Regulatory Impact Statement

Improving the effectiveness of the thin capitalisation rules

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed in this statement is whether the inbound thin capitalisation rules are operating effectively, or whether there are inconsistencies that need to be addressed. Where the thin capitalisation regime is not operating as intended, this statement addresses how it should be changed.

The policy intent of the thin capitalisation rules is to ensure that non-residents pay some New Zealand tax on their New Zealand investments. The thin capitalisation rules protect the New Zealand tax base by denying interest deductions when a non-resident has placed an excessive level of debt in their New Zealand investment.

Key issues with the inbound thin capitalisation rules have been brought to the Department's attention regarding the relative ineffectiveness of the regime. The ineffectiveness arises from the targeted nature of the rules, as they currently only apply to investments controlled by a single non-resident. This means that the thin capitalisation rules are easily able to be avoided, especially in the case of private equity investment and the scenario where a trust is interposed into a corporate structure.

The preferred option is to introduce a package of changes to the inbound thin capitalisation rules to broaden the application of the regime to other types of non-resident investor and tighten the rules around calculating a taxpayer's debt-to-asset ratio and worldwide group. This should increase fairness across different types of non-resident investment and help to ensure that New Zealand collects its fair share of tax.

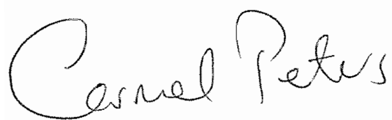
Time has been a significant constraint in this regulatory analysis, due to the inclusion of the proposed package of changes in Budget 2013. As a result, the technical design of the policy has not yet been finalised but this should not impact the fiscal implications of the preferred approach. Further policy analysis is required to determine the technical detail.

Significant consultation was undertaken with several large accounting and other advisory firms prior to and immediately following the release of an officials' issues paper that was released in January 2013. This issues paper drew 15 external submissions. Submitters were largely supportive of the broad proposals put forward in the issues paper, but raised a number of key issues with regard to the design of the policy. Officials are continuing to work through these design issues with interested parties to ensure that any changes to the thin capitalisation rules do not impose unnecessary uncertainty and complexity.

The officials' issues paper requested that submitters consider the likely compliance costs of the proposals in their submissions. Submitters noted that they were not in a position to quantify the costs. It is important to note that such costs are already faced by those taxpayers that are currently subject to the thin capitalisation rules.

Other than those set out in this statement, no significant gaps, assumptions, dependencies, constraints, caveats and uncertainties have been identified.

The preferred package of changes does not impair private property rights, reduce market competition or override common law principles. Some additional compliance costs may be imposed upon certain taxpayers, and the application of the thin capitalisation rules to certain types of non-resident investment currently not subject to the rules may have the effect of reducing returns on investment. This may have the effect of reducing the relative attractiveness of some investment structures in New Zealand. However, we consider that these issues are not significant and the package of changes is overall beneficial to New Zealand



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19 March 2013

STATUS QUO AND PROBLEM DEFINITION

The thin capitalisation rules

1. New Zealand's "thin capitalisation" rules limit the tax deductions that may be taken for interest expenditure. The basis of the rules is to ensure that non-residents (such as multinational companies) pay some New Zealand tax on their New Zealand investments. One way that non-residents can reduce their New Zealand tax liability is by replacing equity with debt, because they can then take interest deductions in New Zealand. This is shown in the example below.

Example

Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.

Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.

2. While taxing non-resident investment reduces incentives to invest here, this must be balanced against non-residents paying their fair share of tax – to ensure New Zealand can capture some of the benefits of that investment. Various reviews, such as the Tax Working Group (2009) and McLeod Review (2001), have considered the tax treatment of non-resident investment and concluded that it should be subject to some reasonable level of taxation. The thin capitalisation rules play an important role in achieving this objective.

3. There are general thin capitalisation rules for foreign investors and specific thin capitalisation rules for registered banks. There are also specific rules for New Zealanders investing abroad.[1] The focus of this statement is on the rules for foreign investors. The integrity problems identified below relate only to the general inbound rules; those problems do not arise under the other two sets of thin capitalisation rules.

Structure of the rules

4. The inbound thin capitalisation rules apply to non-residents directly earning New Zealand income, to New Zealand companies controlled by a single non-resident, and to certain trustees.

5. The rules help to protect the New Zealand tax base by denying further interest deductions in cases where a non-resident has placed an excessive level of debt in New Zealand (relative to the size of their New Zealand operations and the levels of debt that they have in other countries).

[1] A different rationale applies for the outbound thin capitalisation rules. These are to ensure New Zealanders do not allocate debt to their New Zealand operations if that debt should rightly be allocated to their offshore operations.

6. To work out if any interest deductions should be denied, an entity subject to the rules must work out the debt-to-asset ratios of their "New Zealand group" and their "worldwide group". The New Zealand group is, crudely speaking, all the operations of the New Zealand entity. Similarly, the worldwide group is the worldwide operations of the entity's non-resident parent.

7. Interest deductions are not denied if:

- the New Zealand group's debt-to-asset ratio is 110% or less of the worldwide group's ratio; or
- the New Zealand group's debt-to-asset ratio is 60% or less.

8. The intuition of the first condition (the "110% worldwide group test") is that if the New Zealand group is no more indebted than the worldwide group, the debt in New Zealand is a rough but convenient proxy for the group's *external* debt that should be rightly attributable to its New Zealand operations. This condition is also intended to act as a proxy for what a commercially acceptable level of gearing is.[2] If an industry is generally heavily geared, as reflected by high levels of worldwide debt, high levels of New Zealand debt is also acceptable.

9. The second condition (the "60% safe harbour") is provided to reduce compliance costs as it can be difficult and time-consuming to calculate the worldwide group's debt-to-asset ratio. Many companies will have debt-to-asset ratios that are lower than 60% for commercial reasons. Companies below the 60% safe harbour do not need to calculate the worldwide group ratio in order to justify their debt levels.

Scope

10. The focus of the proposals is base maintenance. We have only considered changes to the thin capitalisation rules that ensure the above two tests (the 60% safe harbour and 110% worldwide group test) cannot easily be avoided.

11. We have not considered the thin capitalisation regime more fundamentally – such as whether the current safe harbour levels are appropriate. We received submissions suggesting that we should not proceed with the base maintenance changes to the rules without a more fundamental review of the taxation of non-resident investment. We disagree.

12. As noted above, the basis for taxing non-resident investment has been considered by various tax reviews, most recently the Tax Working Group. These reviews considered that the thin capitalisation rules play an important part in ensuring New Zealand collects its fair share of tax on non-resident investment. We do not consider it necessary to undertake a further review.

13. We have also not considered fundamental changes to treatment of debt held by finance or insurance companies, even though the existing rules appear to be ineffective in both cases.

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[2] Generally speaking, gearing is the relative level of debt to equity held by a company.

This was to keep the size of the review manageable. Consideration may be given to a different set of rules for such entities at a later date and may perhaps be comparable to those for registered banks (the Reserve Bank of New Zealand recently introduced prudential capital requirements for finance and insurance companies, which might be a basis for bank-style thin capitalisation rules).

Problem definition

14. While the thin capitalisation rules generally work well, we are aware of some structures and situations where they do not apply effectively, or at all. This provides a mechanism that allows non-resident investment to avoid paying its fair share of New Zealand tax. This also creates a moderate fiscal risk for New Zealand's tax base and undermines the integrity of the tax system.

15. The methods for planning around the thin capitalisation rules are well known. Under the current rules, New Zealand is relatively more attractive to those who are able to circumvent the thin capitalisation rules and advantages some forms of investment over others. This creates an uneven playing field for non-resident investment due to the fact that some types of non-resident investor, for example private equity investors, are not subject to the thin capitalisation rules and are therefore advantaged over the others.

16. As a result of the status quo providing a mechanism for some foreign investors to shift profits out of New Zealand with little tax being paid, the relative tax burden falls more heavily on other types of taxpayers.

17. It is difficult to quantify the scale of the problem. Private equity, which is highly geared, has been a popular investment vehicle for several years. Although its popularity declined slightly during the global financial crisis, levels of private equity investment are expected to remain steady.

18. Specifically, the key issues that we have identified are summarised in the table below.

Non-residents acting together	At present, the thin capitalisation rules apply only if a single non-resident controls the New Zealand investment. However, there are other cases where a non-resident can arbitrarily determine the level of debt and equity in a company – such as where a private equity manager effectively controls multiple companies that jointly invest into a New Zealand company.
Problems with the 110% worldwide group test	At present, the worldwide debt of a company includes all debt of the group – including shareholder debt. However, to the extent that worldwide debt is shareholder debt, this is not a good reflection of a commercial debt level for the company. Rather, it is likely that shareholders have substituted equity for debt at the worldwide level, which in turn allows them to thinly capitalise their New Zealand operations as well.
Interposition of complying	At present, trusts are only subject to the rules if it is non-

trusts	complying (that is, has not complied with all of its New Zealand tax obligations) and where 50% or more of its settlements have been made by a single non-resident. There are ways around this rule. Most notably, the rules do not apply to complying trusts (i.e. trusts that have complied with New Zealand tax obligations). This allows the trust to borrow from its settlor and fund New Zealand investments without the thin capitalisation rules applying.
Capitalised interest	Whether interest deductions will be denied under the thin capitalisation rules turns on debt-to-asset ratios. Asset values are determined according to generally accepted accounting practice (GAAP). These generally require asset values to include capitalised interest costs. For tax purposes, New Zealand companies are generally allowed a deduction for interest costs even if they have been capitalised. Taxpayers who are capitalising interest costs claim a tax deduction on the expense and can record an increase in their asset values – allowing them to claim even higher interest deductions in later years. This may be inappropriate.
Asset uplifts	Under GAAP, many kinds of intangible property must be valued at cost. Unless the asset is sold to an unrelated party, revaluation of such assets is not permitted because a reliable value cannot be determined. This restriction is being circumvented by some groups who report increased asset values following internal reorganisations. This may allow for inflated asset values. It is not clear that the amount paid by a related party will be a fair reflection of the asset's true value since the transaction is not necessarily at arm's length.

OBJECTIVES

19. The objectives of this reform are to:

- create a level playing field, so all types of non-resident investors that can substitute between debt and equity are caught by the thin capitalisation rules (fairness and efficiency);
- ensure that any changes to the thin capitalisation rules do not add undue complexity and compliance costs for taxpayers (simplicity);
- improve the integrity of the tax system by ensuring that New Zealand collects its fair share of tax on New Zealand investments of non-residents;
- reduce the fiscal risks associated with the thin capitalisation regime; and

- strike a reasonable balance between economic impact (such as incentives to invest into New Zealand) and additional tax revenue.

REGULATORY IMPACT ANALYSIS

20. The key question in this statement is whether the status quo should be retained, or if a package of reforms should be implemented to address the ways taxpayers are able to avoid the thin capitalisation regime.

21. Broadly, the package of reforms features the following:

- applying the thin capitalisation regime to any group of non-residents if they are acting together and have a combined ownership of a New Zealand investment of greater than 50%;
- exclude shareholder debt in calculations of a company's worldwide debt-to-asset ratio;
- extend the thin capitalisation regime broadly so that it also applies to complying trusts; in other words, so the rules generally apply to a resident trustee if 50% or more of the settlements made on the trust have been made by a non-resident (or a group of non-residents acting together), or by an entity already subject to the rules;
- disallow capitalised interest to be included in asset values for thin capitalisation purposes, at least for some purposes; and
- generally disregard asset value increases that arise from internal group restructuring.

22. The focus of this statement is whether, in broad terms, the thin capitalisation reforms, as described above, should proceed. The problems themselves are base maintenance in nature, which constrains the number of practical options available to address them. Aside from the proposal to apply the thin capitalisation rules to groups of non-residents acting together, practical alternatives to the other proposals do not exist.

23. Consider, for example, the proposal to extend the thin capitalisation regime to complying trusts where 50% or more of the settlements made on trust are made by a non-resident, a group of non-residents acting together, or an entity that is subject to the thin capitalisation rules. If it is considered preferable to close this loophole, the only option available is this proposal. Submitters raised the concern that this would capture securitisation vehicles as the on-lending concession does not always work perfectly. We are working through this concern.

24. Further policy analysis is required as technical decisions will need to be made on how each of these reforms should be shaped. These decisions will be informed by the submissions we have received, as well as ongoing discussions with those submitters.

Analysis of the proposed reform package

25. The officials' issues paper that was released in January 2013 identified the problems outlined in the table in paragraph 18 and proposed solutions to these, which are described

above in paragraph 21. Together the problems lead to an overall ineffectiveness of the thin capitalisation rules.

26. Of the proposals described above in paragraph 21, only the proposal to apply the thin capitalisation rules to groups of non-residents acting together had more than one practical option available to achieve the policy intent. These were either an acting together test that was not exhaustively defined in legislation, an acting together test defined using only specific and exhaustive criteria, or applying the thin capitalisation regime to all New Zealand investments where non-residents hold interests that add to 50% or more.

27. These alternative acting together tests are respectively presented as options 2, 3a, and 3b in the tables on pages 9 and 10. These tables are targeted at analysing the impact of a particular acting together test, in conjunction with the other proposals, in relation to the status quo.

28. Officials sought feedback in relation to the proposed package of reforms. Submitters broadly agreed that the problems identified by officials need to be addressed in order to ensure that the thin capitalisation rules operate effectively.

29. A number of submitters provided comments in respect of the technical design of the proposals. For example, some submitters commented that in terms of the definition for 'acting together', an exhaustive list would be preferred over a non-exhaustive definition. The policy intent is to capture private equity regardless of the final definition of 'acting together', in order to improve fairness among different types of non-resident investment and make the thin capitalisation rules more difficult to circumvent.

30. The package of reforms would have a negative impact on the value of some existing non-resident investment, in terms of reduced returns, but overall it is in New Zealand's best interest to subject non-resident investment to some amount of tax, as concluded by a number of reviews.

31. The package of reforms would apply the thin capitalisation rules more broadly, which would create a more level playing field for different types of investment. As a result, it would be harder for these non-residents to avoid paying their fair share of tax. This would have the effect of reducing the relative tax burden placed on other taxpayers.

32. The package of reforms would remove these fiscal risks and would raise revenue of an estimated $10 million per year. This figure is largely based on a sample of existing private equity investment in New Zealand that would be brought into the thin capitalisation rules, as well as some large enterprises already within the rules that would be affected by the exclusion of shareholder debt from the worldwide group ratio.

33. However, it is expected that compliance costs may increase for some taxpayers. For instance, the reform requires that shareholder debt be excluded from a company's worldwide group. We received submissions that stated this would be particularly onerous for companies with large worldwide groups. This particular type of taxpayer is not the focus of the policy concern, so we will work with submitters to try to address these concerns.

34. In the officials' issues paper we requested information on the likely cost of complying with the proposals that would fall onto taxpayers. Ideally, we would like to be able to

quantify transitional as well as on-going compliance costs. Submitters noted that they were not in a position to quantify these costs.

35. The overall policy objective is to balance any additional revenue with the potential economic impact of the proposed reform and to ensure that non-resident investors are paying a reasonable level of tax in New Zealand. However, we will continue to work with affected parties to minimise compliance costs as much as possible when designing the technical aspects of the changes.

36. It is important to note that such compliance costs are already borne by taxpayers currently subject to the thin capitalisation rules.

37. Our preferred option is to reform the thin capitalisation rules by addressing the issues identified in paragraph 18 rather than to retain the status quo. Options 2, 3a, and 3b all go some way in addressing these issues, but at this stage option 2 is our ultimate preference. This is because option 3a carries the risk of the thin capitalisation rules being easily circumvented by those able to plan their corporate structures effectively. Option 3b would have the effect of bringing more taxpayers into the scope of the thin capitalisation rules than intended. Although it would be possible to specifically exclude some types of non-resident investment, there would be the risk

38. In principle, option 2 effectively meets the objectives identified and is specifically designed to address the current problems associated with the thin capitalisation rules: it ensures non-residents pay their fair share of tax, reduces fiscal risks and improves the integrity of the tax system. We also believe it strikes a good balance between the economic impact of taxing non-resident investment and tax revenue raised from that investment. As noted above, appropriate settings for non-resident taxation have been reviewed on a number of occasions. These have concluded that it is in New Zealand's best interest to impose a reasonable amount of tax on non-resident investment. Based on this, it is important the thin capitalisation rules cannot easily be avoided so New Zealand does collect this reasonable level of tax.

39. A summary of our analysis is presented below:

Option 1	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Maintain the status quo **Objectives met:** • Simplicity	• Investing in New Zealand would remain relatively more attractive to those who are able to avoid the thin capitalisation rules, but; • New Zealand would not be collecting its fair share of tax on that investment	• This option has a moderate fiscal risk, because the methods for avoiding the thin capitalisation rules are well known e.g. the use of private equity structures	• Foreign investors would have a mechanism to shift profits out of New Zealand, so New Zealand's tax burden would more heavily on other types of taxpayers, such as New Zealand residents • It would also create an uneven playing field for investments made by non-residents (those are able to avoid the thin capitalisation rules vs. those who are not)	• No additional compliance costs associated with the status quo	Not preferred, as there is significant fiscal risk and there is a large amount of unfairness present in this option. It also undermines the integrity of the tax system as taxpayers are easily able to avoid the thin capitalisation rules, meaning that the rules do not apply and work effectively when they should.

Option 2	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Implement the package of reforms (see paragraph 20), where 'acting together' is *not* exhaustively defined in legislation **Objectives met:** • Fiscal risk • Fairness • Balance between economic impact and tax revenue • Integrity of the tax system	• This option would impact the value of some existing non-resident investment in New Zealand as a result of a reduction in returns. However, the reduction in returns are not considered to be significant • Overall benefit to New Zealand as various reviews have concluded that it is in New Zealand's best interest to impose some tax on non-resident investment	• Fiscal risks associated with the status quo would be closed off • In addition to this, we estimate that this option would raise $10 million per year	• This option would reduce the relative tax burden on other taxpayers • It would also create a more level playing field between non-resident investors	• Some additional compliance costs would fall on taxpayers • This is because some taxpayers may need to determine whether the thin capitalisation rules apply to them • Those already within the thin capitalisation rules may need to change the way they calculate their debt-to-asset ratios. For example, excluding debt linked to shareholders from the worldwide group ratio	Preferred option as it meets the objectives with only minor trade-offs. These trade-offs are the additional compliance costs placed on some taxpayers and the effect on the value of existing non-resident investment. However, it ensures that New Zealand collects its fair share of tax on non-resident investment, increases fairness by reducing the tax burden on other taxpayers and creates a more even playing field between non-resident investors. Overall, the integrity of the tax system is improved as the package of reforms would help to ensure that the thin capitalisation rules are effective in practice.

Option 3a	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Implement package of reforms as in option 2, but with 'acting together' defined using only specific and exhaustive criteria **Objectives met:** The concern is that the thin capitalisation rules could be easily circumvented by a number of taxpayers who should be subject to the regime. This would have the same effect as option 1, but the simplicity objective is not met because of additional compliance costs.	• A test with specific and exhaustive criteria poses a risk as it could be easy to circumvent. • This means that investment in New Zealand would remain relatively attractive to those who can continue to plan their structures to get around the thin capitalisation rules • As per option 1, New Zealand would not be collecting its fair share of tax	• This option poses some fiscal risk as a test with specific and exhaustive criteria could be easy to circumvent • Only a minor proportion of the fiscal risk associated with the status quo would be eliminated as the other proposals would apply to taxpayers already subject to the thin capitalisation rules	• In theory, this option would have a similar impact as option 2 • In reality, this option could have a similar impact as option 1 because those investments able to restructure could do so in order to not be subject to the thin capitalisation rules	• Some additional compliance costs would fall on taxpayers • Some costs would fall on taxpayers in circumventing the rules, however this is already true under the existing rules • Taxpayers already within the scope of the thin capitalisation rules would need to account	At this stage, this option is not preferred because as with the status quo, there is a risk that the thin capitalisation rules could easily be circumvented. However, it is still under consideration as part of finalising the design of the rules. As a result of the discussed risk, there would be a large amount of unfairness and it would undermine the integrity of the tax system. In reality, this option may have the same ultimate effect as not proceeding with the reform.

Option 3b	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Implement package of reforms as in option 2, but instead of an acting together test, the thin capitalisation rules would apply to all New Zealand companies in which interests held by non-residents add to 50% or more. **Objectives met:** • Fiscal risk • Fairness **(partially)** • Balance between economic impact and tax revenue • Integrity of the tax system	• This option would impact the value of some existing non-resident investment in New Zealand as a result of a reduction in returns. • Unlike option 2, the reduction in returns may not be insignificant as the rules would apply to more taxpayers than intended. As such, it may not to result in an overall benefit to New Zealand	• As per option 2, fiscal risks associated with the status quo would be closed off	• As per option 2, this option would reduce the relative tax burden on other taxpayers and creates a more level playing field between non-resident investors • Some unfairness is created, as some taxpayers would be brought into the scope of the thin capitalisation rules when it was not intended that the rules would apply to them	• Some additional compliance costs would fall on taxpayers • Compared with options 2 and 3a, this option would make it easier for taxpayers for determine if the thin capitalisation rules apply to them • A greater number of taxpayers would need to comply with the thin capitalisation rules than under option 2	At this stage, this option is not preferred. However, it is still under consideration as part of finalising the design of the rules. Even though it has largely the same impacts as option 2, it brings into the scope of the thin capitalisation rules a number of taxpayers that should not be subject to the rules. The policy intent of these reforms is to capture non-resident investors who co-ordinate their investments in such a way that they mimic a single non-resident controller. This option goes beyond that to an unnecessary extent.

Transitional rules

40. Given our preferred option is for reform, whether any transitional or grandparenting arrangements should be provided needs to be considered. The options we have considered are:

- have the new rules apply from the 2015/16 year – **our preferred option;**
- have the new rules apply from the first income year after the relevant bill receives Royal asset (likely to be the 2015/16 income year);
- delay the application date for all taxpayers, so that the rules apply from the second income year after the relevant bill receives Royal assent (likely to be the 2016/17 income year);
- provide a savings provision for taxpayers who would have had interest denied under the new rules on existing funding arrangements; and
- phase in the new rules for taxpayers who have interest denied under the new rules on existing funding arrangements.

41. Our preferred approach is the first, so the new rules apply from the 2015/16 income year. This provides taxpayers with sufficient time to review their funding structures and make any changes, if necessary.

42. We note that application from the 2015/16 income year is a relatively long lead-in time given that consultation on the reform package and its likely application date began in January 2013. We also note that new rules would continue to allow deductions for genuinely external debt, which is the type of debt that is most difficult to restructure. We consider that this largely eliminates the case for a delayed application date or savings provisions.

43. Compared to the other options, a 2015/16 start date best meets the objectives of creating a level playing field and reducing fiscal risks. The other options would favour existing investments over new investments (at least until the rules applied to existing investments) and could create boundary issues in distinguishing whether some funding was the continuation of an existing investment or a new investment.

44. One risk with a 2015/16 application date is the potential for legislative delays, which could mean the rules begin to apply for some taxpayers before the legislation is enacted. This risk can be managed by reviewing the application date if there looks to be a significant delay. We note that this risk would not arise if the rules applied from the first income year following enactment. However, compared to a fixed application date, this would provide less certainty and consistency of treatment between taxpayers.

CONSULTATION

45. The package of changes has been developed in consultation with the Treasury.

46. To consult on these proposals we released a public Officials' Issues paper in January 2013. We received 15 submissions from industry groups, accounting and law firms, and some taxpayers who might be affected by the proposals.

47. Many, but not all, submitters understood the rationale behind the proposals (to ensure the thin capitalisation rules cannot be easily avoided). They agreed that in many cases non-residents have structured themselves to avoid the thin capitalisation rules and the rules should clearly be expanded to capture them.

48. Other submitters questioned the reforms. They suggested that the thin capitalisation rules should be reviewed more fundamentally before any reforms are implemented. As noted above, we do not believe this is necessary.

49. Submitters also raised specific issues with elements of the package. Some of these are technical, such as what is the best way to determine whether investors are "acting together" to set levels of debt in a New Zealand business, or about compliance costs if shareholder debt must be excluded from the worldwide group of widely-held companies with large international operations. We do not believe any of these issues are insurmountable; we will continue to work with submitters and other interested parties to ensure the package of reforms to the thin capitalisation rules is practicable. These concerns do not give us reason to cease implementing the reform package.

50. Submitters questioned whether certain elements of the package should proceed at all. These are discussed below.

Problems with the 110% worldwide group test

51. Submitters argued that the 110% worldwide group test does not take into account that different industries have different acceptable debt ratios. For example, infrastructure investment is often heavily debt financed. They submitted that given the perceived problem is companies who are excessively debt financed, simply excluding shareholder debt is far too broad. A better approach would be to use an arm's length test, as that can take into account what an acceptable level of external funding is.

52. We do not agree that an arm's length test is a better approach. This was stated in the officials' issues paper and excluded as an option.

53. In our experience, arm's length tests are very difficult to apply. We understand that this is also the case with other countries that have used an arm's length test. We do accept that different industries and businesses have different acceptable levels of gearing but consider that the only reliable way of demonstrating what constitutes an acceptable level of debt is by sourcing that debt from an unrelated party.

54. We note that the proposal to exclude shareholder debt is likely to be consistent with commercial drivers. This is because it would be very unusual for a shareholder in a company

to have a better credit rating than the company itself.[3] As a consequence, it will generally be cheaper for a company to borrow directly from third parties as opposed to borrowing from its shareholders. Shareholder debt can, however, be used in place of equity, in order to reduce the effective tax rate on the investment. For this reason, it is appropriate to deny further interest deductions where the investment is heavily debt financed and there are high levels of shareholder debt.

Capitalised interest

55. Many submitters disagreed with this proposal. They argued that accounting generally requires assets to be recognised at fair value. If asset values have been increased because of capitalised interest, either the increase is a reflection of an increase in the asset's market value, or the increase will have to be written off as an impairment. Submitters also noted that there would be substantial compliance costs involved in backing out capitalised interest that has been added to asset values in prior years.

56. We note these comments but do not consider them grounds to not include this item in the package of reforms. While most taxpayers use fair value accounting, we understand that some do not. In addition, we also understand that some taxpayers may not recognise impairments to asset values in the same group where they recognise capitalised interest. We consider there is still a rationale to continue with this base protection measure, but perhaps with a more limited scope to address the points raised in submissions.

Asset uplifts

57. Many submitters also disagreed with this proposal. Some submitters noted that they cannot see how asset value uplifts can be recognised in an internal reorganisation. More generally, submitters noted the matter should not proceed because asset valuations must, at the end of the day, be justifiable.

58. We understand that whether or not asset uplifts can be recognised in this way is not entirely clear under GAAP. Most accounting firms would not allow asset uplifts to be recognised in this way, but we are aware that some do. This is creating an uneven playing field. Moreover, the fact that most accounting firms would not allow this type of uplift recognition is a good indication that asset values generated by an internal reorganisation may not be a fair reflection of their value. Including this base protection measure in the package of thin capitalisation reforms is therefore justified.

Public Private Partnerships

59. Some submissions raised concerns regarding the potential impact on public private partnerships (PPPs) as these tend to be heavily debt-funded.

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[3] If a non-resident shareholder borrowed against different assets, they might be able to achieve a better credit rating than the New Zealand company they are investing into. However, we still have a policy concern with this situation because the debt in the New Zealand company may not be a commercial level of debt.

60. However, our expectation is that the impact of the new rules on existing or future PPPs should be minimal. This because the actual and potential PPPs that we are aware of have high levels of external debt (which will continue to be deductible in most cases[4]) and relatively low levels of shareholder debt.

61. We therefore do not consider it necessary to provide any special accommodation for PPPs, but will continue to work through any concerns with submitters.

CONCLUSIONS AND RECOMMENDATIONS

62. Officials have assessed the two main options, with possible alternatives, discussed in this Regulatory Impact Statement against the stated objectives. The recommended approach is to implement the package of reforms set out in option 2 which would add to the thin capitalisation rules already established in the Income Tax Act 2007. The inbound thin capitalisation rules would apply more broadly to trusts as well as groups of non-residents acting together. The aim of this is to make the inbound thin capitalisation rules more difficult to circumvent. The package of changes would also limit what can be included when calculating the debt-to-asset ratios of a taxpayer's New Zealand group and worldwide group. The aim of this is to ensure that non-residents do not take excessive interest deductions in New Zealand in order to reduce their New Zealand tax liability. It ensures that New Zealand collects its fair share of tax from non-resident investment in New Zealand.

63. On balance, the recommended approach achieves four of the five objectives set for the reform of the thin capitalisation rules: creating a level playing field, improving the integrity of the tax system, reducing fiscal risks, and striking a reasonable balance between economic impact and additional tax revenue. The fifth objective, to ensure that no undue complexity results from the changes, is in the process of being achieved as officials are continuing to engage with interested parties to resolve the key design issues of the preferred approach.

IMPLEMENTATION

64. It is recommended that the proposed reform package will apply from the start of the 2015/16 income year. Before that date the existing law will apply, such that taxpayers who are not subject to the thin capitalisation rules under existing law will not be required to account for the new amendments until the 2015/16 income year.

65. During this time, taxpayers should evaluate their financing structures and determine whether any changes are necessary in order to comply with thin capitalisation rules once they are in place. Affected taxpayers may include those already subject to the thin capitalisation rules, as well as those who may be brought into the ambit of the rules as a result of the extended application to trusts and those determined to be "acting together". It is proposed that existing structures will become subject to the new rules at the same time as new funding arrangements.

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[4] Deductions on external debt may be denied in some cases where there is a single non-resident controller, but this is already the case under the existing rules, so there is no change under the new rules.

66. More guidance on implementation will be provided when the technical details of the new changes have been finalised and key design issues have been resolved. Further guidance will be provided when the legislation is introduced and considered at select committee. Detailed guidance will be published soon after enactment, in a Tax Information Bulletin. Because the proposed amendments affect existing rules and systems, there are no significant administrative issues arising from the changes.

MONITORING, EVALUATION AND REVIEW

67. Inland Revenue monitors, evaluates and reviews new legislation under the Generic Tax Policy Process (GTTP). The GTTP is a multi-stage tax policy process that has been used for tax policy in New Zealand since 1995. The implementation and review stage of the GTTP involves reviewing the legislation after implementation and identifying any remedial issues.

68. The effectiveness of the new rules after the start of the 2015/16 income year will be monitored under the GTTP through the use of the financing questionnaire undertaken by Inland Revenue involving a number of large taxpayers. Any further changes that are identified as being necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

69. Inland Revenue officials will continue to make themselves available for discussion with affected taxpayers should any further difficulties arise.