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18 April 2017

Deputy Commissioner (Policy and Strategy)
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policy.webmaster@ird.govt.nz - "BEPS – Interest limitation rules"

Dear Cath

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Yours faithfully

Yours faithfully
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28 April 2017

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Dear Cath

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

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

We would welcome the opportunity to discuss this submission.

Executive Summary

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

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

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

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

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

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

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

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

In summary, our submission is:

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

Current Thin Cap Rules- Inbound investment

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

- New Zealand group debt exceeds 60% of total assets; or
- New Zealand group debt exceeds 110% of the debt percentage of the worldwide group.

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

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

Policy Objective of Inbound Thin Cap Rules

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

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

Proposal

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

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

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

It is proposed:

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

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

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

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

Comment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The policy environment has changed considerably since 1995.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Transfer Pricing Buttressed by Existing Deemed Dividend Rules

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

Safe Harbour Rules

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

Existing thresholds for debt levels

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

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

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

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

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

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

Grandparenting

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

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

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

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

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

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

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

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

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

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

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

Yours faithfully
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