be agreed to by a third party in a comparable transaction. The arm’s length interest rate on a debt is affected by several factors including its term, level of subordination, whether any security is offered, and the credit rating of the borrower.

New Zealand’s transfer pricing rules have been updated and strengthened by including adopting economic substance and reconstruction provisions similar to Australia’s rules through the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. The amended transfer pricing rules disregard legal form if it does not align with the actual economic substance of the transaction. They also allow transactions to be reconstructed or disregarded if such arrangements are commercially irrational and would not be entered into by third parties operating at arm’s length.

Even with these stronger transfer pricing rules, traditional transfer pricing is not effective to prevent profit-shifting using high-priced related party debt.

When borrowing from a third-party, commercial pressures will drive the borrower to try to obtain as low an interest rate as possible and on the best terms and conditions – for example, by providing security on a loan, and by ensuring their credit standing or rating is not adversely affected by the amount being borrowed and the borrowing rate.

These same pressures do not exist in a related-party context. A related-party interest payment, such as from the New Zealand subsidiary of a multinational to its 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. There are no commercial tensions driving interest rates to a market rate. Indeed, it can be profitable to increase the interest rate on related-party debt above a market rate – for example, if the value of the interest deduction is higher than the tax cost on the resulting interest income.

In addition, related-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. For example, the more a third-party lends to a company, the more money is at risk if the company fails. However, the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with debt or equity.
As the foreign parent and New Zealand subsidiary are commonly controlled, in many cases the terms and conditions of any loan can be set having regard to taxation, rather than the commercial considerations that would be most important in an actual arm’s length loan. Related-party loans can feature unnecessary and uncommercial terms (such as being repayable at the borrower’s discretion or having an extremely long term) that are used to justify a high interest rate. Simply making the related party debt subordinated or subject to repayment optionality may also be used as justifications for a higher interest rate. In other cases, a high level of related party debt may be loaded into a New Zealand subsidiary to depress the subsidiary’s creditworthiness, which also is used to justify a higher interest rate.

It can be difficult for Inland Revenue to challenge such arrangements under the transfer pricing rules as similar conditions are not generally found in arrangements entered into by third parties in comparable circumstances. With the new stronger transfer pricing rules, the taxpayer would have to provide evidence that the legal form was consistent with the economic substance and that a third party operating at arm’s length would agree to enter into the arrangement. These new requirements should limit the use of artificial or commercially irrational funding arrangements. However, in isolation, they would 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.

In addition, the highly fact-dependent and subjective nature of transfer pricing can make the rules complex and uncertain to apply. Assessing compliance with the arm’s length principle requires very detailed and specific information and analysis of how a comparable transaction between unrelated parties would have been documented. This makes complying with the transfer pricing rules a resource-intensive exercise which can have high compliance costs and risk of errors. Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue.

New Zealand is not alone in these concerns. The OECD’s final report on interest limitation rules notes that thin capitalisation rules are vulnerable to loans with excessive interest rates. This was one of the reasons behind the OECD favouring the earnings before interest, tax, depreciation and amortisation (EBITDA) approach to limit interest deductions.

**Detailed analysis**

The following flow chart sets out, at a high level, the steps a New Zealand borrower must go through, before determining a credit rating adjustment is required under the new rules. Further detail on each of these steps is provided below:
Flowchart 1: Process for determining NZ borrower’s credit rating

1. Does a non-resident have an interest of 50% or more or are there a group of non-residents acting in concert? 
   - Yes → Do you have related-party cross-border borrowing more than $10 million? 
     - Yes → Are you a high BEPS risk? 
       - Yes → Restricted transfer pricing rules apply* – Determine the credit rating implied by the interest rate on your related party debt. 
         - Yes → Is the credit rating the same as the credit rating implied by significant third party debt? 
           - Yes → No credit rating adjustment required. 
           - No → Credit rating adjustment required. 
       - No → Is the credit rating within (a) two notches of your group’s credit rating and BBB- or higher; or (b) one notch of your group’s credit rating and BB+ or lower? 
         - Yes → Credit rating adjustment required. 
         - No → Is the credit rating the same as if you had a debt to net assets ratio of 40% or less; and (b) BBB- or higher? 
           - Yes → No credit rating adjustment required. 
           - No → Credit rating adjustment required. 
2. No → Transfer pricing rules do not apply.

* >40% debt and >110% group debt or lender has a less than 15% tax rate
* Also disregard exotic terms – not covered by this flow chart
From restricted transfer pricing to interest rate

The guidance in this TIB as well as the legislative restrictions imposed by the restricted transfer pricing rule focus on credit rating, and instrument terms and conditions restrictions, rather than directly determining an appropriate interest rate or margin.

For any particular credit rating, it is necessary to use this information, along with other relevant factors, to determine an appropriate interest rate using the standard transfer pricing rules in section GC 6 to GC 14. This will frequently require access to specialist information such as that provided by Bloomberg or Reuters, on comparable instruments. This approach is unchanged between the previous transfer pricing rules and the additional requirements required under the restricted transfer pricing rule.

Section GC 13, within the standard transfer pricing rules, requires accurately delineating and identifying the transaction including the conditions that independent parties after real and independent bargaining might be expected to agree upon for the identified transaction. While it would typically be expected that a transaction that had been adjusted under the restricted transfer pricing rule in GC 15 to GC 19 would not include any non-arm’s length conditions there is no override of section GC 13 so a taxpayer should still consider how this section may apply.

Selection of suitable comparables and any adjustments that need to be made to them, such as converting into New Zealand Dollars, remains critical to arriving at an appropriate rate for a given transaction.

Cross-border related borrowing

Both the credit rating and disregarded features part of the restricted transfer pricing rule apply only where there is a cross-border related borrowing which is defined in section GC 6(3B). To be a cross-border related borrowing funds must have been provided to the borrower under which deductible expenditure arises and one or more of the following factors:

- the lender and borrower are associated;
- there is a person or group of persons that has an ownership right of at least 50% in the lender and the borrower;
- the funding is provided through an indirect associated funding arrangement (detailed further on); or
- the lender is part of a non-resident owning body or other group of non-residents acting in concert and that body or group has an ownership right of at least 50% in the borrower.

Provides funds

Section GC 6(3B)(a) requires that for an arrangement to be a cross-border related borrowing, a non-resident lender must provide funds to the borrower. This term has been used in the thin capitalisation rules since their inception and is also used in the non-resident financial arrangement income rules. It is explained on pages 54 and 55 of Tax Information Bulletin Volume 29, No 5, June 2017. It includes a finance lease, which in substance is a vendor-financed sale. It does not include an operating lease.

Expenditure arises for the borrower
Section GC 6(3B)(b) requires that for an arrangement to be a cross-border related borrowing, expenditure must arise for the borrower for which the borrower is allowed a deduction. There is no advantage in adjusting the interest on a related party loan if that interest is not deductible including under sections FH 3, FH 7 and FH 11 of the hybrid and branch mismatch rules (that is, one that is not subject to reversal under section FH 12). There is no timing restriction on this provision, so the rules continue to apply if the deduction is temporarily disallowed, for example because it is a hybrid deduction denied subject to reversal under section FH 12.

**Association**

The lender and borrower will be associated if they meet one or more of the existing association tests in subpart YB.

**An ownership right of at least 50% in the borrower**

This test is determined under sections FE 38 to FE 41. These sections provide how ownership interests in companies are determined and ensure that the restricted transfer pricing rule applies to the same groups that are covered by the thin capitalisation rules. The calculations are similar to the control interest calculations in the controlled foreign company rules.

In most cases, where rights are held in equal proportion across all (classes of) shares, having an ownership right of at least 50% will occur where two companies are associated anyway. However, this test will also include some lenders and borrower who are not associated if rights are not held in the same proportion across all (classes of) shareholders.

The test references the direct control interests in section EX 5(1) as if the borrower was a foreign company and looks at the highest interest across the following categories:

- shares in the borrower
- shareholder decision-making rights in the borrower; which are decision making concerning:
  - dividends or other distributions
  - constitution of the company
  - variation in capital
  - appointment of a director
- a right to receive income of the borrower
- a right to receive any of the value of the net assets of the borrower

As this test is based on the highest interest, it is possible for more than one person or group to have an over 50% interest. As this is not an income attribution provision, and only requires potential restrictions on the pricing of interest when a group has control or influence over the pricing of interest paid to them, this does not raise concerns.
Indirect associated funding

An indirect associated funding arrangement is defined in section GC 6(3C). It is based on the similar indirect associated funding arrangement definition in section RF 12I for the purpose of the NRWT rules. The purpose of this test is to prevent a lender from circumventing the restricted transfer pricing rule by channelling funding through an unassociated person to a New Zealand borrower where direct funding would be covered by one of the other limbs of the cross-border related borrowing definition.

Example 2

Foreign Co has a wholly owned subsidiary, NZ Co. Foreign Co has deposited NZ$20 million with Foreign Third Party Bank. Foreign Co and Foreign Third Party Bank have agreed that Foreign Third Party Bank will pay 9.7% interest to Foreign Co on the deposit and will also lend NZ$20 million to NZ Co at a rate of 10%. If Foreign Third Party Bank had lent NZ$20 million directly to NZ Co without this arrangement the interest rate would have been 7%.

If Foreign Third Party Bank had simply lent money to NZ Co, the restricted transfer pricing rule would not apply as Foreign Third Party Bank does not have any interest in NZ Co. However, as the loan is indirect associated funding, it is covered by the restricted transfer pricing rule.

Whether a cash pooling arrangement is classified as indirect associated funding was covered on page 68 of *Tax Information Bulletin* Volume 29, No 5, June 2017 when this term was
introduced for the non-resident financial arrangement income rules. In short, indirect associated funding:

- includes an arrangement entered into with the purpose or effect of avoiding the restricted transfer pricing rule; and
- does not include commercial cash pooling arrangements such as those set up with a fluctuating debit and credit balance to cover working capital requirements.

**Acting in concert**

This test covers borrowers that have at least 50% of their rights held by a group of non-residents that act in concert to control the borrower. This overlays the 50% ownership right test described above with the existing non-resident owning body and acting in concert tests that already apply for thin capitalisation and NRWT.

In section GC 16(3), such a group is referred to as a co-ordinated group and a borrower from a co-ordinated group is referred to in this report as not having an identifiable parent. Each of these terms can be used interchangeably. There are two exceptions to this general treatment:

- If the borrower is owned by a single non-resident with no other business activity, and that non-resident is itself controlled by a co-ordinated group, the New Zealand borrower will be treated as controlled by a co-ordinated group. This is because the New Zealand borrower will be in the same situation as if the direct non-resident did not exist and the New Zealand borrower was owned directly by each of the members of the co-ordinated group.
- If the borrower is controlled by a co-ordinated group but one of the members of that co-ordinated group meets the 50% ownership interest test by themselves the New Zealand borrower is treated as not controlled by a co-ordinated group. This is because the restricted transfer pricing rules apply without the need to consider the existence or otherwise of a co-ordinated group.

**Exclusion of certain preference shares**

Section GC 6(3E) excludes ownership interests arising from certain preference shares from the cross-border related borrowing test. To meet this exclusion the preference shares must be:

- held by a person not associated with the issuer; and
- issued with the intention of satisfying or replacing debt previously provided by the preference shareholder to the issuer in the ordinary course of business.

The purpose of this exclusion is to cater for certain situations where a non-resident, in the business of lending to third parties, lends money to a New Zealand borrower who gets into financial difficulty. In such cases, rather than a portion of the debt being cancelled, the borrower may issue the lender preference shares. In this circumstance the lender, has an ownership right in the borrower, subject to the terms and conditions of the preference share. However, it clearly would not be appropriate to require the interest rate on the remaining debt to be determined having regard to the group credit rating of the preference shareholder.

This exclusion will not apply if the preference shares are issued to a person who is already associated with the borrower, or if the preference shares are sold or transferred to a third party.
These restrictions are designed to prevent investors using this exclusion to take or extend an equity-like interest without this being included in determining ownership for purposes of the restricted transfer pricing rules.

**Credit rating adjustments**

A borrower that is subject to the new rules will follow the process set out in Flowchart 2, to arrive at one of the following issuer credit ratings:

- Default credit rating – the borrower’s own rating.
- Restricted credit rating – the higher of (i) the borrower’s own rating if their debt/assets percentage is no higher than 40% debt and (ii) BBB-.
- Group credit rating – the higher of the group borrower’s credit rating minus one or two notches and the borrower’s own rating (the group borrower is the group company with the highest amount of unsecured long term borrowing).
- Optional credit rating – the credit rating implied from significant third-party debt.

None of the credit rating methods is intended to require a borrower or another entity in the worldwide group to obtain a credit rating if it does not already have one. Instead a credit rating, subject to any restrictions imposed by the methods, can continue to be implied based on an analysis of current and historical information to form a business risk profile that considers competitive position, managerial conduct and intent, industry and country risk and a financial risk profile based on cash flow and leverage. This forms the basis of the borrower’s stand-alone position which may be influenced by other factors including group or governmental support to form the issuer credit rating.

**Default credit rating**

The default credit rating in section GC 16(2) and (8) is the borrower’s rating including any implicit parental support. This is the rate that applies under the rules outside of the restricted transfer pricing rule. It will continue to apply where the borrower is a low BEPS risk. This is also the rating that applies when a borrower has less than $10 million of cross-border related borrowings.

The Commissioner has previously issued administrative guidance for transfer pricing of loans with a total principal up to $10 million in order to minimise compliance costs. The availability of the administrative approach is not intended to be affected by the new restricted transfer pricing rule and a loan priced under this approach is intended to be compatible with the default credit rating. To make this clear, loans where the borrower has less than $10 million of cross-border related borrowings have been carved out of the restricted credit ratings and group credit rating methods discussed below.

Further detail on the administrative approach is available at:


**Restricted credit rating**

The restricted credit rating in section GC 16(3) and (9) will apply where the borrower does not have an identifiable parent, and either is a high BEPS risk or chooses to use it to reduce compliance costs. It is based on the borrower’s standalone rating but adjusted to reduce its debt
level to 40% if it is above this and is subject to a to a minimum rating of BBB-, or equivalent
given by a rating agency approved by the Reserve Bank.

The Reserve Bank approves rating agencies for their non-bank deposit taker rules which are
published at: https://www.rbnz.govt.nz/regulation-and-supervision/non-bank-deposit-takers/requirements/credit-ratings

There are four rating agencies currently approved by the Reserve Bank. BBB- is the lowest
investment grade credit rating assigned to a party by Standard & Poor’s, Fitch and Equifax
Australasia and is equivalent to a Baa3 Moody’s rating.

If a New Zealand borrower is controlled by a non-resident and that non-resident has no other
business activity and itself has no identifiable parent, the New Zealand borrower will be treated
for the purpose of determining its credit rating as having no identifiable parent rather than the
direct non-resident being its parent. The consequence of this is the New Zealand borrower will
need to consider whether the restricted credit rating applies rather than the group credit rating.

**Group credit rating**

The group credit rating in section GC 16(4) and (10) will apply where the borrower has an
identifiable parent and either represents a high BEPS risk (discussed below) or chooses to use
it to reduce compliance costs. A New Zealand borrower’s rating, in comparison with the group
borrower’s rating, is reduced by two notches if the parent’s rating is BBB+ or above and one
notch if it is below this. A notch is referred to in the legislation as the smallest division within
the credit rating categories (for example from AA to AA- or AA- to A+). This distinction is
made as a two-notch difference is only available where the New Zealand borrower would not
end up below BBB-. BBB- is the lowest credit rating that is still investment grade. A one notch
movement at a rating below investment grade would be expected to have a larger impact on the
interest rate than a one notch movement at a rating above investment grade.

As with the equivalent terminology in the restricted credit rating, the reference to BBB+ uses
the rating scale used by Standard & Poor’s and other agencies. An equivalent rating by a
different rating agency (such as a Baa1 Moody’s rating) would also be acceptable.

The following table sets out the lowest available credit rating for a high BEPS risk borrower
with an identifiable parent for certain credit ratings:

<table>
<thead>
<tr>
<th>Group borrower credit rating</th>
<th>Maximum spread</th>
<th>New Zealand borrower credit rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>2 notches</td>
<td>BBB+</td>
</tr>
<tr>
<td>A-</td>
<td>2 notches</td>
<td>BBB</td>
</tr>
<tr>
<td>BBB+</td>
<td>2 notches</td>
<td>BBB-</td>
</tr>
<tr>
<td>BBB</td>
<td>1 notch</td>
<td>BBB-</td>
</tr>
<tr>
<td>BBB-</td>
<td>1 notch</td>
<td>BB+</td>
</tr>
<tr>
<td>BB+</td>
<td>1 notch</td>
<td>BB</td>
</tr>
</tbody>
</table>
Optional credit rating

The optional credit rating in section GC 16(5) and (11) allows a New Zealand borrower to apply a credit rating to an amount of their related party borrowing that is the same as that implied from significant third party borrowing by a member of their New Zealand group. For a borrower that could use the default credit rating the optional credit rating would be consistent with this; however, this option is available for all borrowers, including insuring or lending persons, with cross-border related borrowing and third party debt.

The optional credit rating allows the credit rating of a cross-border related borrowing to be set under the same credit rating that can be implied from third party long-term senior debt. This is based on the same principle as the third-party exceptions used for disregarded features and described below. As with the disregarded features exception the optional credit rating can be used for cross-border related borrowing with a principal of up to four times the third-party debt – this restriction is to prevent a borrower using a small amount of expensive third party debt to justify a full deduction for the interest on a large amount of expensive related party debt.

Usually a well secured loan will have an interest rate that implies a higher credit rating than that of the lower ranking debt of the entity, such as subordinated or even unsecured debt. Where a borrower has both secured and unsecured third party borrowing it would be appropriate for the optional credit rating to be based on the lower credit rating implied by the unsecured debt up to the four times limit.

If this limit was reached and the borrower had no unsecured debt or chose not to base the optional credit rating on its unsecured debt, it could also calculate the optional credit rating based on the rating implied from secured debt.

Choosing to use the restricted, group or optional credit rating

As referred to above, a borrower can choose to apply the restricted credit rating, group credit rating or optional credit rating in certain circumstances (see section GC 16(2)(a)). Where this is available, no election notice is required. The method is chosen by calculating a deduction under the method and including this in the income tax return that first includes this arrangement. Once a borrower chooses a method for a particular arrangement in their first income tax return they cannot change to a different method in a subsequent return.

What is a high BEPS risk?

A borrower will generally be unable to use its standalone credit rating (default credit rating) and required to use the group or restricted credit rating options when it is a high BEPS risk, and the optional credit rating does not apply. This will occur when at least one of two factors are present:

High New Zealand group debt percentage

A borrower with an identifiable parent has a high New Zealand group debt percentage if its debt percentage is greater than 40%, unless its ratio is within 110% of its worldwide group (section GC 16(4)(b)). Where there is no identifiable parent, the 110% safe harbour cannot apply, and the equivalent relevant test is in section GC 16(3)(c).

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1 “Significant” is not a term used in the legislation, but is discussed in the next paragraph.
In calculating the debt percentage for the purpose of this test, the borrower should use the same methodology and arrive at the same result as for their overall thin capitalisation calculation. This would include, for example, adjusting for non-debt liabilities and (if applicable) utilising the on-lending concession in section FE 13.

**Borrowing from a low tax rate jurisdiction different from the ultimate parent**

Borrowing from a low tax jurisdiction is borrowing from a lender resident in a country where the interest is subject to a lower than 15% tax rate. This factor is in section GC 16(3)(c)(i) and (ii), and GC 16(4)(b)(i) and (ii) for borrowers without and with an identifiable parent respectively. This factor does not apply if the ultimate owner of that lender is also resident in that jurisdiction. This factor is intended to apply to lending routed through a low tax country, which may be structured to achieve a tax advantage. It should not apply simply because a lender group is based in a low tax country. This factor does not apply to entities that are subject to lower, or no, tax due to a policy decision such as exempt sovereign wealth funds. This is achieved, by looking at both the lender’s own tax rate and the tax rate that would apply to a company with the usual tax status of a company. This test considers the jurisdiction of each lender when a loan is provided by more than one person. If any of the lenders of a specific loan fail this test the borrower will be a high BEPS risk for that entire loan rather than just the portion provided by the lender in the low tax jurisdiction.

**Calculation dates**

The high BEPS risk tests are calculated on the latest calculation date provided by section GC 16(6).

For a loan that is entered into, renewed or renegotiated after the new rules apply, the calculation date will be the day the loan is entered into (under paragraph (6)(b)) or the day it is renewed or renegotiated (under paragraph (6)(c)). The calculation dates for other loans is covered separately below.

The calculation date may not be on a thin capitalisation measurement date\(^2\). To reduce compliance costs of a borrower determining whether it exceeds the 40% threshold on that date, section GC 16(7) allows the borrower to estimate their debt percentage by making appropriate adjustments to the thin capitalisation calculations done on the most recent measurement date rather than having to re-do the entire calculation. While “appropriate adjustments” is not defined this is intended to include the effect of the new loan as well as any actions related to that wider arrangement such as using the loan to repay an existing loan or purchase a new asset.

**De minimis**

A de minimis has been included in section GC 16(3)(b) and GC 16(4)(a) to minimise compliance costs of borrowers with smaller amounts of related party cross-border loans. A borrower with less than $10 million of cross-border related borrowing will not have to consider the credit rating adjustment part of the rules and will apply the default credit rating as they do now. The optional credit rating will continue to be available for a borrower with less than $10 million of cross-border related borrowing who chooses to use it.

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\(^2\) Taxpayers are only required to calculate whether they comply with thin capitalisation on their measurement dates which, under section FE 8, can be daily, 3-monthly or annually. Most taxpayers choose to have an annual measurement date.
The de minimis continues to apply to a loan in future years even if the de minimis is not satisfied in those future years, unless the loan is renewed, extended or renegotiated. The borrower will have to consider whether the de minimis applies each time they enter into a new cross-border related borrowing.

An equivalent de minimis also applies in sections GC 17(b) and GC 18(1)(a) which are discussed elsewhere in this report.

Implicit parental support

A borrower must include any implicit support arising because it is a member of the foreign parent’s worldwide group when determining its default credit rating in section GC 16(8) or group credit rating in section GC 16(10)(b). This is consistent with the OECD transfer pricing guidelines, in particular paragraphs 1.157 and 1.164 to 1.167 of those guidelines, reproduced below:

1.157 Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors...

Example 1

1.164 P is the parent company of an MNE group engaging in a financial services business. The strength of the group’s consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S’s balance sheet would support a credit rating of only Baa. Nevertheless, because of S’s membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, i.e. a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

1.165 Assume that S borrows EUR 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows EUR 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender (i.e. an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S’s other borrowings including the simultaneous loan to S from T.

1.166 Under these circumstances the interest rate charged on the loan by T to S is an arm’s length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from S’s group membership alone and not from any deliberate concerted action of members of the MNE group.

Example 2

1.167 The facts relating to S’s credit standing and borrowing power are identical to those in the preceding example. S borrows EUR 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate

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that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm’s length guarantee fee, the fee should reflect the benefit of raising S’s credit standing from A to AAA, not the benefit of raising S’s credit standing from Baa to AAA. The enhancement of S’s credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S’s credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

We note that some of the OECD guidelines, including those quoted above, use the Moody’s rating scale. The rest of this document uses the Standard & Poor’s rating scale which is more common in New Zealand. A rating of Baa3 in the Moody’s scale is equivalent to BBB- in Standard & Poor’s.

Group Borrower’s credit rating

For simplicity, the term ‘group borrower’s credit rating’ is used in a number of places in this TIB; however, this term is not used in the legislation. Instead section GC 16(10)(a) refers to “the credit rating for debt that is long-term senior unsecured debt and not related-party debt or between associated non-residents, of the member of the borrower’s worldwide group under subpart FE, that has the most such debt”.

It is not appropriate to always base the parent’s credit rating on the credit rating of the ultimate parent of a group as in some instances this company will not be the highest rated member of the group. For example, where the ultimate parent is a non-operating holding company. This entity would not be the one providing implicit support to the New Zealand borrower and it would instead be more appropriate to base the implicit support on the credit rating of a higher rated member of the group.

The group borrower’s credit rating is used because it should be easier for the New Zealand borrower to identify this entity without having to obtain the credit rating of all group members including those that may not have a published credit rating.

In most instances the group borrower will be either the main operating entity of the worldwide group or a separate treasury entity that funds the group. Multinationals have a commercial incentive to ensure that the credit rating of the largest group borrower from third parties is as high, and therefore the interest rate is as low, as possible. Accordingly, the credit rating of the member with most long-term senior unsecured third-party debt is expected to reasonably reflect the credit of the worldwide group.

The members of the worldwide group are identified using the existing rules in section FE 17 which is based on entities that are consolidated under generally accepted accounting practice. Where an entity is part of the group but not wholly-owned or does not have exactly the same shareholding as other members of the group this will not exclude that entity from being considered the group borrower for the purpose of these rules. The amount of long-term senior unsubordinated debt is not apportioned to reflect different shareholdings. For example, if a group only has two entities with long-term senior unsecured debt – a 100% owned entity with $400m of debt and a 60% owned entity with $500m of debt – the 60% owned entity would be treated as having debt of $500m rather than $300m and therefore would be the group borrower for the purpose of determining the group credit rating.
Long term senior unsecured debt

The legislation does not define ‘long term’, as this is a commonly used and understood term. Typically long term refers to debt with a term when issued of at least one year. In many circumstances a borrower determining which entity in their group has the highest level of long term senior unsecured debt will be able to consider non-current liabilities on each member’s balance sheet. However, this distinction may not be sufficient to differentiate between long-term senior unsecured debt and other instruments such as subordinated or secured debt or where debt that has been issued with a term of more than one year is nearing maturity.

The purpose of this part of the rules is to provide a cost-effective measure for determining what an appropriate credit rating for the group is. It will typically not be necessary to identify and classify all debt within an entity or group as it is only necessary to determine which is the entity with the most senior unsecured debt rather than the absolute amount of such debt.

The reason for choosing unsecured debt only is that it more accurately reflects the credit risk of the entity or group rather than the specific security provided. The exclusion of secured debt may also exclude special purpose vehicles (SPVs) set up for a specific project, such as an infrastructure investment.

Where a group has no long-term senior unsecured third-party debt

In a limited number of situations, a group may have no long-term senior unsecured third-party debt, in which case the standard test will not be able to identify which entity to base the group borrower’s credit rating on. Sections GC 16(10)(ab) and GC 17(ab) allow the group to determine the credit rating based on the member of the worldwide group with the highest credit rating. To reduce compliance costs, the group does not have to determine or consider the credit rating of any group member that could be reasonably considered to be unlikely to have the highest credit rating. Officials expect the member with the highest rating would typically be the one that may be expected to support the New Zealand borrower if needed, such as a main trading entity or entity with the largest balance sheet. A group would typically not be expected to consider the credit rating of entities within the group operating in countries outside the chain of ownership to the ultimate parent unless these entities were sufficiently large relative to other members of the group that they could reasonably be expected to have a higher credit rating.

Application to existing arrangements

The restricted transfer pricing rule applies to cross-border related borrowing for income years beginning on and after 1 July 2018. This includes existing arrangements entered into before this date in which case, under section GC 19, the interest rate will be calculated at the date the loan was entered into (or renewed, extended or renegotiated if this resulted in the interest rate being reset) with application to income years starting on or after 1 July 2018.

The high BEPS risk tests for an existing arrangement can be calculated at either of the following dates:

- The last day before the new rules apply – GC 16(6)(a).
- When the loan was last repriced before the new rules apply – GC 16(6)(d).

No separate election is required for this choice; however, the borrower should document this choice in the records used to support their tax return calculations. In this way a borrower who is a low BEPS risk at either of these two dates will not have to calculate the credit rating.
adjustment for existing arrangements. They may still have to calculate the impact of the disregarded features (discussed below).

A borrower calculating their debt percentage on the date the existing arrangement was last repriced before the new rules apply will be required to apply the calculation as it applied before the amendments in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. This means the debt percentage calculation will not be required to adjust for non-debt liabilities as discussed elsewhere in this TIB.

When the new rules mean that a portion of the interest payments under an existing loan is non-deductible, the parties may want to reduce the amount of the payments so there is no non-deductible portion. Inland Revenue accepts that such a reduction will not, on its own, require any amendment to the amount of the interest payments which is deductible under the new rules.

The restricted transfer pricing rule will not apply to arrangements that comply with an advance pricing agreement issued by the Commissioner before 1 July 2018.
Flowchart 2: Determining the credit rating to use for restricted transfer pricing

- **Borrower is an insuring or lending person**
  - **GC 15(2)**

- **Total cross-border related borrowing > $10bn**
  - **Yes**
  - **Credit rating of member with most debt**
    - **GC 17(a)**
  - **No**

- **Total cross-border related borrowing > $10bn & (4)(a)**
  - **Yes**
  - **Do you want to calculate credit rating based on third party debt?**
    - **Yes**
    - **Optional credit rating**
      - **GC 17(c)**
    - **No**

- **Do you want to calculate credit rating based on third party debt?**
  - **Yes**
  - **Borrower has an identifiable parent**
    - **GC 16(3) & (4)**
  - **No**

- **Borrower’s thin cap ratio <40% in NZ**
  - **Yes**
  - **Safe harbour: Elect to use group credit rating**
    - **GC 16(2)(a)**
  - **No**

- **Lender subject to >15% tax***
  - **Yes**
  - **Safe harbour: Elect to use restricted credit rating**
    - **GC 16(2)(a)**
  - **No**

- **Borrower’s thin cap ratio <40% in NZ**
  - **Yes**
  - **Safe harbour: Elect to use group credit rating**
    - **GC 16(2)(a)**
  - **No**

- **Group credit rating**
  - **GC 16(10)**

- **Default credit rating**
  - **GC 16(8)**

- **Restricted credit rating**
  - **GC 16(9)**

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**Key**

* unless the lender is in the same jurisdiction as the owner(s) or ultimate parent

^ taking any implicit support into account
**Mutual Agreement Procedure**

Double Tax Agreements often contain a mutual agreement procedure (MAP) provision, which can be invoked when a taxpayer considers the actions of one of the contracting states will result in taxation not in accordance with the agreement.

A lender may wish to invoke MAP if it considers that the deductible amount in New Zealand under the restricted transfer pricing rules is less than the lender’s jurisdiction will require to be returned as income, applying an arm’s length standard. This will require the presentation of a case to the lender jurisdiction’s Competent Authority or, depending on the provision, the New Zealand Competent Authority. Borrowers are not entitled to determine their deductible interest on the basis that the restricted transfer pricing rules are overridden by a double tax agreement unless they have first been through the MAP process. This guidance does not consider the substantive issues raised by such an application.

Further guidance is available on MAP on Inland Revenue’s website at:  

**Effect of paying non-deductible amounts**

If a borrower pays an amount of interest in excess of the amount which is deductible under the restricted transfer pricing rule, that payment will give rise to a dividend under subpart CD. This will not affect the borrower’s obligation to apply the withholding tax rules applicable to interest payments to the excess amount, unless the lender applies to the Commissioner under section GC 11. See example 1 on page 4 of TIB Vol 11 No 7 (March 1996).

**Guarantee fees**

The restricted transfer pricing rule does not explicitly refer to guarantee fees. The OECD is currently developing guidance on how guarantee fees should be priced. IR officials will continue to monitor this situation including whether future legislative change may be required.

No fee is appropriate for a guarantee of debt between parties who are commonly owned.

Payment of a guarantee fee to a non-resident related party may be appropriate if it guarantees third party debt. However, this would have to be considered on a case-by-case basis and would not be expected to materially exceed the cost of a non-resident group member borrowing from a third party and on-lending to the New Zealand borrower with the New Zealand borrower’s interest deduction calculated under the restricted transfer pricing rule.
Example 3

NZ Sub is 100% owned by Foreign Parent and is a high BEPS risk as it has a debt percentage of 50%. Foreign Parent has an AA credit rating. Under a traditional transfer pricing analysis, NZ Sub would be rated BB+; however, the restricted transfer pricing rule requires related party debt borrowed by NZ Sub to have a credit rating of A+.

If Foreign Parent borrowed $100 million from third party bank and on lent this to NZ Sub the cost to the group would be based on Foreign Parent’s AA credit rating and the cost to NZ Sub would be based on its A+ credit rating with Foreign Parent profiting on the margin difference between AA and A+.

If, instead, NZ Sub borrowed directly from third party bank with a guarantee from Foreign Parent the cost to NZ Sub would be based on Foreign Parent’s AA credit rating. If NZ Sub paid a guarantee fee to Foreign Parent equal to the margin difference between AA and A+ the transaction would be equivalent to the related party lending example above, if the fee was greater than this NZ Sub would make a smaller profit and Foreign Parent would make a greater profit on what is economically an equivalent transaction. The guarantee fee in this case would have a high risk of being challenged.

Ignoring surrounding circumstances, terms, and conditions

Another way related party interest rates can be inflated is by using borrower friendly loan terms. To mitigate this risk the following features will be disregarded or adjusted for when considering the pricing of a particular instrument, subject to certain exemptions:

The term of the loan being greater than 5 years

Almost all NZ$ bank debt owed by New Zealand borrowers, and the majority of third-party bond issues, are for a term of 5 years or less. Due to a (generally) positive sloping yield curve and the lack of comparables with terms of over 5 years, debt with very long duration can be priced higher than equivalent shorter terms. If the term of cross-border related borrowing is more than 5 years section GC 18(4) and (8)(b) will price it as if its term is 5 years unless an exception applies. This pricing should apply for the term of the loan. Further detail is provided on this provision below.

Subordination

Subordination is where an instrument ranks behind other instruments in the event of default. This reduces the chance of the creditor receiving all their money back in the event the borrower runs into financial difficulty and can be used to justify a higher interest rate. Often in a related party context any subordination will not affect the amount the parent (or other lender within the group) would receive in the event the subsidiary failed. Arrangements with subordination will have that subordination disregarded by section GC 18(3)(g) for the purpose of calculating the interest rate.

Exotic features

Exotic features are those generally not seen with third-party lending. Section GC 18(3) provides a list of features that will be disregarded in determining the transfer price for cross border related borrowing, which include:

- payment other than in money (for example, repaying a loan by issuing shares)
- interest payment deferral beyond 12 months;
• options which give rise to premiums on interest rates (for example, on early repayment by the borrower);
• promissory notes or other instruments which do not provide rights to foreclose/accelerate repayment in the event of borrower default;
• contingencies (for example, where interest is repaid only under certain conditions).

**Deferral beyond 12 months**

Any increased interest rate that arises where payment of interest is made less than annually to the extent that increase is due to the increased risk of default due to interest being deferred beyond 12 months is disregarded. This provision will not apply where the increase in interest reflects the loss of the ability to reinvest the deferred interest so that the effective rate of return is the same as if the interest was not deferred.

**Example 4**

The arm’s length rate if a borrower borrows $100 with annual interest is 5%. If instead, the borrower issues a zero-coupon bond for $100 with a $127.63 redemption payment in 5 years’ time section GC 18(3)(b) will not apply as this bond has the same 5% interest rate. Any higher interest rate, for example to compensate for the higher credit risk from longer exposure to the borrower, will be disregarded.

**Third party features**

While generally the above features will be disregarded under the new rules for cross-border related borrowing, they will be taken into account under section GC 18(9) if the borrower (or its worldwide group, if it is part of one) has a significant amount of third-party debt with that feature.

The extent to which disregarded features can be taken into account depends on the structure of either the borrower’s (or its worldwide group’s) third-party debt. That is:

• the borrower’s related-party debt can have a disregarded feature in proportion to its third-party debt. For example, if the borrower has $100m of senior third-party debt and $50m of subordinated third-party debt, related-party debt that is 2:1 senior:subordinated would be allowable; or
• the character of debt owed by the borrower matches the character of the borrower’s group’s third-party debt provided that type of debt is commercially appropriate in the New Zealand context. For example, say on a worldwide consolidated basis the borrower’s group has $200m of ordinary debt and $50m of convertible notes. If the borrower has $40m of ordinary related-party debt, this means that up to $10m of convertible related-party debt would be allowable (as this means the borrower’s debt character – a 4:1 mix of ordinary and convertible debt – would match that of its group).

In order for the borrower to use its own third-party debt to justify an otherwise disregarded feature, that third-party debt must be significant. That is the related-party debt with a feature cannot be more than 4 times the third-party debt with that feature. This is to prevent taxpayers agreeing to small amounts of expensive third-party debt in order to justify expensive related-party debt.
Terms greater than 5 years

Section GC 18(4) to (8) determines whether a term greater than 5 years is disregarded for the purposes of calculating the interest rate.

Section GC 18(4) includes that the 5-year term restriction does not apply to instruments that qualify as regulatory capital under section GC 18(10). This is explained further in the insuring or lending persons section below.

For New Zealand borrowers that are not an “insuring or lending person” whether a term of over 5 years can be included in calculating an interest rate is determined under a similar process to the general third-party features test above. The rules are necessarily more complicated for the over 5 years terms exclusion as not all loan terms can be treated equally; for example, a 6-year term third party loan could not be used to justify a 30-year term related party loan.

The third-party exception can either be (at the option of the taxpayer) based on third party debt of the worldwide group or third-party debt of the New Zealand group. Due to minor differences in terminology this decision affects which subparagraphs of sections GC 16(4) to (8) apply. This choice is also consistent with the choice available for other disregarded features in section GC 18(9)(a).

The threshold term is calculated at the date the loan was entered into renewed or extended rather than the remaining term.
The following table sets out the steps a taxpayer must go through to if they seek to apply the third-party exception to a loan with a term over 5 years:

<table>
<thead>
<tr>
<th>Step</th>
<th>Reference if using worldwide group third party debt</th>
<th>Reference if using New Zealand third party debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Choose whether the calculation is based on worldwide or NZ third party debt</td>
<td>GC 18(5)(a)(i)</td>
</tr>
<tr>
<td>2.</td>
<td>Calculate the threshold term – weighted average term of third-party debt with a term over 5 years</td>
<td>GC 18(6) using GC 18(7)(a), (b) and (c)(i)</td>
</tr>
<tr>
<td>3.</td>
<td>Calculate the threshold fraction – proportion of third-party debt with a term over 5 years</td>
<td>GC 18(5)(b)(i)</td>
</tr>
<tr>
<td>4.</td>
<td>No adjustment is required if:</td>
<td>GC 18(5)(a)(i) and (b)(i)</td>
</tr>
<tr>
<td></td>
<td>• the related party term is less than (or equal to) the threshold term; and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• the proportion of related party debt with a term over 5 years is less than (or equal to) the threshold fraction</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Term is adjusted to the threshold term if:</td>
<td>GC 18(8)(a)(i), (a)(ii) and (b)(ii)</td>
</tr>
<tr>
<td></td>
<td>• the related party term is greater than the threshold term;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• the proportion of related party debt with a term over 5 years is less than (or equal to) the threshold fraction; and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• related party debt with a term over 5 years is less than 4 times third party debt with a term over 5 years.</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Term is adjusted to 5 years if:</td>
<td>GC 18(8)(b)(i) or (b)(ii)</td>
</tr>
<tr>
<td></td>
<td>• the proportion of related party debt with a term over 5 years is greater than the threshold fraction; or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• related party debt with a term over 5 years is (equal to or) more than 4 times third party debt with a term over 5 years</td>
<td></td>
</tr>
</tbody>
</table>
Foreign Parent Ltd has debt from third parties of the following amounts and terms:

<table>
<thead>
<tr>
<th>Loan</th>
<th>Principal</th>
<th>Original term at issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>$70 million</td>
<td>Less than 5 years</td>
</tr>
<tr>
<td>#2</td>
<td>$10 million</td>
<td>7 years</td>
</tr>
<tr>
<td>#3</td>
<td>$10 million</td>
<td>9 years</td>
</tr>
<tr>
<td>#4</td>
<td>$10 million</td>
<td>11 years</td>
</tr>
<tr>
<td>Total</td>
<td>$100 million</td>
<td></td>
</tr>
</tbody>
</table>

The threshold term under section GC 18(5)(a)(i) is 9 years, which is calculated under section GC 18(6) as:

<table>
<thead>
<tr>
<th>Loan</th>
<th>Term</th>
<th>Term Debt</th>
<th>Long-term Debt</th>
<th>Threshold Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>#2</td>
<td>7 years</td>
<td>$10 million</td>
<td>$30 million</td>
<td>2.3 years</td>
</tr>
<tr>
<td>#3</td>
<td>9 years</td>
<td>$10 million</td>
<td>$30 million</td>
<td>3.0 years</td>
</tr>
<tr>
<td>#4</td>
<td>11 years</td>
<td>$10 million</td>
<td>$30 million</td>
<td>3.7 years</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>9 years</td>
</tr>
</tbody>
</table>

The threshold fraction under section GC 18(5)(b)(i) is $30 million/$100 million or 3/10.

NZ Subsidiary Ltd has existing loans of $700,000 from Foreign Parent with a term of less than 5 years. It enters into three further loans with Foreign Parent with terms over 5 years on successive days and needs to consider what term will be included for setting the interest rate.

**Loan 1**

A $50,000 loan with a term of 7 years.
- Section GC 18(8)(a) does not apply as the term of the loan (7 years) does not exceed the threshold term (9 years).
- Section GC 18(8)(b)(i) does not apply as related party loans having a term of more than 5 years ($50,000) as a proportion of total related party loans ($700,000 + $50,000 = 750,000) is 6.7% which is less than the threshold fraction of 30%.
- Section GC 18(8)(b)(ii) does not apply as related party loans having a term of more than 5 years ($50,000) is less than 4 times the value of worldwide loans with this feature (4 x $30,000,000).
- Section GC 18(8)(b)(iii) does not apply as the threshold fraction was not determined under subsection (5)(b)(ii).

Therefore the 7-year term is not adjusted and is included in calculating the interest rate.

**Loan 2**

A $100,000 loan with a term of 11 years.
- Section GC 18(8)(a)(i) applies as the term of the loan (11 years) exceeds the threshold term (9 years).
- Section GC 18(8)(a)(ii) applies as related party loans having a term of more than 5 years ($50,000 + $100,000 = $150,000) as a proportion of total related party loans ($750,000 + $100,000 = $850,000) is 17.6% which is less than the threshold fraction of 30%.

Therefore the 11-year term is adjusted to the threshold term of 9 year for the purpose of calculating the interest rate.

**Loan 3**

A $200,000 loan with a term of 9 years.

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4 For simplicity for the purpose of this example disregard the $10 million de minimis in GC 18(2)(a).
Section GC 18(8)(a) does not apply as the term of the loan (9 years) does not exceed the threshold term (9 years).

Section GC 18(8)(b)(i) applies as related party loans having a term of more than 5 years ($150,000 + $200,000 = $350,000) as a proportion of total related party loans ($850,000 + $200,000 = $1,050,000) is 33.3% which exceeds the threshold fraction of 30%.

Therefore the 9-year term is adjusted to 5 years for the purpose of calculating the interest rate.

Example 6

Foreign Co has three senior unsecured loans from third parties. These are each for US$100 million and had terms at issue of 5 years, 10 years and 15 years respectively, so the average maturity of their long-term senior unsecured debt is 10 years.

NZ Co, a wholly owned subsidiary of Foreign Co, has a loan from Foreign Co for NZ$20 million with a term of 10 years.

The threshold term is 12.5 years (as the 5-year loan is not included in the calculation). The threshold fraction is US$200 million/US$300 million or 2/3. NZ Co’s related party debt with a term of more than five years as a fraction of total related party debt is NZ$20 million/NZ$20 million or 1/1. This exceeds the threshold fraction. So, for the purposes of calculating the deductible interest on the related party loan, the term of the loan from Foreign Co would be adjusted to 5 years.

Suppose Foreign Co chooses to restructure its loan to NZ Co by lending NZ$10 million for 5 years and NZ$10 million for 12.5 years and using this to repay the original NZ$20 million loan. NZ Co’s average term of related party debt greater than 5 years is now 12.5 years and its related party debt with a term of more than five years as a fraction of total debt is NZ$10 million/NZ$20 million or 1/2. These amounts are less than or equal to the threshold term and fraction, so no adjustment is made to the term of the 12.5-year loan under the restricted transfer pricing rule.

Example 7

NZ Co has a $100 million 30-year loan from its parent, Foreign Co and no third-party debt. The interest rate on this loan is reset on 1 January each year. Foreign Co has an embedded call option whereby it can demand repayment on the reset date provided it gives 30 days prior notice. Foreign Co does not face any more risk than if they provided a one-year loan that was rolled over each year.

The term of this loan would be required to be adjusted to 5 years, but the annual interest rate reset, and embedded call option would continue to be included in the pricing so it is unlikely any adjustment would be required to the amount of deductible interest.
Flowchart 3: Determining the interest rate on a particular instrument – not for insuring or lending persons

Key

~ A significant amount of long-term senior unsecured third party debt has feature, or feature is present in worldwide group, and feature in related party debt is in overall proportion with feature in third party debt.

Credit ratings of insuring or lending persons

Financial institutions (referred to in the legislation as an “insuring or lending person”) are generally required to use the credit rating of the member of the group with the highest amount of debt rather than the default credit rating, restricted credit rating or group credit rating discussed above. There are two reasons for this:
• Financial institutions are more integral to their worldwide group in that a default is more likely to affect the risk perception of the worldwide group. This results in a higher level of implicit support.

• Financial institutions apply a different funding model from most other businesses, with much higher levels of leverage and, as interest is their main income source, calculating their debt percentage under the standard thin capitalisation rules is not appropriate.

An “insuring or lending person” is defined in section GC 15(2) to include the following persons:

• Banks, insurance companies and non-bank deposit takers regulated by the Reserve Bank of New Zealand.

• A member of a group or subgroup not regulated by the Reserve Bank of New Zealand whose main business is lending to third parties.

• An individual entity in the business of lending to third parties.

These last two bullet points are dealt with by section GC 15(2)(d) and (e) respectively.

An example of the last category is where a motor vehicle importer is a member of a group which also has a finance company to assist its customers to lease their vehicles. This will essentially require the group to be split into two for the purpose of applying the rules with the finance company subsidiary having a credit rating under section GC 17 and the motor vehicle importer applying section GC 16. If importing motor vehicles and operating a finance company was undertaken in a single company, the company would need to determine its main business activity so that it is treated for purposes of transfer pricing its debt as either an insuring or lending person or not.

Credit ratings

The default credit rating for insuring or lending persons is the group borrower’s credit rating in section GC 17(a). Unlike the approach for non-insuring or lending persons there is no high-BEPS risk test and there is no difference between the group borrower’s rating and the New Zealand borrower’s rating. In many instances, including the majority of the banking industry on their current ratings, this should not provide a practical restriction as the New Zealand rating is already the same as the group borrower’s. Even if the group borrower and New Zealand subsidiary ratings diverge in the future this may not impose a restriction in practice due to the availability of the optional credit rating – which is explained further below.

Although the credit rating must be the same as the group borrower’s, this does not require the interest rates on identical debt to also be identical. If there is market observable data that a New Zealand financial institution with the same credit rating as its group borrower pays a higher or lower interest rate for an equivalent instrument, then the new rules will not prevent that differential also applying in the determination of interest rates on cross-border related borrowing.

One notable example that has been identified is the credit rating of certain insurance companies. Many insurance companies, either internationally or in New Zealand, will have a high credit rating but little or no debt compared with another entity in the group that will have a slightly
lower credit rating but the majority of borrowing for the group. As noted above, the group borrower’s credit rating is based on the entity in the group with the highest amount of long-term senior unsecured debt. Therefore, the credit rating of the insurance group will be based on the credit rating of the entity that borrows externally which will be lower than the credit rating of the insurance company. This lower rating should more accurately reflect the actual borrowing costs of the group.

There are two alternative methods of determining the credit rating. The first is a $10 million de minimis in section GC 17(b). This is consistent with the $10 million de minimis for non-insuring or lending persons and allows an insuring or lending person with less than $10 million of cross-border related borrowing to apply the credit rating that would apply under the standard transfer pricing rules in the absence of the restricted transfer pricing rule.

The second alternative method is the optional credit rating in GC 17(c). This follows the same methodology as the optional credit rating for non-insuring or lending persons. The borrower can use the credit rating implied from this debt for up to four times the value of the third-party debt. Further detail on this method is provided in the non-insuring or lending person section above.

**Regulatory capital of banks, insurers and non-bank deposit takers**

The Reserve Bank requires banks, insurance companies and non-bank deposit takers to hold certain levels of capital to support their operations. Some of this regulatory capital can take the form of debt with deductible interest for tax purposes.

There are legitimate commercial reasons why multinational banking and insurance groups often issue regulatory capital in their home country, and then invest some of that regulatory capital down into other countries where they operate. Where this capital is passed down to New Zealand, it would not necessarily satisfy the general third-party exception as:

- the foreign parent will often be subject to different regulatory requirements in its home jurisdiction so will have issued instruments with different features; or
- the worldwide group may have a more comprehensive range of activities in its home jurisdiction. An example is a group that operates a bank and an insurance company internationally but only operates as an insurance company in New Zealand.

It is important that the tax rules do not discourage the existence of regulatory capital as that increases the risk of that business being unable to meet its obligations to depositors, policy holders or other creditors.

For banks, insurance companies, and non-bank deposit takers, the third-party test is replaced with a regulatory capital test in section GC 18(10). This test allows a bank, insurance company or non-bank deposit taker to include features in pricing related party debt if that feature was required for the instrument to be recognised by the Reserve Bank as regulatory capital or solvency capital, even where those features would otherwise have to be disregarded under the restricted transfer pricing rules.
There are four further areas of detail on this regulatory capital test which are:

- minimum standards;
- terms;
- disqualification; and
- back-to-back loans.

**Minimum standards**

Banks, insurance companies and non-bank deposit takers usually maintain regulatory capital above the minimum standards, primarily so they can remain above the standards if a future event, including losses and payments of dividends, causes their regulatory capital to drop. Banks can also issue different levels of capital depending on what features it has. Potential loss of interest deductions should not discourage this behaviour. Any features that are required to meet the Reserve Bank requirements should be included in pricing even where the regulatory capital is over the minimum standard or where the entity issues a type of capital that has a greater risk than another type of capital.

**Terms**

Under the current regulatory framework, banks can issue Tier 2 capital which, amongst other requirements, must have a minimum original maturity of at least five years. However, when such an instrument has less than five years to maturity, the amount that is recognised as regulatory capital is amortised on a straight-line basis at a rate of 20% per annum as follows:

<table>
<thead>
<tr>
<th>Years to maturity</th>
<th>Amount recognised</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than 4</td>
<td>100%</td>
</tr>
<tr>
<td>Less than and including 4 but more than 3</td>
<td>80%</td>
</tr>
<tr>
<td>Less than and including 3 but more than 2</td>
<td>60%</td>
</tr>
<tr>
<td>Less than and including 2 but more than 1</td>
<td>40%</td>
</tr>
<tr>
<td>Less than and including 1</td>
<td>20%</td>
</tr>
</tbody>
</table>

Due to this amortisation, banks are incentivised to issue Tier 2 capital for terms exceeding the minimum 5 years. Section GC 18(4) recognises this by allowing any term of greater than 5 years to be included in pricing on any instrument that is recognised as regulatory capital, even though that longer term is not required in order for the instrument to qualify as regulatory capital.

Section GC 13(1)(b) still requires identifying conditions that independent parties after real and independent bargaining might be expected to agree upon for the comparable transactions. This means terms would not be expected to be significantly longer than the term of equivalent Tier 2 capital issued to third parties, or where there is no such capital what would be expected to be agreed by a New Zealand borrower who was issuing Tier 2 capital to third parties.
Disqualification

From time to time, the Reserve Bank changes the regulatory capital requirements. For example, it is currently consulting on removing the requirement for regulatory capital to convert to common equity in certain circumstances. Where there is a regulatory change there will often be a transitional period where a former regulatory capital instrument will only be partially recognised and will eventually cease to qualify as regulatory capital. Where this occurs, the bank or insurance company will not necessarily repay the instrument as there may be other commercial reasons to retain it (such as meeting the expectations of external investors). The features that formerly qualified it as regulatory capital will still be present, even where it ceases to qualify as regulatory capital. In these circumstances, these features will still be included in the pricing, so the test is based on the instrument qualifying as regulatory capital when it was entered into rather than any subsequent changes.

Officials will monitor the use of this provision and would not expect an insuring or lending person to maintain high priced related party debt that no longer qualifies as regulatory capital when there is no commercial reason to do so other than to obtain a higher tax deduction than on a new instrument, especially when equivalent third-party instruments have been repaid.

Back-to-back loans

Some banks, insurance companies and non-bank deposit takers have an entity, such as a New Zealand holding company or a New Zealand branch of the foreign parent, which is not itself regulated by the Reserve Bank but raises funds from the worldwide group to on-lend to the regulated entity. A consequence of this is a New Zealand taxpayer may receive high priced debt with features that provide no direct benefit to it as a stand-alone entity but will match the instrument/funding on-lent to a group member which is regulated and therefore the group is provided with a regulatory benefit.

Any features included in an instrument issued by a non-regulated entity that would be necessary for it to qualify as regulatory capital (refer to the tests discussed above) if the entity was a regulated entity will be included in pricing provided that instrument is part of a back-to-back loan to the regulated entity/group. These two instruments are referred to in the legislation as the funding arrangement and the funded arrangement.

This is achieved in section GC 18(10)(b), (d) and (f) by requiring that the feature “reflects” a feature of regulatory or solvency capital. This term is not intended to require perfect mirroring between features of the funding and funded arrangements, but this should not provide the opportunity for inclusion of any features in the funding arrangement under the pretext of imperfect mirroring. The inclusion or non-inclusion of a feature in the funding or funded arrangement should not prevent that instrument qualifying in respect of other features. Where more judgement is required is where a different feature is included in the funding arrangement than in the funded arrangement. An appropriate approach would be to include a feature in a funding arrangement, which does not exactly match a feature in a funded arrangement, only if the feature provides protection to the banking/insuring/deposit taker associate in a similar circumstance to that faced under the funding arrangement. Furthermore, the increase in price due to the feature in the funding arrangement should not exceed the increase in price due to the feature in the funded arrangement.
Not all regulatory capital will be a financial arrangement as a bank may also issue preference shares which are an excepted financial arrangement. The rules also allow the funded arrangement to be an excepted financial arrangement while the funding arrangement is a financial arrangement. In this instance, it is expected that the terms of both arrangements will less perfectly mirror each other than where the funded arrangement is a financial arrangement; however, the paragraph above that discusses the limits on features of the funding arrangement will continue to be relevant.

**Flowchart 4: Determining whether a feature can be included in pricing for banks, insurance companies and non-bank deposit takers**

Use credit rating determined in flowchart 2

Is the feature a disregarded feature in section GC 18(3)

Does the loan qualify as regulatory capital by the Reserve Bank?

Is the feature necessary to meet a Reserve Bank regulatory capital requirement?

Is the feature back-to-back with regulatory capital?

Is the feature a term greater than 5 years?

Include feature

Disregard feature
**THIN CAPITALISATION**

*Sections EX 20D, EX 20E, FE 5, FE 6, FE 8, FE 10 – FE 12, FE 14 – FE 16B, FE 18, FZ 8, GB 51B, and YA 1 (total group non-debt liabilities) of the Income Tax Act 2007*

Debt percentages determined under the thin capitalisation rules have historically been based on an entity’s debt relative to its gross assets. The thin capitalisation rules in subpart FE have been amended so that debt percentages will now be based on an entity’s assets net of its “non-debt liabilities”.

A number of other changes have been made to strengthen the thin capitalisation rules. These are:

- a de minimis in the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;
- new rules for when a company can use an asset valuation for thin capitalisation purposes that is different from what is used for financial reporting purposes;
- an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of a year to circumvent the thin capitalisation rules; and
- a minor remedial to clarify how the owner-linked debt rules apply when the borrower is a trust.

**Application date**

These amendments apply to income years starting on or after 1 July 2018. Grandparenting for five years has been included for the 110 percent debt threshold for non-residents acting together, which is set out in more detail below.

**Key features**

The thin capitalisation rules in subpart FE have been amended so that the debt percentages are based on an entity’s assets net of its non-debt liabilities. This applies to both inbound and outbound thin capitalisation.

There are consequential amendments to the Controlled Foreign Company (CFC) rules in subpart EX of the Act to ensure the non-debt liabilities adjustment applies in relation to the CFC rules where relevant.

A number of other changes have also been made to the thin capitalisation rules. These changes have:

- extended the *de minimis* in section FE 6 of the outbound thin capitalisation rules (New Zealand companies with foreign subsidiaries) to the inbound thin capitalisation rules (foreign controlled New Zealand companies);
• reduced the 110 percent worldwide debt threshold to 100 percent for a NZ group controlled by a group of non-residents acting together for the purposes of the interest apportionment rule in section FE 6;

• strengthened the integrity of the rules that allow taxpayers to value assets using values not reported in their financial accounts for the purposes of determining total group assets under section FE 16;

• introduced an anti-avoidance rule in new section GB 51B to prevent taxpayers circumventing the thin capitalisation rules by repaying a loan just before a measurement date; and

• amended the owner-linked debt provisions in section FE 18(3B) to ensure they operate correctly for trusts.

Background to non-debt liabilities

The thin capitalisation rules form part of New Zealand’s international tax rules and are designed to protect our tax base. Like many countries, New Zealand has been reviewing its thin capitalisation/interest limitation rules in light of the OECD’s 2015 Final Report, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, on Action 4 of the BEPS Action Plan. This review identified aspects of New Zealand’s thin capitalisation rules that could be strengthened, and these aspects were subject to public consultation that followed the release of the Government discussion document, BEPS – Strengthening our interest limitation rules, in March 2017.

New Zealand’s thin capitalisation rules are based on the principle that a multinational group should not have significantly less capital in New Zealand, relative to the size of its New Zealand business, than it has on a worldwide basis, unless it has no more than a 60% debt/assets ratio. Historically this comparison has been made by comparing the ratio of debt to assets for the New Zealand group with the same ratio for the worldwide group. This measure did not deal well with companies with non-debt liabilities. When a New Zealand group has significant non-debt liabilities, its debt/assets ratio can appear relatively low, even though it has very little equity contributed by its owners. The thin capitalisation rules in subpart FE have been amended to prevent this, by excluding non-debt liabilities from the definition of assets.

The non-debt liabilities change better aligns New Zealand’s thin capitalisation regime with its core objectives and with other countries’ thin capitalisation rules.

Detailed analysis

Non-debt liabilities adjustment

Section FE 12 has been amended so that in calculating its New Zealand group debt percentage, an entity will be required to measure its assets net of its non-debt liabilities, as defined in section FE 16B.

In addition, there are consequential amendments to sections EX 20D and EX 20E to ensure the non-debt liabilities adjustment also applies in relation to the CFC rules where relevant.
Section FE 16B has separate, albeit similar, definitions for non-debt liabilities, depending on whether they are being calculated for the New Zealand group (section FE 16B(1)) or the worldwide group (section FE 16B(2)).

**Non-debt liabilities for New Zealand group – section FE 16B(1)**

For a New Zealand group, non-debt liabilities are all liabilities shown in the entity or group’s financial statements, except for:

- liabilities that are debt under section FE 15;
- certain interest-free loans from shareholders;
- certain shares held by shareholders;
- provisions for dividends; and
- certain deferred tax liabilities.

This effectively means that non-debt liabilities comprise the liabilities that are not debt, nor shareholder funding that is akin to group equity, and certain deferred tax liabilities. This represents a broad range of liabilities that include, but are not limited to:

- trade credits;
- GST payable;
- provisions and accruals for employee benefits such as wages, bonuses, redundancy and holiday pay and long service leave;
- financial liabilities from derivatives such as interest rate swaps and foreign exchange contracts; and
- current and deferred tax liabilities.

The exclusions in paragraphs FE 16B(1)(a) to (c) are covered in more detail below.

**Debt liabilities**

Paragraph (a) excludes from non-debt liabilities any liabilities that are counted as debt under section FE 15. This includes, but is not limited to, financial arrangements that provide funds to the entity and give rise to deductions for the entity. Financial arrangements that provide funds include finance leases and some credit sales. This is discussed in the definition of “cross-border related borrowing” above.

The primary example of debt liabilities under section FE 15 is interest-bearing debt.

**Interest-free loans from shareholders**

Paragraph (b) excludes from non-debt liabilities any financial arrangements providing funding to the entity if either:

- the funding is advanced pro rata with shareholding; and/or
- the shareholder (along with any associated persons) holds 10 percent or more of the voting interests in the company.
This is because such loans are akin to group equity if they are held pro rata with shareholding, or by a substantial shareholder.

This exclusion is targeted at interest-free loans from shareholders.

The exclusion does not include related-party agreements for the sale and purchase of property or services (defined in section YA 1 and colloquially known as trade credits), which will therefore be treated in the same way as other non-debt liabilities. Trade credits are treated this way because the price payable for the corresponding goods or services is generally increased by an implicit interest charge for the deferral of payment, and therefore it is not appropriate to treat them as non-interest bearing.

As drafted, the exclusion only applies to a loan from a shareholder.

Example 8

A Co is owned by two non-resident shareholders in the following proportions: B Co (80%) and C Co (20%). B Co and C Co provide a combination of interest-bearing and interest-free loans in proportion to their shareholdings.

The interest-bearing loans are debt under section FE 15 and therefore are not non-debt liabilities under section FE 16B(1)(a).

The interest-free loans are not debt under section FE 15 but also are not non-debt liabilities under section FE 16B(1)(b) as the loans are advanced in proportion to shareholding.

Therefore, neither the interest-bearing nor interest free loans should be treated as non-debt liabilities for thin capitalisation purposes.

This means the interest-bearing loans will have the same effect on A Co’s thin capitalisation calculation as any other third party loan, while the interest free loans will have the same effect as shareholder equity.

This exclusion (like those in paragraphs (c) and (d) of section FE 16B(1)), does not apply funding to a trust, other than a unit trust.

Preference shares

Shares can be treated as liabilities for accounting purposes in some circumstances (for example, if the shares are redeemable at the holder’s option or on a specific date).

Paragraph (c) excludes shares held by a shareholder from the definition of a non-debt liability if either:

- the funding is advanced pro rata with shareholding; and/or
- the shareholder (along with any associated persons) holds 10 percent or more of the voting interests in the company.

Similar to the exclusion targeted at interest-free loans in paragraph (b) such shares are akin to group equity if they are held pro rata with shareholding, or by a substantial shareholder. Otherwise it is appropriate for them to be excluded in determining the extent of equity funding in a New Zealand group. They are commercially more in the nature of third-party funding, rather than equity.
Provisions for dividends

Paragraph (d) excludes a provision for dividends from the definition of a non-debt liability. This is because it is similar in substance to an interest-free loan from shareholders.

Deferred tax liabilities

Paragraph (e) excludes a deferred tax liability from the definition of a non-debt liability if it satisfies three requirements. The general purpose of these requirements is to exclude a deferred tax liability only if it has in effect already been taken into account in the valuation of the relevant asset. The three requirements are as follows:

- It arises as a result of the difference between the value of an asset in the financial statements and the amount which remains depreciable or deductible for tax purposes.
- It reflects an amount of tax that would not arise if the relevant asset were sold for the value in the financial statement.
- The value of the relevant asset in the financial statements takes into account the deduction or depreciation actually available for tax purposes in relation to the asset (rather than the deduction or depreciation recorded in the financial statements), or on the basis that the asset is non-depreciable or depreciable at a rate of zero.

The first limb will be met relatively often, due to either a difference between accounting and tax depreciation rates, or asset revaluations. For example, suppose a building acquired in 2011 for $10m. The building is revalued in the 2018 financial statements to $15m. This gives rise to a deferred tax liability of $1.4m. The liability arises as a result of the difference between the building’s value in the financial accounts ($15m) and the depreciable amount for tax purposes ($0). It therefore comes within the first limb of section FE 16B(1)(e).

The second limb means that a deferred tax liability relating to a depreciable asset can only be excluded from being a non-debt liability to the extent that it is higher than the tax that would be payable if the asset was sold for its accounting value. This means that a deferred tax liability should be taken into account to the extent it reflects tax that would be paid on depreciation recovery income if the asset was disposed of.

The third limb reflects the “no double-counting” purpose of the exclusion. If the valuation of an asset already reflects the limited amount of depreciation available for tax purposes, it is not appropriate for the difference between accounting and tax depreciation to be taken into account again by way of the reduction in the thin capitalisation denominator for non-debt liabilities. For instance, in the case of a building which is revalued after buildings became depreciable at a rate of 0% (i.e. the 2011-12 income year), the accounting value of the building would be expected to recognise there are no depreciation deductions. This means the debt percentage calculation takes into account, through the calculation of the asset amount, the non-depreciable nature of the building for tax purposes. It is not then appropriate to make a further reduction in the debt percentage calculation. Any valuation based on the market value of the building after the 2011-12 tax year would be expected to reflect its non-depreciability, and therefore to mean that section GC 16(1)(e)(iii) is met with respect to any deferred tax liability in respect of that asset. However, a valuation based on the net present value of future cash flows might not take non-depreciability into account, in which case those requirements would not be met.
For the avoidance of doubt, the third limb should not exclude a deferred tax liability relating to a building which was acquired before buildings became depreciable at a rate of 0% (i.e. the 2011-12 income year), if the building has not been revalued in the financial statements since that time. In that case, the value (say, the original cost) of the building in the financial statements reflects an assumption of depreciability, so it is reasonable that the deferred tax liability does reduce the thin capitalisation denominator.

**Example 9**

D Co is currently recognising a deferred tax liability on its buildings of $4.2m calculated as follows:

<table>
<thead>
<tr>
<th>Accounting Base</th>
<th>Tax Base</th>
<th>Temporary Difference</th>
<th>Tax Rate</th>
<th>DTA/(DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>15m</td>
<td>0</td>
<td>15m</td>
<td>28%</td>
<td>(4.2m)</td>
</tr>
</tbody>
</table>

D Co purchased the building in 1995 for $20m. It claimed tax depreciation of $8m on the building until the depreciation rate was reduced to 0% from the 2011-12 income year. The building has not been revalued for accounting purposes since that time although accounting depreciation continues to reduce its carrying value which is currently $15m. Because the building is held for use rather than sale, this results in a deferred tax liability of $4.2m which is recognised in the financial statements.

**Question**

Can any of the deferred tax liability be excluded from being a non-debt liability under section FE 16B(1)(e)?

**Answer**

No. The accounting value of $15m has not been revalued to take into account the 0% depreciation on the building for tax purposes. Therefore, the third limb of section FE 16B(1)(e) is not met.

**Example 10**

The facts are the same as above, except that the building has been revalued for accounting purposes post-the 2011-12 income year to $30m. The revaluation was undertaken on a discounted cash flow basis that reflects that there is no tax depreciation shield from the building.

<table>
<thead>
<tr>
<th>Accounting Base</th>
<th>Tax Base</th>
<th>Temporary Difference</th>
<th>Tax Rate</th>
<th>DTA/(DTL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>30m</td>
<td>0</td>
<td>30m</td>
<td>28%</td>
<td>(8.4m)</td>
</tr>
</tbody>
</table>

Can any of the deferred tax liability be excluded from being a non-debt liability under section FE 16B(1)(e)?

Yes. The first limb is met. The second limb is met to the extent that the deferred tax liability exceeds the tax liability that would arise if the building was sold for $30m. If the building were sold for $30m, D Co would have a tax liability of $2.24m, being $8m of depreciation recapture income x 28%. The amount of the DTL that is within paragraph (ii) is therefore $8.4m - $2.24m = $6.16m. The third limb is met as the $30m valuation takes into account that tax depreciation on buildings is 0%.

This means that $2.8m of the DTL of $6.16m will be excluded from being a non-debt liability under section FE 16B(1)(e).
Example 11

Y Co’s balance sheet is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest-bearing debt</td>
<td>50</td>
</tr>
<tr>
<td>Deferred tax liability*</td>
<td>30</td>
</tr>
<tr>
<td>Provision for dividends</td>
<td>15</td>
</tr>
<tr>
<td>Equity</td>
<td>105</td>
</tr>
</tbody>
</table>

*The deferred tax liability may be split into $10 that meets criteria of section FE 16B(1)(e) and $20 that does not. The $10 deferred tax liability may reflect that the accounting value recognised in the financial statements for a particular class of assets already takes into account the level of tax depreciation shield available for those assets.

Z Co’s debt for the purposes of the thin capitalisation rules is $50. Its total liabilities are $95, but $15 of this is a provision for dividend and $10 of the deferred tax liability meets the criteria of section FE 16B(1)(e). Both of these are excluded from being non-debt liabilities. Its non-debt liabilities are $20 (the non-excluded portion of the deferred tax liability) and its thin capitalisation percentage under section FE 12 is $50 ÷ (200 − 20) = 27.8%.

Note that Z Co may not wish to consider whether any component of its deferred tax liability meets the criteria of section FE 16B(1)(e). In such a case, it treats the full quantum of the deferred tax liability as a non-debt liability and it would calculate its thin capitalisation percentage under section FE 12 to be $50 ÷ (200 − 30) = 29.4%.

Example 12

Z Co’s balance sheet is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest-bearing debt</td>
<td>20</td>
</tr>
<tr>
<td>Non-debt liability – trade credits</td>
<td>10</td>
</tr>
<tr>
<td>Interest free loan from parent</td>
<td>20</td>
</tr>
<tr>
<td>Equity</td>
<td>50</td>
</tr>
</tbody>
</table>

Z Co’s debt for the purposes of the thin capitalisation rules is $20. Its total liabilities are $50, but $20 of this is an interest-free loan from Z Co’s parent company and $20 is debt, which are both excluded from being non-debt liabilities. Its non-debt liabilities are therefore $10 (trade credits) and its thin capitalisation debt percentage under section FE 12 is $20 ÷ (100 − 10) = 22.2 percent.

Non-debt liabilities for worldwide group – sections FE 16B(2) and FE 18

For a worldwide group, non-debt liabilities means:

- all liabilities (as shown in the entity’s financial statements) that are not counted as debt under section FE 18; less
- any owner-linked debt that is excluded under section FE 18(3B), as such debt is treated as equity for the purposes of the worldwide group debt test.

This is similar to the definition of non-debt liabilities for a New Zealand group, although there are fewer exclusions.

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5 There is an error on page 123 of the Tax Information Bulletin Volume 31 Number 3, April 2019. It shows equity as 10 – it should show equity as 105.
Consequential amendments to the CFC rules – sections EX 20D and 20E

In calculating the net attributing CFC income or loss for a CFC, sections EX 20D and EX 20E outline rules to help determine the deductibility of interest expenditure for excessively-debt funded CFCs. The test for whether a CFC is considered to be excessively debt-funded is whether it has a debt-asset ratio, determined under section EX 20D(4), of more than 75 percent and also has a relative debt-asset ratio, determined under section EX 20E, of more than 110 percent.

Similar to the changes to the thin capitalisation rules in subpart FE, sections EX 20D and EX 20E have been amended to reflect that non-debt liabilities should be deducted from the denominator of the formula in calculating the CFC’s debt-asset ratio and the CFC’s relative debt-asset ratio. The meaning of non-debt liabilities for the purposes of these calculations is the total value of the non-debt liabilities determined under generally accepted accounting practice for the CFC and group respectively, as provided in sections EX 20D(8B) and (6B) respectively.

De minimis for inbound thin cap

Section FE 6(3)(ac)(i) provides a de minimis which means that a person subject to the outbound thin capitalisation rules does not derive an amount of income (equivalent to any disallowed interest) if they have a group finance cost for a year of less than $1 million. The de minimis reduces between $1 million to $2 million of group finance cost.

This is achieved by section FE 6(ac)(ii) or (iii), which reduce the amount of income derived by an excess debt entity, but only where paragraph (i) does not apply.

Amendments to section FE 6(3)(ac) have extended this de minimis to a person subject to the inbound thin capitalisation rules unless they have owner-linked debt – that is debt from a person with an ownership interest in the entity – under section FE 18(3B).

This change is intended to reduce compliance costs for smaller firms.

Worldwide debt test for non-residents acting together

The inbound thin capitalisation rules were extended with application from the 2015-16 tax year to include New Zealand entities owned by non-residents that act together as a group in relation to the way they fund a New Zealand investment and own 50 percent or more of that entity (we refer to these New Zealand entities as “group controlled”).

The 2015-16 changes also tightened what is known as the “110 percent worldwide debt test” in the inbound rules, which compares the amount of debt in a group’s worldwide operations to the debt in their New Zealand operations. The effect of section FE 18(3B) is that owner-linked debt (as discussed above) is excluded when calculating the worldwide debt percentage.

A New Zealand group’s allowable debt percentage under section FE 5(1)(a) is the greater of 60 percent of its assets and 110 percent of its worldwide debt percentage. For a group controlled New Zealand entity, the worldwide group is the New Zealand group itself under section FE 31D, as a company owned or controlled by a group of non-residents acting together has no identifiable parent. As such, the 110 percent worldwide debt test is effectively a measure of the New Zealand group’s total debt relative to its third-party debt.
This means that shareholders of group controlled entities with high levels of third-party debt were able to invest in New Zealand predominantly through owner-linked debt. For example, a project funded 90 percent with third-party debt could have 9 percent shareholder debt and only 1 percent equity without breaching the thin capitalisation limit.

Sections FE 5(1)(ab) and FE 6(3)(c)(iii) require that when a taxpayer has a worldwide group given by section FE 31D, interest deductions will be denied if the entity has any owner-linked debt and its total debt level exceeds 60 percent. In effect, this means that its allowable debt level is the greater of 60 percent and 100 percent of its third-party debt rather than the greater of 60 percent and 110 percent of its third-party debt as was previously the case.

Grandparenting

For relevant entities that are above 60 percent total debt and 100 percent of their third-party debt, transitional provisions have been included in section FZ 8. In determining its allowable debt level, a group-controlled entity can continue using its current percentage of its worldwide group debt percentage up to the 110 percent threshold for up to five years from the rules applying. The borrower’s current percentage of third-party debt can be calculated at either the date of introduction of the Taxation (Neutralising Base Erosion and Profit Shifting) Bill (6 December 2017) or the thin capitalisation measurement date immediately prior to this.

Example 13

On 30 June 2018, NZ Co’s worldwide group debt percentage is 70% and its debt percentage is 76.3% which is 109% of its worldwide debt percentage. NZ Co enters into a new loan with a third party in 2019. As a result, its debt percentage as a percentage of its worldwide group debt percentage drops to 105% (because NZ Co’s related-party debt level has not changed since year 2018). NZ Co’s allowable debt level under the transitional provisions will stay at 109% of its worldwide group debt percentage.

In 2020, NZ Co repays a number of large loans and, as a result, the debt percentage of its New Zealand group drops to 55%. NZ Co does not need to rely on its grandparented 109% of worldwide debt anymore, but is still covered by the grandparenting provisions for the remainder of the five-year period. This means that NZ Co will not be denied interest deductions if its debt percentage exceeds 60% in 2021 unless its debt percentage also exceeds 109% of its worldwide debt percentage.

Asset valuation

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

Asset valuations reported in financial statements are subject to a higher level of scrutiny than asset valuations that are adopted solely for thin capitalisation purposes. Moreover, there was a concern that taxpayers may be valuing assets for thin capitalisation purposes without seeking an independent valuation.

New section FE 16(1BAA) provides that taxpayers can only use the net current value of an asset if they have received a valuation from an independent valuer or the valuation methodology, assumptions and data have been approved by an independent valuer.

This provision does not provide guidance on how frequently such a valuation must be undertaken. It would not be practical to expect a valuation to be undertaken for each period;
however, times when a valuation may be necessary include where there is an impairment event for financial reporting purposes or if the taxpayer is seeking to increase the value.

**Anti-avoidance rule around measurement dates**

Section FE 8 provides a taxpayer’s assets and liabilities can be valued for thin capitalisation purposes on a daily, 3 monthly, or annual basis. An annual measurement date is the simplest and most widely-used of these approaches.

Annual valuation means taxpayers can use the annual measurement date to effectively breach the thin capitalisation debt limits for up to one year without facing any interest denial, by partly repaying a loan or converting it to equity on or before their balance date.

Previously, section FE 11 prevented taxpayers from benefitting from temporary increases or decreases in values if the change had a purpose or effect of defeating the intent and application of the thin capitalisation rules. However, this section only applied to changes between measurement dates and did not cover the initial year when an arrangement was entered into.

Section FE 11 has been amended and new section GB 51B reconstructs certain situations, transactions or arrangements where a taxpayer subject to the thin capitalisation rules substantially repays a loan or, more generally, enters into a transaction near a measurement date with the purpose or effect of manipulating the thin capitalisation rules.

**Owner-linked debt when the borrower is a trust**

To reduce compliance costs, the owner-linked debt provisions in section FE 18(3B) only count debt as owner-linked if the owner has an ownership interest in a member of the group of companies of 5 percent or more. This test worked correctly when the entity was a company but not if it was a trust as settlements on a trust do not convey ownership interests.

Amendments to section FE 18(3B) now count debt as owner-linked if the owner:

- has a direct ownership interests in a member of the group of 5 percent or more; or
- has made 5 percent or more (by value) of the settlements on the trust.

**Worldwide group debt percentage and the on-lending concession**

Existing section FE 13 allows the debt percentage of a New Zealand group and a worldwide group to be reduced to the extent a person subject to thin capitalisation:

- has provided funds to an unrelated party or a related party outside the lender’s NZ group; or
- is a trust with no property other than financial arrangements and incidental property.

This is known as the on-lending concession.

If a person (or group) who can rely on the on-lending concession has a mixture of funding from related and unrelated parties there was previously no guidance on which debt was reduced or how the reduction was allocated between the two sources of debt. This becomes a problem when the person is controlled by a non-resident owning body or trustee under section FE 31D so that the New Zealand group is the worldwide group.
New section FE 18(3B) confirms that when a person applies the on-lending concession the proportion of related and unrelated party debt remains the same as prior to the on-lending concession being applied.
Amendments have been made that will provide entities carrying out eligible infrastructure projects a limited exemption from the thin capitalisation rules by allowing them to claim deductions on debt that exceeds the thresholds set out in section FE 5(1).

The debt that is allowed to exceed the ordinary thin capitalisation thresholds under this rule is limited to third-party debt (or debt that is from an investor but is made in the capacity of a third-party lender) that only has recourse against the assets associated with the infrastructure project and the income arising from those assets.

Background

This measure is intended to deepen the market and improve the competitiveness in the bidding process for eligible infrastructure projects by ensuring that investors are subject to similar levels of thin capitalisation restrictions.

New Zealand-owned entities have no thin capitalisation restriction on the level of third-party debt they can take on. Similarly, New Zealand entities owned by a group of non-residents (none of which have a controlling interest in their own right) are unrestricted in how much third-party debt they can take on (provided that debt is not guaranteed by the owners). The amendment effectively provides other entities (i.e. New Zealand entities controlled by a single non-resident) involved in eligible infrastructure projects with an exemption from the thin capitalisation rules if they only have third party debt.

Key features

The thin capitalisation rules have been amended to provide entities carrying out eligible infrastructure projects a limited exemption from the thin capitalisation rules by allowing them to claim deductions on debt that exceed the thresholds in section FE 5(1).

The debt that can exceed the ordinary thin capitalisation thresholds under the exemption is limited to third-party debt (or debt that is from an investor but is made in the capacity of a third-party lender) that only has recourse against the assets associated with the infrastructure project and the income arising from those assets.

Application date

The amendments apply to income years starting on or after 1 July 2018.
**Detailed analysis**

**Public project assets**

This exemption will apply only to debt that relates to public project assets – defined in section FE 4B(1), which are assets arising from a project performed under a contract that meets the following criteria:

- The project is established at the request of the New Zealand Government or a public authority.
- The project is to provide, upgrade, or create assets in New Zealand and to operate or maintain those assets.
- The contract is for a period of at least 10 years.
- The public funding relating to the contract is approved by the Minister of Finance.
- The contract provides that the assets are owned by the New Zealand Government or the public authority after the completion of the contract.

**Public project debt**

The exemption will apply only to public project debt – defined in section FE 4B(2). This debt must meet the following criteria:

- The debt is applied to:
  - a project in order to give rise to public project assets, or income derived from public project assets; or
  - refinance a loan that was public project debt, including previous refinances of public project debt.
- The debt must not be on-lent to a party that is not associated with the performance of the project, unless the on-lending is minor or incidental and the funds are still expected to be applied to the project. This is discussed further below under the heading on-lent funds.
- The debt must give rise to interest expenditure that is incurred in New Zealand.

**Threshold debt amount**

The threshold debt amount is the amount of debt that an entity carrying on an eligible infrastructure project could have without being required to apportion its interest expenditure under section FE 6. It is calculated by multiplying the value of the public project assets and assets used in performing the project by the threshold debt percentage given by FE 5(1). If the amount of public project debt is less than this amount, all interest on the public project debt will continue to be deductible, even if the debt is of a type that is not intended to receive the benefit of this exemption (public project participant debt and unrestricted debt). If the amount of public project debt exceeds this amount, only interest on debt that is intended to receive the benefit of the exemption will be deductible.
Public project participant debt

Public project participant debt, defined in section FE 4B(3) and used to define the item “member debt” in the formula in section FE 7B(4)(f), is public project debt issued by a participant in the infrastructure project that is made under an arrangement that has the purpose or effect of funding the project with debt equal to each participant’s interest in the project.

Public project participant debt is not intended to get the benefit of the exemption. If this form of debt was able to get the benefit of the exemption, it could result in some private investors being able to allocate more debt to the infrastructure project than is appropriate.

Example 14 is an example of where the partners in a partnership that is performing an eligible infrastructure project contract partially fund the project using debt in a way in which the debt is effectively a substitute for equity.

Example 14

A Co, B Co and C Co, all of which are foreign companies, entered into a partnership called ABC Partnership. ABC Partnership entered into a contract with the New Zealand government to provide and maintain an asset for a 20-year period. All three partners have permanent establishments in New Zealand due to the activities of ABC Partnership.

In order to carry out the project, ABC Partnership required $100 million. All three partners contributed $5 million of capital contribution. In addition, ABC Partnership received a loan from Bank Co of $70 million at an interest rate of 10% p.a.

The final $15 million is provided in equal proportions by A Co, B Co and C Co by way of loans to ABC Partnership at a rate of 10% p.a.

All of the $70 million debt from Bank Ltd will be considered public project debt. All of the $15 million from the three partners will also be considered public project debt. However, it will also be considered to be public project participant debt, because it was advanced under an arrangement between the three partners in a way that allowed them to fund the partnership in proportion to their interest in the partnership.

Funding that is provided by a participant will not automatically be considered funding that is under an arrangement with a purpose or effect of allowing the participants to fund the project equal to their own ownership interests in the project. Examples 15 and 16 provide two types of situations in which debt from an investor in a project will not be public project participant debt.
Example 15

A Co, B Co and C Co, all of which are foreign companies, entered into a partnership called ABC Partnership. ABC Partnership entered into a contract with the New Zealand Government to provide and maintain an asset for a 20-year period. All three partners have permanent establishments in New Zealand due to the activities of ABC Partnership.

In addition to being a direct investor in infrastructure projects in New Zealand, C Co is also in the business of providing debt funding to a variety of New Zealand based projects. As a part of ABC Partnership’s process of procuring adequate debt funding for the project, it was decided that a combination of debt facilities from Bank Ltd and C Co was the best available funding option.

Therefore, ABC Partnership obtained debt from Bank Ltd of $60 million at the beginning of the project at a rate of 10% p.a., with terms that gave Bank Ltd recourse solely to assets and income derived from the project. ABC Partnership also obtained debt from C Co of $15 million on the same terms as the debt facility from Bank Ltd.

The funds provided under the debt facility from C Co are applied by ABC Partnership to give rise to public project assets, which means that the debt will be public project debt. However, it will not be considered public project participant debt. This is because the debt facility was only provided by one of the three partners (C Co).

In addition, there is no evidence that this loan was made with the intent of being a substitute for C Co’s capital contribution to the project.

Example 16

A Co, B Co and C Co, all of which are foreign companies, entered into a partnership called ABC Partnership. ABC Partnership entered into a contract with the New Zealand government to provide and maintain an asset for a 20-year period. All three partners have permanent establishments in New Zealand due to the activities of ABC Partnership.

The partners agreed that capital contributions would be made once construction of the asset was complete.

ABC Partnership obtained debt from Bank Ltd of $60 million at the beginning of the project at a rate of 10% p.a., with terms that gave Bank Ltd recourse solely to assets and income derived from the project.

Before Bank Co would provide its debt facility, it required recourse to the capital contributions that all three of the partners would provide as a part of the project contract. Bank Ltd agreed that to secure this, each partner could provide a letter of credit, or provide the funds to ABC Partnership through a convertible debt instrument.

At the beginning of the project, B Co and C Co provided letters of credit for the amount of their capital contribution. A Co decided to provide debt funding to ABC Partnership using a convertible debt instrument. That instrument provided for a fixed rate of return at an arm’s length price, and converted into A Co’s partnership interest at the same time that B Co and C Co put in their capital contribution.

The convertible debt instrument is an arrangement that provides funding to the project, but it only provides funding from one of the partners (A Co). There is no evidence that the arrangement was designed with the purpose of allowing all of the participants to provide funding in proportion to their interests in the project. Further, rather than being a substitute for partnership interest, the convertible debt instrument is a substitute for the letters of credit provided by the other parties. As such, the convertible debt will not be public project participant debt.
**On-lent funds**

A loan will not be considered public project debt if it is on-lent to a third party, unless that on-lending is simply due to a delay in the application of the funds to the project. This is to prevent an excess debt entity that has an interest in an eligible infrastructure project from taking on more debt than is necessary for the project and applying that debt to a separate project, while still getting the benefit of these measures.

Depositing funds from a loan with a financial institution will generally be a delay in the application of funds to a project, unless it is intended that those funds will not be applied to the project.

**Unrestricted debt**

Unrestricted debt, defined in section FE 7B(4)(c), is public project debt that does not meet the definition of “public project participant debt” that is made on terms that give the creditor recourse that is not limited to the project. Recourse over public project assets, income derived from those assets and ownership interests in entities that are only involved in the infrastructure project will be recourse that is limited to the project. Unrestricted debt is not intended to receive the benefit of this concessionary rule.

“Public project participant debt” is excluded from this definition to ensure that debt that meets both definitions does not have its interest deductions denied twice, as well as ensuring that an excess debt entity is still allowed an amount of debt that meets the threshold debt amount provided by the ordinary thin capitalisation rules. This principle is illustrated in Example 17.

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**Example 17**

X Co, Y Co and Z Co are all foreign companies and are the only shareholders in XYZ Co, a company incorporated in New Zealand. X Co is a majority shareholder with 60% ownership interest, while Y Co and Z Co each have a 20% ownership interest. XYZ Co entered into a contract with the New Zealand Government to provide and maintain an asset for a 20-year period.

To carry out the project, XYZ Co required $100 million. All three partners contributed $5 million of equity. XYZ Co also secured a loan from Bank Co of $50 million with an interest rate of 10% p.a. This loan only has recourse against assets and income associated with the project.

XYZ Co also secured a separate loan from Bank Co of $20 million with an interest rate of 5% p.a. This loan had a lower interest rate because it was on terms that gave Bank Co recourse over specific assets held by the shareholders of XYZ Co. As this item of debt gave Bank Co recourse that was not limited to the project, it will meet the definition of unrestricted debt.

The final $15 million is provided by X Co, Y Co and Z Co in proportion to their ownership interest by way of loans to XYZ Co with an interest rate of 15% p.a. These loans meet the definition of public project participant debt.

Over the course of the first year of the project, XYZ Co spends all of the $100 million on constructing the asset for the New Zealand Government. XYZ Co has a $110 million asset in its financial statements, which incorporates the present value of the expected payments from the New Zealand government over the next 20 years.

For the purpose of section FE 7B, XYZ Co has a debt percentage of 77% (85 ÷ 110), assuming no non-debt liabilities for simplicity. In addition, XYZ Co has a worldwide group debt percentage of 50%. This means that it will have to apply the apportionment formula in section FE 7B(3).
For the purpose of the apportionment formula, the value of public project participant (member) debt is $15 million and member interest is $2.25 million. Member excess is $15 million, because the amount of public project debt that is not public project participant debt is $70 million and the threshold debt amount is $66 million ($110 million × 60%).

Unrestricted debt is $20 million and unrestricted interest on this debt is $1 million. Unrestricted excess will not be the whole amount of the unrestricted debt however, as the amount of public project debt that is not either public project participant debt or recourse debt is $50 million, which is less than the threshold debt amount of $66 million. The amount of unrestricted excess is instead $4 million, which is the amount that the public project debt that is not public project participant debt ($70 million) exceeds the threshold debt amount.

The result of the formula will be ($1 million × $4 million ÷ $20 million) + ($ 2.25 million × $15 million ÷ $15 million) = $2.45 million of income derived by XYZ Co.

**Disposing of interest**

Section FE 4B(1)(b) provides that public project assets cannot be disposed of within 10 years from the beginning of the contract, unless it is to the Crown, a public authority, or another person performing the contract. By allowing public project assets to be disposed of to “another person performing the project”, it is intended that an investor in an eligible infrastructure project will be able to dispose of their investment to a separate investor who will step into their shoes.

The intent of this provision is to ensure that the concessionary rules will only apply to projects that cannot be abandoned at the discretion of the private investor(s). It is not intended to prevent an investor from disposing of its interest in the project to a third party that intends to carry on the original investor’s obligations under the project contract.

**Scope of exemption**

Section FE 7B(1) provides that this exemption will only apply to entities controlled by a single non-resident, partnerships, and New Zealand resident entities subject to the outbound thin capitalisation rules. A similar exemption already applies (in effect) where a separate entity is controlled by a group of non-residents.

Where a person has an interest in more than one eligible infrastructure project, each project will be treated separately under section FE 7B(5). This bifurcation will prevent the debt that is related to one infrastructure project that is denied a deduction from mixing with a low debt project.

**Option of applying the rule**

Each excess debt entity that is required to apply the thin capitalisation rules in relation to public project debt has the choice of whether to apply the ordinary thin capitalisation rules, or to apply the special rules for eligible infrastructure projects.

Section FE 7B(1)(c) allows an excess debt entity to choose whether or not they want to apply the concessionary rule. An election to apply the concessionary rule must be made at the time that the excess debt entity is first able to apply the concessionary rule to public project debt associated with the project.

Once an election is made to apply the concessionary rule to a project, the excess debt entity must continue to use that approach for the life of the project. If an excess debt entity applies the ordinary thin capitalisation rules to the first calculation for public project debt that relates to the
project, then that entity will be unable to utilise the concessionary rule. However, if the concessionary rule was not in place before the first time in which the thin capitalisation rules are applied to the project, then the concessionary rule can still be applied to the project after the application date for the rule.

Each excess debt entity that is applying the thin capitalisation rules for a specific infrastructure project will be able to make its own election. In addition, if an excess debt entity disposes of its interest in an eligible infrastructure project to a new investor, that new investor will have the opportunity to make an election at the time in which it is first required to make a thin capitalisation calculation that relates to the project.