BEPS – Strengthening our interest limitation rules

A Government discussion document

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CHAPTER 1

Introduction

1.1 The use of debt is one of the simplest ways of shifting taxable profits from one jurisdiction to another. For example, because interest payments are deductible, a related-party cross-border loan between a foreign parent and their New Zealand subsidiary will reduce taxes payable in New Zealand.

1.2 New Zealand has rules that limit the interest deductions of firms with international connections (the inbound and outbound thin capitalisation rules together with the transfer pricing rules). Our thin capitalisation rules, first introduced in 1996 have been strengthened numerous times, such as reducing the safe harbour from 75 per cent to 60 per cent in 2011, and by extending the rules so they apply to New Zealand firms controlled by non-residents who act together in 2015.

1.3 Overall, we consider that our rules are serving us well. The rules are well understood and set clear and largely predictable limits on the amount of deductible debt allowable in New Zealand. Firms subject to the rules are significant taxpayers in New Zealand – for example, foreign controlled firms paid 39 per cent of company tax in the 2015 tax year.

1.4 While the majority of firms subject to the thin capitalisation rules have taken conservative debt positions, there is a minority that engages in more aggressive tax practices. Of particular concern is that some firms have borrowed from their foreign parents at high interest rates, resulting in very large interest deductions in New Zealand. A proposal to address this is discussed in chapter 3.

1.5 In reviewing our thin capitalisation rules, we have identified several other areas for improvement. A proposal to change how a firm's total assets are determined for the thin capitalisation rules – that they should be determined net of a firm's non-debt liabilities – is discussed in chapter 4. This change would bring New Zealand into line with other countries with thin capitalisation rules.

1.6 Chapter 5 discusses other proposals to improve the rules. These include introducing a de minimis, which will reduce compliance costs for smaller firms, and a permissive regime for project-financed infrastructure projects funded with third-party debt, reflecting the fact that such projects represent a low profit shifting risk.

Scope of review

1.7 New Zealand's thin capitalisation rules apply to outbound investment (New Zealand-based firms that have international operations) as well as inbound investment (foreign-owned firms operating in New Zealand).

1.8 We propose that the proposals discussed in this document apply to both foreign-owned firms and domestically-owned firms with foreign affiliates. While the focus of the BEPS project in New Zealand has been on inbound investment, similar base protection considerations can arise in an outbound context. We consider that it makes sense for a similar set of rules to apply to both inbound and outbound investment.

1.9 In the context of the interest rate proposal discussed in chapter 3, this means that the rule would apply to loans from a foreign-parent to a New Zealand owned subsidiary, and to loans from a foreign subsidiary to a New Zealand parent.[1] The rule would not apply to loans from a New Zealand parent to its foreign affiliates, as the same base protection concerns do not arise.

1.10 In the context of the changes discussed in the other chapters, this means that the proposals would apply in relation to both the inbound and outbound thin capitalisation rules.

1.11 A special thin capitalisation regime also applies to registered banks operating in New Zealand. Most of the changes discussed in this paper would not apply as they are not relevant to that regime. However, we propose to apply the interest rate proposal discussed in chapter 3 to banks subject to the banking thin capitalisation rules.

1.12 This paper does not discuss a reduction in the thin capitalisation safe harbour of 60 per cent. Setting the safe harbour is ultimately a matter of judgement, and the Government is satisfied with its current level.

Submissions

1.13 The Government seeks submissions on the proposals set out in this discussion document.

1.14 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

1.15 Submissions should be made by 18 April 2017 and can be emailed to policy.webmaster@ird.govt.nz with "BEPS – Interest limitation rules" in the subject line.

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[1] Loans between a foreign subsidiary and domestic parent are not common but are possible. For example, the recent *Chevron* case in Australia was about such a loan.

1.16 Alternatively, submissions may be addressed to:

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

1.17 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

1.18 In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document with key interested parties.

CHAPTER 2

New Zealand's approach

New Zealand's inbound investment framework

2.1 New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment. FDI can also bring ancillary benefits to New Zealand, such as new technology and management practices. As such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

2.2 At the same time, it is important that firms operating here pay a fair amount of tax. Base protection measures, such as interest limitation and transfer pricing rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment.

2.3 As noted in New Zealand's inbound investment framework,[2] the amount of tax payable to New Zealand on an investment is substantially affected by the choice of how it is funded. Investments funded with equity are subject to full taxation at 28%. In contrast, since interest paid on debt-funded investment is deductible, the New Zealand tax paid on debt is generally limited to non-resident withholding tax (NRWT) on the interest payments (at either 10% or 15%).

2.4 However, an important factor in determining the tax impost on FDI is how the foreign investor is taxed in their home jurisdiction. This is illustrated in the framework document with a hypothetical decrease in the thin capitalisation safe harbour to 50 per cent.

2.5 For some investors, this would decrease the attractiveness of New Zealand as an investment destination while for other investors it would have no impact.[3] As discussed by the Tax Working Group,[4] choosing the thin capitalisation safe harbour threshold involves trade-offs between the potential effect on the desirability of New Zealand as an investment location and the benefits to New Zealand arising from having taxes paid in New Zealand.

2.6 This discussion document does not propose a change to the thin capitalisation safe harbour. It does, however, suggest some changes that will reduce the ability for some foreign-owned firms to take interest deductions. This involves similar trade-offs to those discussed above.

2.7 The analysis of thin capitalisation rules in the inbound investment framework applies only if a firm borrows at a reasonable interest rate – at the very least, the marginal cost of debt should be no more than the marginal return from

[2] The draft framework is available at http://taxpolicy.ird.govt.nz/publications/2016-other-nz-framework-inbound-investment/overview

[3] An investor who is tax exempt on interest income would face a lower effective tax rate on a New Zealand investment if they took advantage of the lower safe harbour. In contrast, an investor who is taxed at 28% or more on interest income would likely be indifferent to the change: increasing the gearing of their New Zealand investment would not reduce total tax paid (and could actually increase tax paid).

[4] *Debt and equity finance and interest allocation rules* (2009), Background paper for the Tax Working Group.

further investment. If this is not the case, the use of debt will depress tax payments in New Zealand by far more than discussed in the framework.

2.8 With regards to the proposed adjustment for non-debt liabilities discussed in chapter 3, the fundamental question is whether a firm's total assets should be determined on a gross basis or net of non-debt liabilities. The inbound investment framework paper did not consider this matter; it assumed a company's assets would only be funded with debt and equity. As discussed in chapter 4, we consider measuring total assets net of non-debt liabilities is more consistent with the objectives of the thin capitalisation rules, and accordingly propose a change.

2.9 Overall, the Government considers that this package of proposals strikes an appropriate balance between ensuring New Zealand is an attractive place to invest while helping ensure that firms operating here pay a reasonable amount of tax.

Link to the OECD's BEPS Action 4

2.10 Because of the large potential for interest to be used to shift profits internationally, the OECD developed best-practice interest limitation rules as part of the OECD BEPS project (BEPS Action 4).[5]

2.11 There are two broad approaches to the design of an interest limitation rule. One is the approach adopted by New Zealand, which is to limit the amount of tax deductible debt a company can have, usually based on either its level of assets or equity. By restricting debt levels, allowable interest deductions are also restricted, albeit in an indirect manner. The second approach is to directly limit the interest a company can deduct based on some measure of the company's profits (normally either EBIT or EBITDA).[6]

2.12 There are advantages and drawbacks to each approach, which are outlined in the BEPS Action 4 Final Report (September 2015). These include the following:

[5] *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (2015), OECD.

[6] *Earnings before interest and tax*, and *earnings before interest, tax, depreciation and amortisation*, respectively.

Interest limitation rule comparisons

	Rule based on the level of debt relative to assets	Rule based on the level of interest expense relative to earnings
	Advantages	***Disadvantages***
1	The level of debt is more stable than profitability and is more within the control of management.	The amount of interest expense may vary due to interest rate changes that are outside the control of management.
2	An assets-based approach is typically stable and predictable.	Measuring economic activity using earnings, which might be relatively volatile, means it is hard to anticipate the level of interest expense that will be permitted from year to year. [7]
3	There is no need to have specific provisions to deal with the effect of losses.	Entities and groups with negative earnings (losses) require specific rules.
	Disadvantages	***Advantages***
1	BEPS risks will not be addressed where an excessive rate of interest is applied to a loan.	This rule is much less vulnerable to excessive rates of interest.
2	An assets-based approach requires a consistent and acceptable model for valuing each class of assets.	Concerns over the recognition and valuation of assets is less of an issue.
3	The level of debt may vary throughout a period, so debt on a particular date may not be representative of an entity's true position.	The level of interest expense in an entity will reflect all changes in borrowings throughout the period.

2.13 The OECD acknowledged that fixed ratio rules are blunt tools which do not take into account the fact that groups operating in different sectors may require different amounts of leverage. However, it encourages countries to make their rules robust and effective. To avoid double taxation for groups leveraged above the fixed ratio level, countries are encouraged to combine a fixed ratio rule with a group ratio rule, as New Zealand has already done within its current interest limitation rules.

2.14 The OECD concluded that the advantages of a profit-based interest restriction outweighed the drawbacks. The best-practice rule it developed involves restricting interest deductions to between 10–30 per cent of a company's EBITDA. However, the OECD outlined a number of issues that should be considered in designing a profit-based approach, including:

- Whether to base earnings on EBITDA or EBIT.
- Whether to adopt a worldwide group ratio rule.
- Whether to apply a *de minimis* to remove entities which pose the lowest risk from the scope of an interest limitation rule.

[7] Based on responses to Inland Revenue's International Questionnaires, 54 groups had net finance costs greater than 30 per cent of EBITDA in the 2014 financial year; of these, only 23 (43%) had net finance costs greater than 30 per cent of EBITDA in the 2015 financial year. The variation was more extreme for groups with net finance costs and negative EBITDA; 20 groups had negative / nil EBITDA in the 2014 financial year; whilst the total number was similar in the 2015 financial year, only five (11%) had negative / nil EBITDA in both years.

- Whether to address volatility concerns, for example by carrying forward or backwards disallowed interest and/or unused interest capacity, or by averaging EBITDA over a three-year period.
- Whether an entity in a loss-making position is able to deduct its net interest expense in the current period, or whether alternative mechanisms will be used to limit interest deductions when profits are negative.

2.15 The final report from the OECD did note that there are other effective methods to address profit shifting through interest – including a well-designed rule based on a company's level of debt.

2.16 This discussion document does not consider the issue of whether New Zealand should change to an EBITDA-based rule. No decision on this has been taken at this stage. The purpose of this discussion document is to explore whether there are some rules that could address some of the disadvantages of an asset based rule outlined in the table above.

2.17 This is because, overall, we consider that our current approach to limiting interest deductions is working well. Accordingly it seems preferable to put forward specific proposals that seek to address some of the problems we are currently seeing in our rules without abandoning this general framework.

2.18 In particular, we consider an asset-based thin capitalisation regime must be bolstered by rules to restrict the ability of taxpayers to use excessive interest rates for related-party loans. A proposed rule to prevent this is discussed in chapter 3. We also consider that our rules will be more robust and effective if there is a change to how total assets are determined. A proposed rule to achieve this is discussed in chapter 4.

2.19 If it is not possible to address the problems in our rules, we acknowledge that an alternative approach would be to use an EBITDA based rule, as suggested by the OECD. We welcome submissions on which approach is preferable.

CHAPTER 3

Limiting the interest rate on related-party loans

3.1 This chapter discusses a proposal to limit the interest rate on cross-border related-party loans. While in principle transfer pricing should limit the interest rate on such loans, we are concerned that the rules are not always effective. Their application is also resource intensive for both Inland Revenue and taxpayers.

3.2 Under the proposal, the thin capitalisation rules will limit the deductible interest rate on related-party loans based on objective and readily observable factors, such as the credit rating of the borrower's ultimate parent.

Background

3.3 New Zealand's thin capitalisation rules limit the amount of deductible debt a company can have, rather than directly limiting interest deductions. In order 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.

3.4 Historically this limitation has been achieved through transfer pricing. However, we are concerned that this approach has not been wholly effective.

3.5 The transfer pricing rules require taxpayers to adjust the price of cross-border related party transactions so it aligns with the arm's length price that would be paid by a third party on a comparable transaction. The arm's length interest rate on a debt is affected by a number of factors, including its term, level of subordination, whether any security is offered, and the credit rating of the borrower.

3.6 As discussed in the discussion document *BEPS – Transfer pricing and permanent establishment avoidance*, the Government is proposing to update and strengthen New Zealand's transfer pricing rules including adopting economic substance and reconstruction provisions similar to Australia's rules. The proposed transfer pricing rules would disregard legal form if it does not align with the actual economic substance of the transaction. They would also allow transactions to be reconstructed or disregarded if such arrangements would not be entered into by third parties operating at arm's length.

3.7 Even with these stronger transfer pricing rules, we are not convinced that transfer pricing will be the most effective way to prevent profit-shifting using high-priced related party debt.

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

3.9 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 – for example, if the value of the interest deduction is higher than the tax cost on the resulting interest income.

3.10 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 related-party debt or equity.

3.11 Some related-party loans feature unnecessary and uncommercial terms (such as being repayable on demand or having extremely long terms) that are used to justify a high interest rate. Simply making the related party debt subordinated or subject to optionality may also be used as justifications for a higher interest rate. In other cases, a very high level of related party debt may be loaded into a New Zealand subsidiary to depress the subsidiary's credit rating, which also is used to justify a higher interest rate.

3.12 It can be difficult to challenge such arrangements under the transfer pricing rules as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and a similarly high interest rate. With the proposed 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 the arrangement. These new requirements should limit the use of artificial or commercially irrational funding arrangements. However, we are concerned that they may still provide scope for taxpayers to choose to borrow from related parties using higher-priced forms of debt than they would typically choose when borrowing from third parties.

3.13 In addition, the highly factual 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 conducted. 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.

3.14 For these reasons we consider an objective and certain rule such as an interest rate cap is a better option for ensuring the pricing of debt is reasonable.

3.15 We note that we are 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.[8] This was one of the reasons behind the OECD favouring the EBITDA approach to limit interest deductions.

3.16 Nevertheless, as discussed above, we consider it preferable to attempt to directly limit interest rates on related-party debts. If this is not possible or effective, we may need to consider other possible changes including an EBITDA-based rule.

Proposal

3.17 We propose amending the thin capitalisation rules to limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower. We consider that such a cap is the best approach to ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would agree to with a third-party lender. We consider that such a rule would also reduce or eliminate costly disputes over what an appropriate interest rate is under standard transfer pricing.

3.18 Our proposed design of a cap is set out below, but we welcome submissions on alternative approaches.

3.19 No cap would apply to loans from third parties.[9]

Rejected approach: hard interest rate cap

3.20 One approach would be to set a hard cap – either limiting deductible interest rates to some absolute number or limiting them based on yields on corporate bonds at a certain credit rating. This approach has the advantage of clarity and simplicity, but it has numerous drawbacks.

3.21 It would not align well with the objective above of ensuring that the interest-rate on related-party debt is roughly in line with the interest rate the borrower would agree to with a third-party lender. In some cases the cap would be higher than what a taxpayer would have been willing to pay – so would either be ineffective or permit higher interest rates (if the interest rate cap operated as a safe harbour). In other cases the cap would be too low – because of a firm's particular circumstances, it might be willing to borrow from third-parties at very high interest rates.

3.22 A hard cap would also not be well targeted. While, at first blush, a hard cap may appear to target only firms who have most egregiously structured their related-party loans to get the highest possible interest rates, this is not necessarily the case. The interest rate that a borrower would accept on a third-party loan is a question of fact and circumstance (such as the borrower's industry, current interest rates, and general economic conditions). A hard cap is not able to take these factors into account.

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[8] *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (2015), OECD.
[9] Provided the third-party loan was not part of a back-to-back arrangement.

Preferred approach: cap based on parent credit rating

3.23 We consider a better approach to an interest rate cap is, wherever possible, to base the cap on the interest rate that the borrower's ultimate parent[10] could borrow at on standard terms. That is, to set the maximum deductible interest rate on a loan from a non-resident to a New Zealand resident to:

- where the ultimate parent of the borrower has a credit rating for senior unsecured debt, the yield derived from appropriate[11] senior unsecured corporate bonds for that credit rating, plus a margin.
- where the ultimate parent has no credit rating, the interest rate that would apply if the parent raised senior unsecured debt on standard terms, plus a margin.
- where there is no ultimate parent, the interest rate that would apply if the New Zealand group raised senior unsecured debt on standard terms (with no margin).

3.24 We consider that the interest rate that a multinational could obtain when raising senior unsecured debt (either determined with reference to its credit rating, or calculated based on other factors) is a reasonable approximation of the multinational's cost of funds.

3.25 This proposed rule would therefore anchor the deductible interest rate on intra-group debt to a multinational's actual cost of debt. We consider this reasonable. For example, one funding option available to a multinational would be to raise third-party debt and on-lend the debt to its New Zealand subsidiary. We consider it unlikely that the multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational's cost of debt, since this would lower its overall profits.

3.26 More detail of how this proposed rule would work is set out below.

Appropriate margin

3.27 When the New Zealand borrower has an identifiable parent, we have proposed that some margin be added. The margin ensures, for example, that the rule does not apply in relation to a loan where there are only small differences between a multinational's cost of funds and the interest rate on that loan.

3.28 This is similar to the approach taken in the thin capitalisation rules with the worldwide group debt test. The maximum amount of deductible interest is based on the debt to asset ratio of the worldwide group, plus a 10 per cent margin.

[10] Where the ultimate parent is a holding company and the main operating entity in the group has a higher credit rating, the operating entity's credit rating would be used.

[11] For example, the margin on bonds at the same credit rating can vary across industries. A taxpayer should be able to demonstrate that their choice of comparator bonds is appropriate.

3.29 We welcome submissions on what an appropriate margin would be.

3.30 To illustrate, say the allowable margin attributable to the New Zealand subsidiary was limited to that which could be derived from appropriate bond yields one credit rating notch below that of the senior unsecured rating attributable to the ultimate parent. This means if a multinational group had a credit rating for senior unsecured bonds of AA-, the deductible interest rate on an intra-group loan would be based on A+ corporate bond yields.

3.31 The exception to this rule would be if the New Zealand borrower itself has a credit rating. In this case, we propose that the maximum deductible interest rate would be based on the higher of:

- the multinational's credit rating for senior unsecured debt plus the margin; and
- the New Zealand group's credit rating for senior unsecured bonds.[12]

Borrowers with no identifiable parent

3.32 Most firms subject to the thin capitalisation rules are controlled by a single non-resident, making it possible to determine the credit rating (or interest rate on senior unsecured debt) for its ultimate parent. However, this is not possible when a New Zealand firm is controlled by a non-resident owning body. Such a firm has no single parent company.

3.33 In this case, we propose that the appropriate cap for related-party debt is determined based on the rate at which the New Zealand borrower could issue senior unsecured debt. This is because it is not possible to base the cap on the cost of funds of the borrower's parent.

3.34 Similar to when there is an identifiable parent company, we propose that the deductible interest rate be limited to the rate at which the company could raise senior unsecured debt (on standard terms). We believe this is a reasonable requirement as most companies typically raise the majority of their debt on standard senior unsecured terms.

3.35 In addition, this rule ensures that unusual features added to related-party debts (such as convertibility into shares) cannot be used to justify high interest rates.

3.36 However, the proposal to price debt as if it is senior unsecured debt does not prevent a firm's owners loading it with uncommerical levels of debt, pushing down its credit worthiness and therefore increasing the allowable interest rate on related-party debt. We consider that there are two options for addressing this concern:

[12] If the New Zealand group had a credit rating for another type of bonds, this would be used to calculate a rating for senior unsecured bonds for the purposes of this rule.

- determine the borrower's credit worthiness based on an arm's length amount of debt, as determined under transfer pricing (this is the approach taken in Australia);[13] or
- deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

3.37 This first approach is likely to result in higher interest rates, but is more uncertain and would result in higher compliance costs: the borrower would need to be able to justify the quantum of debt and this could be subject to challenge by Inland Revenue (for the purpose of determining the appropriate interest rate). We welcome submissions on this point.

International comparison

3.38 We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules. However, many countries are instead adopting an EBIT or EBITDA based interest-limitation rule, in part because of concerns over the difficulty of pricing related-party debt appropriately through transfer pricing.

3.39 As discussed in the introduction, we consider that our proposed approach – implementing a regime to limit the interest rates on related-party debt – to be preferable to adopting an EBIT/EBITDA based rule.

Further detail

Interest rate cap

3.40 Interest rates on corporate debt can either be fixed for a period or floating (i.e. calculated using a benchmark index, such as the interest rate swap curve, plus a fixed margin).

3.41 With fixed interest loans, the interest rate cap would be determined on and apply from the day the interest rate on the loan is struck (or seven days prior to the date on which the funds are committed, if the interest rate on the loan is struck more than seven days from the commitment date).[14] Subsequent movements in bond yields would have no bearing on the allowable interest rate.

[13] As in Australia, the overall level of deductible debt would continue to be determined under the thin capitalisation rules. Transfer pricing would be used to determine the level of debt solely for calculating the borrower's credit worthiness.

[14] This is to prevent gaming of the rule in situations where interest rates are viewed as likely to decrease, by striking an interest rate well before funds are committed.

Example 1

A New Zealand company is borrowing from its foreign parent in NZD at a fixed interest rate. The parent's credit rating for senior unsecured bonds is BBB+. With a one notch margin this means the maximum deductible interest rate on the loan would be based on appropriate BBB bond yields.

Say the interest rates on BBB bond yields (swapped into NZD) at the time the related party loan was arranged were:

1 year:	2%
2 years:	3%
3 years:	4%
5 years:	5%

The interest rate on a NZD-denominated related-party loan will be restricted to no more than the above rates. So, a loan with a one year term will be restricted to a 2% interest rate, while a loan with a five year term will be restricted to a 5% interest rate.

Subsequent movements in bond yields will not affect this maximum interest rate.

3.42 For floating-rate debt, the cap would apply to the fixed margin over the benchmark index, again on the day the fixed margin is struck and by reference to appropriate bonds trading at that time. The loan's margin would be compared to the difference between the rate on the relevant credit curve and the rate on the relevant interest rate swap curve corresponding to the committed term of the loan. If the loan's margin exceeded this difference, the excess would be non-deductible.

Example 2

Say the company above decides instead to borrow in NZD at a floating interest rate with a term of five years.

When the loan was entered into, the USD interest swap rate for five years was 1% and five year US corporate BBB bond yields were 3%. The maximum margin on the loan, for the life of the loan, would therefore be 2%.

Since the loan is in NZD and has a floating interest rate, an appropriate benchmark index would be a NZD floating interest rate.[15] Say when the loan was entered into, the NZD floating interest rate benchmark rate was 2%. This means that, when the loan was first entered into, the maximum deductible interest rate would be approximately 4% (2% floating interest rate benchmark index plus the 2% margin).[16]

Subsequent movements in the floating interest rate benchmark index would result in a higher or lower, as the case may be, maximum deductible interest rate. Say six months after the loan was entered into, the floating interest rate benchmark index increases to 3.5%. The maximum allowable interest rate on the loan would therefore be approximately 5.5% (3.5% benchmark index plus 2% margin).

[15] For example, the New Zealand three-month bank bill rate.

[16] This example is simplified. A 2% margin in USD does not equate to exactly a 2% margin in NZD due to financial market practice – for example, incorporating a basis swap.

Meaning of "related-party"

3.43 For the purposes of this rule, we propose that a loan be treated as being from a related-party if it originates from a member of the firm's worldwide group, a member of a non-resident owning body, or an associated person of the group or body.

Treatment of guarantee fees

3.44 When the New Zealand subsidiary of a multinational borrows from a third party, that loan is sometimes guaranteed by the multinational group. In some situations, the New Zealand subsidiary a fee is charged for this – known as a guarantee fee.

3.45 Guarantee fees are calculated based on the difference in credit worthiness of the multinational group and the New Zealand subsidiary. Under our proposal, the maximum deductible interest rate on a related-party loan is based on the credit worthiness of the multinational group, plus a margin. For consistency, we propose that guarantee fees be limited to the margin allowable under the interest rate cap. Otherwise there is a risk that the total cost of debt to the New Zealand subsidiary (third-party interest rate plus guarantee fee) could be significantly higher than the actual cost of debt facing the multinational.

De minimis

3.46 Applying this interest rate cap will likely require the engagement of financial analysts or other subject matter experts, who have access to bond yield data and are able to perform the required calculations. This is no different to the situation at present – firms borrowing from related-parties should be involving subject matter experts to perform comparability analysis and ensure that the interest rate (and the other terms and conditions) of the related-party loan is reasonable.

3.47 We therefore believe this proposal will not result in increased compliance costs; indeed, compliance costs may reduce in some instances.

3.48 However, consistent with current administrative practice to reduce compliance costs for smaller firms,[17] we propose a de minimis for groups where the principal of all cross-border related-party loans is less than NZ$10m. We propose that, for these firms, ordinary transfer pricing rules will apply. This will allow Inland Revenue's approach to low value cross-border loans to continue, where a specified margin (currently 250 basis points) above the benchmark rate is allowable.

Link to transfer pricing

3.49 We propose that this rule will override the general transfer pricing rules, except as provided for in paragraphs 3.36 and 3.48. This means that related-party loans that are subject to the interest rate cap would not also be subject to adjustment under transfer pricing.

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[17] http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html

3.50 We propose that all other tax rules would continue to apply as normal. For example, the general anti-avoidance rule (or other anti-avoidance rule) could apply to an arrangement, even if its deductible interest rate has been adjusted under these rules.

Anti-abuse rule

3.51 When market interest rates or borrowing margins increase, taxpayers have an incentive to reset the interest rate on related-party loans, as this increases the deductions available in New Zealand. For example, say a taxpayer has a loan from its foreign parent at 4% with a maturity of 1 April 2020. Say market interest rates increase, such that a new loan with a maturity of 1 April 2020 would have an interest rate of 7%. The taxpayer may have an incentive to break the current loan early and enter into a new loan to take advantage of the now higher interest rate and thus increase New Zealand deductions.

3.52 We are not proposing a specific rule to prevent taxpayers from breaking loans to take advantage of increasing interest rates or borrowing margins. However, such an arrangement would defeat the intention of our proposals. We anticipate that the general anti-avoidance rules could apply to such an arrangement.

Maximum loan term

3.53 It is unusual for a commercial loan to be committed for longer than five years. Most banks are reluctant to commit to funding for a longer period than this. Accordingly, for the purposes of this rule, we propose that a related-party loan with a term of longer than five years will be treated as having a term of five years for the purpose of determining the appropriate interest rate.

Transitional rules

3.54 We do not propose any special transitional rule. This means that, once these rules take effect, related-party cross-border financing arrangements currently under foot will be subject to the interest rate cap.

3.55 Prevailing interest rates change over the economic cycle – current interest rates and floating-rate margins may be higher or lower than when a loan was first entered into. The maximum interest rate should therefore be calculated based on historic interest rate data for the day on which the interest rate was struck.

Consistency with New Zealand's DTAs

3.56 We believe that our proposed interest rate cap is consistent with New Zealand's double tax agreements (DTAs), including the articles of our DTAs relating to the arm's length principle. This is for three reasons.

3.57 The interest rate cap proposed is consistent with our existing thin capitalisation rules, in that it denies deductions by reference to a group formula (debt to asset ratios) rather than by reference to arm's length amounts. The Commentary to the Model Tax Convention states that thin capitalisation regimes are consistent with the arm's length principle insofar as their effect is to assimilate the overall profits of the borrower with those which would have accrued in arm's length situations. This is on the basis that, while a thin capitalisation regime does not expressly refer to arm's length amounts, it aims to approximate a similar overall level of interest expense for a taxpayer as would arise in arm's length situations.

3.58 Our current thin capitalisation regime achieves this by allowing the taxpayer to borrow up to 110 per cent of the debt to asset ratio of its worldwide group instead of the safe harbour in determining the maximum amount of debt in respect of which interest can be deducted. Similarly, the proposed interest rate cap sets the maximum rate at which interest can be deducted by reference to the rate at which the taxpayer's worldwide group can borrow from independent lenders (that is, the parent's credit rating). In this regard, we note that independent lenders take the credit rating of the group into account when determining the interest rate payable by a New Zealand subsidiary, even without an explicit parent guarantee. Therefore, the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Consequently it should also be consistent with the arm's length principle.

3.59 Second, both the Commentary to the Model Tax Convention and the BEPS Action 6 Report state that, as a general rule, there will be no conflict between domestic anti-avoidance provisions and a DTA. To the extent that it can be seen as going beyond a strict application of the arm's length principle, the interest rate cap is a domestic anti-avoidance provision intended to stop profits being shifted out of New Zealand through the use of excessive interest payments between related parties. Related enterprises can adjust the legal terms of loans in order to impose higher interest rates, even though those terms do not have economic consequences on a group basis. This means that any departure from the overall profits that would result from application of the arm's length principle is necessary to address the tax avoidance concerns arising from excessive interest payments (as noted by the OECD in its report on BEPS Action 4). Therefore the interest rate cap is consistent with our DTAs as a domestic anti-avoidance rule to the extent it does not produce an arm's length amount of interest expense for the borrower.

3.60 Finally, the OECD specifically recommends countries adopt an interest limitation rule in its Report on BEPS Action 4. While the OECD recommends an earnings-based rule (such as one based on EBITDA) rather than an asset-based rule with an interest rate cap, one of the reasons the OECD favoured the approach is because it largely neutralises the effect of highly priced debt. However, as discussed above, we consider that our proposed approach of maintaining an asset-based rule combined with an interest rate cap is a better course of action. Like an EBITDA-based rule, it largely neutralises highly priced debt, but in a more consistent and predictable manner. On this basis we consider that our proposed thin capitalisation regime coupled with the interest rate cap is consistent with international practice and the OECD's recommendations.

CHAPTER 4

Treatment of non-debt liabilities

4.1 This chapter proposes a change to how total assets are determined under the thin capitalisation rules. Currently the thin capitalisation rules are based on a firm's gross assets; however, we consider that a better measure would be a firm's assets net of its non-debt liabilities.

4.2 We consider that requiring this adjustment for non-debt liabilities would be more consistent with the core objectives of the thin capitalisation rules.

Background

4.3 New Zealand's thin capitalisation rules are based on a company's debt to asset percentage. A company's assets are, in most cases, the value of its assets disclosed in its financial accounts. In contrast, a company's debts for thin capitalisation purposes are much narrower than its liabilities for accounting.

4.4 Debt in the thin capitalisation rules is limited to *financial arrangements* that *provide money* and that *give rise to deductions* under the financial arrangement rules.

4.5 The remaining liabilities on a company's balance sheet (its *non-debt* liabilities) do not count as debt for thin capitalisation purposes. Examples of non-debt liabilities are trade credits, provisions, out-of-the-money derivatives and interest free loans.

Example 3

ABC Co has the following balance sheet:

Assets	100
Debt	60
Shareholder capital	40

ABC Co's current thin capitalisation ratio is 60 per cent – reflecting that its assets are 60 per cent funded with debt and 40 per cent funded with equity.

Say ABC Co makes an after-tax profit of $50. Its balance sheet then becomes:

Assets	150
Debt	60
Retained earnings	50
Shareholder capital	40

ABC Co's thin capitalisation ratio falls to 40 per cent, reflecting its higher level of assets and equity. ABC Co could pay out a dividend of up to $50 without breaching the thin capitalisation safe harbour. Say instead ABC Co makes an after-tax loss of $25. Its balance sheet would become:

Assets	75
Debt	60
Retained earnings	(25)
Shareholder capital	40

ABC Co's thin capitalisation ratio would increase to 80 per cent. It would have to pay down some of its debt, inject more equity, or face interest denial on some of its debt.

The problem

4.6 We are concerned that this treatment of non-debt liabilities is inconsistent with the core objectives of the thin capitalisation rules. At present the rules limit an entity's debt relative to its gross assets. However, we consider that a better basis for the rules is to limit debts with reference to its assets net of its non-debt liabilities (its net assets) – which is the same as its equity plus its interest-bearing debt.

4.7 The thin capitalisation rules have three interrelated objectives:

- to restrict companies' interest deductions to interest on only a commercial level of debt;
- to ensure that only a reasonable portion of a multinational's worldwide debt is allocated to New Zealand; and
- to restrict the ability for companies to shift profits out of New Zealand using interest.

4.8 These three factors all suggest that net assets, rather than gross assets, would be a better basis for the rules.[18]

Commercial debt levels

4.9 The thin capitalisation rules are intended to, in part, restrict the level of deductible debt to the amount a third-party would lend to an entity on reasonable terms (that is, a commercial level of debt).

4.10 In reality, third-party lenders consider numerous factors when considering how much to lend. However, the nature of thin capitalisation rules means only a single factor can be considered: the value of an entity's assets.

4.11 We consider that third-party lenders would be more concerned with an entity's net assets than its gross assets. The presence of non-debt liabilities reduces the assets the company may have available to repay its debt. The

[18] The exception to this is interest-free loans from a parent or other associated person as they are in substance equity.

existence of non-debt liabilities may also impact on a borrower's solvency and therefore whether it can continue to trade.

4.12 Measuring a company's assets net of non-debt liabilities seems more consistent with the objective of ensuring commercial levels of debt.

Worldwide apportionment

4.13 Multinational companies often borrow from external parties through a central treasury function. The central treasury then on-lends funds as needed across the multinational's operations.

4.14 The purpose of the worldwide test in New Zealand's thin capitalisation rules is to ensure that the amount of debt that has been on-lent to New Zealand is a reasonable portion of the multinational's total debt, having regard to the relative size of its New Zealand operation. Interest deductions are denied if it appears too much debt has been placed in New Zealand.

4.15 The treatment of non-debt liabilities is relevant when considering the relative size of a multinational's New Zealand operation. Again, we consider that the best approach is based on net assets. This is because, as discussed above, we consider net assets to be a better measure of a company's commercial borrowing ability than gross assets. It is therefore a better measure of how the multinational's total debt should be spread across all its operations.

Restrict profit shifting

4.16 The final objective of the thin capitalisation rules is to prevent companies from shifting profits out of New Zealand through excessive interest deductions.

4.17 An increase in a company's non-debt liabilities with no change in its debt liabilities will also bring about an increase in its assets or a reduction in its equity. If equity is reduced, this means that the company's shareholders' investment in the company has decreased. However, at present this decrease has no impact on the allowable level of debt under the thin capitalisation rules.

4.18 Alternatively, if assets increase, the level of allowable debt increases even though the shareholders have not increased their investment in the company.

4.19 We are therefore concerned that the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company by shareholders.

4.20 We are also concerned that this treatment does not produce equal outcomes across companies. As illustrated below, firms earning the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities. In addition, some companies naturally have high levels of non-debt liabilities, such as distributors that generally have large trade payable balances. The current treatment of such liabilities under the thin capitalisation rules means a much smaller percentage of the company's assets need to be funded with shareholder equity compared to a company with no non-debt liabilities.

Example 4

Mining Company has the following balance sheet:

Assets	100
Interest bearing debt	60
Shareholder capital	40

Mining Company opens a mine and earns $100 after tax; however, in the future Mining Company will be required to close the mine at a cost of $50 (which it records as a provision in its accounts). Its profit is the*r*efore $50, and its balance sheet will be:

Assets	200
Interest bearing debt	60
Non-debt liability – provisions	50
Shareholder capital	40
Retained earnings	50

Mining Company has made $50 profit and so is $50 more valuable. However, at present the thin capitalisation rules treat the company as if its value has increased by the full $100 cash it has earned, so its thin capitalisation ratio falls to 30 per cent (= 60/200). The company would be able to distribute its $100 of earnings without breaching the safe harbour (that is, pay out its $50 profit plus reduce shareholder capital to -10).

This is in contrast to ABC Co in Example 3, which also made $50 after-tax profit. However, in that case ABC Co was only able to distribute its actual profit of $50 before breaching the thin capitalisation safe harbour. The treatment of non-debt liabilities is not neutral across firms.

If instead the thin capitalisation rules were based on net assets, Mining Company's thin capitalisation would have fallen only to 40 per cent (= 60/(200 – 50)). Accordingly, the company would only be able to distribute its actual profit of $50 without breaching the thin capitalisation safe harbour.

Example 5

Instead, say Mining Co had opened a mine and earned $25 after tax. As above, however, it would be required to close the mine at a cost of $50 in the future.

Mining Co would have an after-tax loss of $25. However, this is not captured in the current rules. Mining Co's thin capitalisation ratio would fall to 48 per cent (= 60/125). It would be able to distribute its $25 of earnings (effectively withdrawing $25 of shareholder capital) without breaching the safe harbour.

This is in contrast to ABC Co in example 4, which also made a loss of $25. However, in that case ABC Co's thin capitalisation ratio *increased* to 80 per cent. It would have had to repay some of its debt, received an equity injection, or would face interest denial on some of its debt.

Example 6

Say Distributor Co has the following balance sheet:

Cash	30
Other assets	70
Interest bearing debt	60
Retained earnings	30
Shareholder capital	10

Distributor Co's thin capitalisation ratio is 60 per cent.

Distributor Co then acquires $30 of trading stock, which it purchases on trade credit. At the same time, Distributor Co pays out its retained earnings. Its balance sheet is now:

Cash	0
Other assets	100
Interest bearing debt	60
Non-debt liability – trade credits	30
Retained earnings	0
Shareholder capital	10

Under current rules Distributor Co's thin capitalisation ratio is still 60 per cent, even though its owners have withdrawn $30 of their capital from the company.

If, however, the thin capitalisation rules were based on net assets, Distributor Co's thin capitalisation ratio would increase to 86 per cent (= 60/(100 – 30)).

Proposal: non-debt liability adjustment

4.21 We propose that a company will be required to measure its assets net of its non-debt liabilities.

4.22 For a company's New Zealand group, we propose defining non-debt liabilities as:

- all liabilities (as shown in the company's financial accounts) that are not counted as debt under section FE 15; *less*
- any interest-free loans from a shareholder in the group, or person associated with a shareholder, as such a loan is more akin to equity.

4.23 We propose a similar definition of non-debt liabilities for a company's worldwide group, being:

- all liabilities (as shown in the company's financial accounts) that are not counted as debt under section FE 18; *less*
- any debt that is excluded from being counted under section FE 18(3B), as such debt is effectively treated as equity for the purposes of the worldwide group debt test.

Example 7

Z Co's balance sheet is as follows:

Assets	100
Interest-bearing debt	20
Non-debt liability – trade credits	10
Interest free loan from parent	20
Equity	50

Under the proposed change, Z Co's thin capitalisation ratio would be 22 per cent.

Its debt for the purposes of 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. Its non-debt liabilities are therefore $10 and its thin capitalisation calculation is 20/(100 – 10).

International comparison

4.24 Like New Zealand, Australia has thin capitalisation rules that limit a company's deductible debt based on a debt to asset test. However, unlike in New Zealand, Australia requires assets to be measured net of non-debt liabilities.

4.25 Indeed, New Zealand's approach to basing a thin capitalisation rule on gross assets, rather than net assets or equity (which are equivalent),[19] appears to be unique. A recent study by the IMF[20] looked at 28 countries with thin capitalisation rules. It shows that, apart from New Zealand, all countries base their rules off either net assets or equity.

4.26 This reinforces our view that the proposed adjustment for non-debt liabilities is appropriate.

Impact of the proposals

4.27 We do not expect this change to affect most companies, who either have low levels of non-debt liabilities, low thin capitalisation ratios, or both. However, we expect that as a result of this proposal, a small number of companies will face interest denial without a reduction in the level of debt, or injection of new equity.

4.28 As discussed in chapter 5, we do not propose to grandparent existing arrangements. As with previous changes to the thin capitalisation rules, we consider that the delayed application of these proposals will give companies sufficient time to rearrange their affairs as required.

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[19] Assets = debts + non-debt liabilities + equity, or A = D + NDL + E. This means that if a country has a D/E limit of 1.5, this is the same as requiring equity to be at least (A-NDL)/2.5. This is equivalent to limiting debt to 60 per cent of A-NDL.

[20] Blouin, J, Huizinga, H, Laeven, L, and Nicodeme, G, *Thin Capitalisation Rules and Multinational Firm Capital Structure*, IMF Working Paper WP/14/12.

4.29 As noted above, certain types of companies – such as distributorships, mining companies, and insurance companies, tend to have relatively large non-debt liability levels. We have considered whether specific rules are required for any industry but have concluded they are not necessary. We note that Australia does not have special rules for these industries.

CHAPTER 5

Other matters

5.1 This chapter discusses five additional proposed changes to our thin capitalisation rules. They are:

- a de minimis for the inbound thin capitalisation rules
- a special rule for infrastructure projects that are controlled by a single non-resident
- reducing the ability for companies owned by a group of non-residents to use related-party debt
- removing the ability to use asset valuations for the thin capitalisation rules that differ from those reported in a firm's financial accounts
- removing the ability to measure assets and debts on the final day of a firm's income year; and
- a minor remedial relating to the changes made in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014

5.2 This chapter also discusses the application dates for all of the proposals in this paper.

De minimis for the inbound thin capitalisation rules

5.3 Thin capitalisation regimes can be fairly complex. Accordingly, many countries provide an exemption for companies with little interest expense, on the basis that they present a low BEPS risk. The OECD's final report on Action 4 also raises the possibility of a de minimis on this ground.[21]

5.4 New Zealand does not currently have a de minimis in its inbound thin capitalisation rules, but does have one in its outbound rules (of $1 million of interest deductions).[22]

Proposal: De minimis for companies with little interest expense and third-party debt

5.5 We recognise that some type of de minimis is appropriate for companies that pose little BEPS risk. We therefore propose extending the existing de minimis in the outbound rules so that it applies to inbound entities as well, provided none of the entity's debt is *owner-linked debt*.[23] The de minimis would operate exactly as it does for outbound entities (for example, phasing out between $1m and $2m of interest deductions).

[21] OECD 2015, *op. cit*, p. 35.
[22] The de minimis then phases out between $1m and $2m of interest deductions.
[23] Broadly speaking, owner-linked debt is debt from a person with an ownership interest in the entity or debt that is guaranteed by such a person. It is defined in section FE 18(3B).

5.6 Our proposed de minimis is restricted to firms with only third-party debt because firms with owner-linked debt carry a higher BEPS risk compared to firms with only third-party debt. This is because there are no commercial constraints that limit the amount of owner-linked debt an entity can take on.

Infrastructure projects controlled by single non-residents

5.7 The OECD's final report on Action 4[24] discusses an exemption for specific third-party loans, provided on non-recourse terms, used to fund infrastructure projects. This exemption recognises that such funding presents little risk of BEPS.

5.8 New Zealand's rules do not feature such an exemption. Nevertheless, when a New Zealand entity is owned by a group of non-residents (none of which has a controlling interest in their own right), the entity is unrestricted in how much third-party debt it can take on (provided that debt is not guaranteed by its owners). In practice, this operates more or less like the exemption discussed by the OECD.

5.9 In contrast, New Zealand entities controlled by a single non-resident do face restrictions on how much third-party debt they can take on. In general this restriction is well-placed: it prevents multinationals from allocating a disproportionate amount of their worldwide debt in New Zealand.

5.10 However, in some situations – when all of a New Zealand investment's financing is from third-party lenders who are lending on a limited recourse basis, there is limited ability for debt to be over-allocated to the investment because of the limited recourse nature of the loan. In addition, third-party debt provided on limited recourse terms will, by definition, be no more than a commercial level of debt.

5.11 At the same time, we are aware that the worldwide group debt test is not particularly effective in relation to multinationals involved in constructing new assets, such as infrastructure. This is because such projects generally start with high debt levels that reduce over time. However, the worldwide group debt test only allows the New Zealand subsidiary to have slightly more than its average worldwide debt level – which may be insufficiently low for a new project.

Proposal: carve-out for infrastructure projects with third-party funding

5.12 Because of these two factors, we propose adopting the exemption discussed in the OECD's final report. The restrictions to accessing the exemption discussed below are taken from that report. Under this proposal, a firm will be able to exceed the 60 per cent safe harbour if:

- The firm has been established for a project to provide, upgrade, operate and or/maintain assets for at least 10 years, and the assets cannot be disposed of at the discretion of the entity;

[24] OECD 2015, *op. cit*, p. 39.

- The project has been established at the request of the New Zealand Government, a Government department or a local/regional council.
- The loan is not *owner-linked debt*, so that the lender is a third-party and only has recourse to and a charge over the assets and income streams of the specific project;
- The loan or loans made to the entity do not exceed the value or estimated value of the assets once constructed unless additional investment is made to maintain or increase their value. Subject to minimal and incidental lending to a third party (such as a bank deposit), none of the funds should be on-lent.
- The entity, the interest expense, and project assets, and the income arising from the project assets must all arise or be incurred in New Zealand. Where the project assets are held in a permanent establishment, the exclusion applies only to the extent that the income arising from the project is subject to tax in New Zealand.

5.13 If a firm uses this exemption, any debt that does not qualify (such as shareholder loans) would not be deductible. The third-party debt of the firm is a reasonable measure of a commercial level of debt. As such, it does not seem appropriate to allow the firm to claim deductions on any additional debt, since one of the objectives of the thin capitalisation rules is to ensure firms can claim interest deductions on no more than a commercial amount.

5.14 Indeed, since these projects tend to have high levels of third-party debt, allowing additional shareholder debt would mean that shareholders could invest in the firm almost entirely through debt. Say, for example, total allowable debt is 110 per cent of the firm's third-party debt. In this case, if a project was funded with 90 per cent third-party debt, its shareholders could make 90 per cent of their investment by way of debt without facing interest denial (and only 10 per cent through equity).

5.15 This exemption will apply only to entities controlled by a single non-resident. A similar exemption already applies (in effect) where an entity is controlled by a group of non-residents.

5.16 We are interested in submissions on this proposal, such as whether the restrictions above, taken from the OECD's report on interest limitation rules, are reasonable.

5.17 We note that one of the restrictions is that the infrastructure project has been established at the request of the Government or other public body. We are not aware of any projects that would qualify for this exemption other than those established at the request of the Government or other public body – however, we would consider removing the exemption if submitters provide private sector examples where this rule could otherwise apply.

Example 8

Infrastructure Co is building a road that will be worth $100m in New Zealand at the request of the Government.

Infrastructure Co has borrowed $80m from Bank on non-recourse terms to fund the construction of the road. The remaining $20m of funding is from Infrastructure Co's shareholders, who have advanced $15m of equity and $5m of debt.

The loan from Bank Co is not owner-linked debt and is on non-recourse terms, so meets the relevant conditions of this exemption. Infrastructure Co and the road project also meets all the other required conditions.

Infrastructure Co is able to exceed the 60 per cent safe harbour without facing interest denial in relation to its loan from Bank Co. However, the $5m of shareholder debt does not qualify for the exemption. All of the interest on the shareholder debt would not be deductible.

Firms controlled by non-residents acting together: related-party debt

5.18 A firm controlled by a group of non-residents acting together is able to have total debt equal to 110 per cent of its third-party debt.[25] This means, in effect, shareholders of firms with high levels of third-party debt are able to invest in New Zealand predominately through debt. As illustrated in paragraph 5.14, a project funded with 90 per cent third-party debt could have nine per cent shareholder debt and only one per cent equity without breaching thin capitalisation limits.

5.19 Allowing this additional shareholder debt is inconsistent with the objective of ensuring firms can claim deductions only for a commercial level of debt, since the third-party debt of a firm is a reasonable measure of a commercial debt level.

Proposal: restrict the use of related-party debt

5.20 We propose to amend the rules for firms controlled by a group of non-residents acting together. If such a firm exceeds the 60 per cent safe harbour, any *owner-linked debt* will be non-deductible.

5.21 This aligns with the proposal for infrastructure projects with third-party funding discussed above.

5.22 These rules for firms controlled by non-residents acting together have only just come into effect. Companies controlled by a group of non-residents may have recently restructured their borrowing to include some level of related-party debt, on the reasonable expectation that the newly introduced rules would remain unchanged for some time.

[25] Strictly, 110 per cent of its debt that is not *owner-linked debt*.

5.23 As such, we propose that this rule apply only on a prospective basis. Financing arrangements entered into before the application date of the proposals in this document (the first income year after the enactment of the legislation) will not be subject to this rule.

Asset valuations

5.24 In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, under sections FE 16(1)(b) and FE 16(1)(e), a company is able to use the net current value of the assets as an alternative to its financial statement values, or a combination of the financial statement values and net current values, provided that would be allowable under GAAP.

5.25 This valuation method was originally provided as it was considered that valuation methods for financial reporting purposes are likely to have been adopted for non-tax reasons.[26] However, while this may be the case, we consider that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets. It therefore seems appropriate to require the resulting asset valuations to be adopted for thin capitalisation purposes.

5.26 Moreover, asset valuations reported in financial statements are subject to a reasonable level of scrutiny – they will be reviewed by auditors and its directors, as both may face repercussions if the values are found to have been materially misstated. This is not the case with asset valuations adopted solely for thin capitalisation purposes.

Proposal: remove net current valuation method

5.27 We therefore propose to remove the net current valuation method from the list of available asset valuation methods.

Measurement date for assets and liabilities

5.28 Taxpayers currently can choose one of three methods for valuing their assets and liabilities. Taxpayers can use:

- their value on the last day of the taxpayer's income year;
- the average of their values at the end of each quarter of the income year; or
- the average of their value at the end of every day in the income year.

[26] Inland Revenue *Tax Information Bulletin*: Volume Seven, No. 11 (March 1996).

5.29 The first method, valuing assets and liabilities on the last day of the income year, is clearly the simplest approach. However, there is the potential for taxpayers to breach the thin capitalisation debt limits for up to one year without facing any interest denial. Provided a taxpayer repays a loan or converts it to equity on or before its balance date, they can have any amount of debt without facing interest denial. This is one of the problems with an asset based thin capitalisation rule identified by the OECD.

5.30 The thin capitalisation rules do feature a specific anti-abuse rule (section FE 11) that requires temporary changes in asset or liability values to be ignored. However, this section does not apply to one-off events, such as a company borrowing large amounts at the beginning of the year and repaying it all at the end.

Proposal: Allowing only average valuation methods

5.31 We propose to remove the first asset valuation method, so that assets and liabilities can only be valued based on the average values at the end of every quarter or at the end of every day. This would ensure that the rules apply effectively to a loan that was entered into and repaid within a year.

Remedial change: trusts and owner-linked debt

5.32 The 2014 changes to the thin capitalisation rules introduced section FE 18(3B), which sets out the meaning of *owner-linked debt* in the context of both companies and trusts settled by non-residents.

5.33 Paragraph (c) provides that, in order for a financial arrangement to be counted as owner-linked debt, the owner must have ownership interests in a member of the group of companies of five per cent or more. This rule is intended to reduce compliance costs.

5.34 This test makes sense when the New Zealand entity is a company. However, the current legislation does not specify how the rule should work in relation to trusts as settlements on a trust do not convey ownership interests in the trust or entities owned by the trust.

Proposal

5.35 We propose amending section FE 18(3B) to ensure it operates clearly in relation to trusts. That is, in addition to the requirements of FE 18(3B)(a), (b) and (d), in order for a financial arrangement to be counted as owner-linked debt:

- the owner must have a direct ownership interests in a member of the group of five per cent or more; or
- the owner must have made five perccent or more (by value) of the settlements on the trust.

Application date for all proposals

5.36 If these proposals are implemented, we generally propose that they apply from the first income year beginning after enactment of the legislation.

5.37 We expect that most foreign-owned firms will not face interest denial because of these proposals. This is because most foreign-owned firms either have low levels of debt, use only third-party debt, or both.

5.38 That said, some firms will face denial unless the firms change their mix of debt and equity funding. We consider this delayed application should give companies sufficient time to rearrange their affairs, so do not propose any special transitional measures.

5.39 The exception to this approach is the grandparenting of existing arrangements for the firms owned by non-residents acting together discussed in this chapter.