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QIC

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Commercial in Confidence
Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
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Dear Deputy Commissioner

Submission on the government discussion document - "BEPS - strengthening our interest limitation rules"

QIC Private Capital Pty Limited is a leading investor in the global infrastructure market and manages a 58% interest in Powerco NZ Holdings Limited (PNZHL) on behalf of Australian superannuation funds, Queensland Government entities and other large sophisticated investors. PNZHL is the holding company for Powerco Limited, which is New Zealand's second largest Electricity and Gas Distribution Company. Powerco Ltd owns infrastructure assets that transport electricity and gas to end customers in the residential, agricultural and industrial sectors.

We are writing in relation to the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). We appreciate the opportunity to make a submission on this discussion document.

The key items we raise in our submission are summarised as follows:

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact industries such as regulated infrastructure industries which have traditionally been funded using greater than average gearing given the predictable cash flows generated by their underlying businesses;
- This is exacerbated by the inclusion of deferred tax liabilities in the calculation of the deductible debt limit which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity;
- The interest rate cap is a novel and untested approach which we believe is unnecessary in light of the current and proposed transfer pricing rules and is inconsistent with internationally accepted transfer pricing requirements;
- In our view, the issue being addressed by the proposed interest rate cap is best solved through the application of the current and proposed transfer pricing rules;
- The proposed changes create an unequal playing field between foreign and New Zealand investors, which can have the impact of reducing appetite from foreign investors as well as potentially harming local New Zealand investors who frequently invest alongside foreign investors.
- As a net importer of capital, the proposed changes would increase the average cost of capital in New Zealand, particularly for capital-intensive industries where capital structures would likely

become less efficient, increasing the cost to New Zealand of building the infrastructure necessary to support and grow its economy.

Background

QIC appreciates that New Zealand needs to ensure that all businesses contribute an appropriate level of tax. However, in this context, we note the OECD as part of its BEPS project acknowledges that special rules may be needed for infrastructure businesses given their long-term capital intensive nature and public benefit outcome. The proposals suggested in the discussion document however are likely to result in horizontal inequity between businesses based on the residency of their owners and it will have the greatest impact on long term infrastructure businesses, which typically rely on at least a portion of overseas capital. Further, a series of recent law changes have already significantly reduced the perceived tax benefits that these measures are seeking to curtail.

Treatment of non-debt liabilities - Introduction of an arm's length fall back

The discussion document proposes changes in the current thin capitalisation rules to be based on assets net of non-debt liabilities rather than total assets. We consider the existing 60% gearing ratio to be too low for regulated public benefit infrastructure as external debt can be secured on economic terms in excess of the existing 60% thin capitalisation gearing ratio. The impact of moving to a net asset calculation will reduce this gearing threshold even further.

Measurement date for assets and liabilities

The proposal to require quarterly or daily measurement risks imposing significant and unnecessary compliance costs given that the calculation is based on IFRS accounting values which may not be prepared on a quarterly basis. IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. To require these to be done solely for tax purposes at points in the year when they are not already being done for financial reporting purposes imposes additional and unnecessary compliance costs.

Interest rate cap – use transfer pricing principles instead

The discussion paper suggests a bolster to the asset-based thin capitalisation rules in the form of an interest rate cap. This is a novel and untested approach. We consider that the cap on related party loans adds significant complexity, limits flexibility in raising debt capital, increases horizontal inequity between local and foreign-owned businesses and when combined with the reduced debt to asset ratio, makes New Zealand a uniquely complex thin capitalisation regime in the international community. We expect this would result in a higher cost of capital for New Zealand infrastructure assets, resulting in higher charges to end users and/or cost to Government.

The interest rate cap introduces a high risk of double taxation when dealing with jurisdictions that apply transfer pricing principles. The ability to utilise the mutual agreement process in our double tax treaties (MAP) helps avoid double taxation and supports the integrity of the global tax system. While thin capitalisation adjustments have always been unilateral, managing debt levels within the current safe harbour rules has been relatively straightforward. However, the combined impact of the thin capitalisation rules and the interest rate cap will make it much harder to avoid double taxation where interest is not deductible in New Zealand but assessable in the offshore jurisdiction.

These fundamental concerns can be addressed if the interest rate cap is replaced or supplemented by an arm's length debt pricing test relying on transfer pricing rules.

ALTERNATIVE APPROACHES

Paragraph 2.19 of the discussion paper notes that failure to address the perceived problems with the rules may mean an EBITDA based rule is adopted. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by the discussion paper, there are also a number of problems with the EBITDA approach and as noted above, the OECD recognises that public benefit infrastructure has special characteristics that might mean an exemption from the EBITDA test is appropriate.

In the discussion document "New Zealand's taxation framework for inbound investment" (June 2016), it is noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish". In our view, the imposition of an EBITDA based rule without an exemption for public benefit infrastructure would be at odds with this priority.

Further, in that discussion document the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to income tax...minimising the potential for base erosion by [related party interest] payments" . The OECD 2016 update emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules (which focused on closing a perceived gap in taxation of related party lending) negates the need for New Zealand to consider an EBITDA approach.

We submit that following a series of recent amendments to the deductibility of interest on shareholder loans, the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well supported by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

IMPLEMENTATION CONCERNS

We note that a common theme of recent law changes affecting interest deductions is the New Zealand Government's focus on reducing the use of loans from equity investors. We wish to make Treasury aware that where we have considered proposals to reduce loans from equity investors in response to the law changes, a number of New Zealand tax provisions (e.g. general anti avoidance rule) have had the potential to result in very significant New Zealand tax consequences when such loans are repaid. This is in addition to tax consequences in the foreign investor's home jurisdiction (i.e. realisation for tax purposes of foreign exchange gains due to appreciation of the NZ dollar).

For these reasons, should our earlier comments on the appropriateness of the proposed amendments be put aside, we request that consideration be given to grandfathering existing arrangements given regulated infrastructure investments are large investments made with long term investment horizons based on the policy settings at the investment time, or at the least, providing relief where loans from equity investors are repaid.

GENERAL

We trust you find our comments useful. If you have any questions, please contact Warren Knight, Principal - QIC Global Infrastructure on 9(2)(a) [redacted] or at w.knight@qic.com.

Yours sincerely

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