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TP EQuilibrium | AustralAsia LP

A Duff & Phelps Transfer Pricing Alliance Partner

To: Deputy Commissioner of Taxation, Policy and Strategy, New Zealand Inland Revenue

From: Leslie Prescott-Haar, Stefan Sunde / TP EQuilibrium | AustralAsia LP

Subject: BEPS – Interest Limitation Rules

Date: 18 April 2017

TP EQuilibrium | AustralAsia ("TPEQ") has prepared this submission in respect of the New Zealand Government's discussion document, *BEPS – Strengthening our interest limitation rules*, published in March 2017.

TPEQ has prepared these comments on the discussion document specifically from a transfer pricing perspective. In this regard, we have limited our comments to certain proposals contained in Chapter 3 of the discussion document. As such, TPEQ has not commented on all aspects of the various proposals.

We are comfortable discussing these points raised further with Inland Revenue or Treasury officials, as may be requested.

The submission is generally structured in alignment with the structure of the discussion document, unless otherwise indicated.

Overall Comments

Our primary concern is the need to maintain the arm's length standard as a 'base case' for transfer pricing analyses. Any departures from the arm's length approach should be well supported on the grounds of protecting New Zealand's tax base, rather than based on the Inland Revenue's issues encountered in audits. As discussed below, some of the proposed changes require further consideration and explanation as to their necessity and justification as part of the wider Base Erosion and Profit Shifting ("BEPS") project.

In principle, TPEQ supports the proposed symmetry of inbound and outbound approaches, expressed in Para. 1.8. However, given the predominantly inbound nature of financial transactions in New Zealand that would be impacted by the proposed interest rate limitation rules, we acknowledge the inbound context of this discussion, but consider that the symmetrical approach is commercially disadvantageous to New Zealand-based multinationals.

Moreover, the proposed departure from the OECD's thin capitalisation approach under BEPS Action 4 by legislating an interest rate limit will adversely impact the compliance burden for multinationals with New Zealand operations, and arguably is inconsistent with the arm's length principle embedded in New Zealand's DTAs. Our technical view is that the Inland Revenue's position with respect to the arm's length nature of the proposed interest rate cap is inconsistent with seminal international case law (*The Queen v. General Electric Capital Canada Inc., 2010 FCA 344; Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092*). Referencing paras. 3.38 and 3.60, the IRD should clearly articulate why its preferences should outweigh and override the OECD BEPS guidance.

Further justification is needed to support the proposed non-arm's length approach

We are of the overarching view that the interest rate limitation outlined in paras. 3.17 et. seq. reflects a broad rejection of the arm's length principle for financial transactions. While we acknowledge the theoretical compliance and enforcement benefits of this approach to the Inland Revenue, we consider this 'rule making' an attempt to pre-determine or disregard an arm's length outcome. Para. 3.19 suggests an implicit acknowledgement by the Inland Revenue that the proposal does not necessarily reflect the behaviour of independent parties, given the provision would not apply to uncontrolled finance transactions as well. This is arguably discriminatory with regard to inter-company funding within multinationals, and therefore inappropriate from a policy perspective, particularly given the Government's stated commitment to FDI (para. 2.1). In this regard, intercompany funding is commercially cost-effective for multinationals, which is the primary reason these financial transactions arise. Although presented as the opening premise of the proposal (para. 1.1), the use of intercompany debt is not determinative of shifting of taxable profits. Multinationals should not be penalised for seeking to minimise financial costs, and the financial institutions operating in New Zealand should not be commercially advantaged through taxation legislation.

Capping the interest rate may not provide adequate flexibility to accommodate actual facts and circumstances

Further to the above, we are concerned that the interest rate cap is likely to be inflexible in its application. Consider an example where offshore borrowing costs are 5%, New Zealand borrowing costs are 7%, and offshore investment returns are 8%:

- From the borrower's perspective, the intra-group funding cost to the New Zealand borrower should arguably be at least 7%, as this is reflects the conditions that independent New Zealand or offshore parties borrowing in New Zealand would likely face.
- From the lender's perspective, by limiting the inbound interest rate to the New Zealand entity of 5% "plus some margin", the proposal reduces the attractiveness for multinationals to invest their global resources in New Zealand subsidiaries, relative to the offshore investment options. The New Zealand government should not create a framework which could discourage inbound foreign direct investment by multinationals.

Further, we note the real-world possibility that a New Zealand subsidiary may be able to borrow at an interest rate lower than its parent entity. Under the interest rate limitation proposal, the higher cost of funds available to the parent entity would presumably allow the New Zealand entity to enjoy interest rate deductions on a loan from its parent in excess of what is arguably an arm's length amount for the New Zealand borrower. A true arm's length comparison would be simpler.

Determining the "some margin" remains subjective, and 'pegging' the interest rate to a parent's cost of funds appears arbitrary and does not offer significant advantages over a true arm's length approach

Per para. 3.27 et. seq., the "some margin" proposed may reflect a practical approach to accommodate actual facts and circumstances of a particular case. However, determining the appropriate margin will likely be subjective. Imposing, as a starting (and approximate finishing) point, the interest rate at which the ultimate parent could borrow is arbitrary and does not appear to offer any significant advantages with regards to simplicity or objectivity, as compared to a true arm's length approach. Therefore, we suggest the introduction of this rule as a safe harbour only, rather than as a blunt legislative instrument which prevents an arm's length analysis.

Clearly, the additional margin to be adopted should take into account currency differences, market conditions, specific country/company issues, administrative costs of funding, etc. For example, should a New Zealand parent be forced by the Inland Revenue to lend to its USA subsidiary at New Zealand interest rates? Not all countries are equal in global financial markets. Thus, again, a true arm's length approach would be simpler.

Other specific details of the proposals are too rigid

Per para 3.41, there may be circumstances wherein third parties may agree to re-assess the interest rate and/or margin on a given loan, for example to account for changing conditions, mergers, acquisitions, etc. The IRD should account for such flexibility and consider a less rigid approach to the fixed margin / rate rule proposed.

Per para 3.53, the maximum term or tenor should be lifted to 10 years for determining the appropriate interest rate and additional margin. A 10 year tenor is not 'uncommercial' for long term inbound investments and in bond markets.