#013

BEPS – Strengthening our interest limitation rules

20 April 2017

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20 April 2017

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

Dear Cath,

BEPS – Strengthening our interest limitation rules

CA ANZ welcomes the opportunity to respond to proposals in the Government's Discussion Document on BEPS – Strengthening our interest limitation rules.

We support the Government's work to combat BEPS by reducing the opportunities that allow multinationals to inflate interest deductions artificially and shift profits offshore. Our submissions are aimed at helping the Government ensure the reforms fit within New Zealand's overall tax framework and do not unduly discourage the foreign investment needed for a small capital importing economy like New Zealand.

Striking balance – attracting foreign investment and collecting 'reasonable' amount of tax

The Discussion Document acknowledges that the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest while recognising it is important that firms operating here pay "a fair amount of tax". The Government also considers our current approach to limiting interest deductions is working well but needs to be bolstered by rules to restrict the ability of taxpayers to use excessive interest rates for related party loans.

We commend the Government for not proposing to adopt the OECD recommended approach of using an EBITDA-based rule. In our view an EBITDA-based rule is not appropriate for New

Zealand and the disadvantages of such a rule (such as the loss of interest deductions during periods of poor trading conditions) outweigh any benefits.

However, we have a number of concerns with the proposals raised in the Discussion Document, which, if implemented, could have significant and far-reaching consequences for many taxpayers.

Our principal concern is that the interest rate cap approach is a blunt instrument. Perhaps it is for this reason that only New Zealand appears to be planning to implement such a rule. We are also concerned that the proposal is not accompanied by any analysis or examples of the practical difficulties that arise in the application of the transfer pricing rules, which is the stated justification for the cap. This lack of analysis makes it difficult for us to support the proposed solution.

The Discussion Document notes 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. We do not think the revised transfer pricing rules should be dismissed as an effective solution. In our view, the revised transfer pricing rules are the appropriate rules for dealing with excessively-priced debt.

The interest rate cap proposals effectively intermingle two policy initiatives. The first is a change to the measurement of debt levels for thin capitalisation purposes and is targeted at the volume of debt on taxpayers' balance sheets. The second is an interest rate limitation which, although framed as such, is not a thin capitalisation measure. It is a transfer pricing measure aimed at the pricing of debt, and is a wholly arbitrary measure, quite inconsistent with the arm's length principle which underpins all other transfer pricing and anti-avoidance rules.

It appears to us that a key driver for this proposal may be lack of appropriate Inland Revenue resourcing for transfer pricing matters. If so, that issue should be addressed directly. An arbitrary attempt to cap New Zealand interest deductions in order to simplify the administrative burden on Inland Revenue at the cost of uncertainty and almost certainly double tax for taxpayers if the cap is disregard by other jurisdictions, as is likely to be the case, is not an appropriate solution.

The Government is proposing to strengthen the transfer pricing rules including by adopting economic substance and reconstruction provisions similar to those in the Australian rules. Given these additional measures and measures in line with other BEPS Actions that address

base erosion issues arising in respect of interest deductibility, we do not believe the interest rate cap approach is needed.

Changes to the measurement of volume of debt

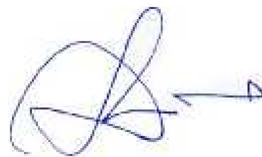
We are also concerned that the proposed changes could affect perceptions of New Zealand as a destination for foreign capital that boosts investment in the economy. One of New Zealand's advantages is the ease of doing business here, which is facilitated by our generally well regarded and certain tax and regulatory frameworks. New Zealand is well regarded partly because it is not seen as being out of step with international norms. The interest rate cap approach will mean New Zealand is seen as being out of step, and, under the current proposals, funding will almost always result in some element of double taxation. This may directly affect foreign investment in New Zealand and increase the cost of capital with any additional funding costs being passed on to local consumers. Furthermore, the proposals will result in double tax becoming mainstream, rather than something that occurs at the margins.

We address the specific issues raised by the interest rate cap proposal in the attached Appendix.

Please note, that given the significant workload on our advisory group members, our submission is of necessity a preliminary response. We may raise other issues once we have had more to consider the detail.

We would be happy to discuss our submission with you and look forward to the opportunity to do so.

Yours sincerely



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Appendix

Chapter 2: New Zealand's approach

We agree that the current thin capitalisation approach is appropriate and submit that the EBITDA-based rule is inappropriate in a New Zealand context. The disadvantages to an EBITDA approach as outlined in the Discussion Document convince us that this approach is not appropriate for New Zealand. However, this does not mean we support an interest rate cap approach.

We are concerned that the Discussion Document considers there are only two solutions to address a relatively minor problem for a limited number of firms that borrow from their foreign parents at high interest rates which results in very large interest rate deductions. The Discussion Document agrees that the problem is not the volume of debt but the measurement of the impact of the interest rate (pricing of the debt) which is a transfer pricing issue. In our view it is more appropriate for the interest rate between related parties to be addressed via transfer pricing rules.

We are concerned that the effect of shifting to arm's length conditions for the transfer pricing rules is not discussed. We note Australia has decided it is comfortable relying on its MAAL, arm's length debt and the thin capitalisation rules. The Australian Government also considers it is unnecessary to take any further action in relation to related-party debt. Australia relies on its transfer pricing rules to set the appropriate pricing of debt.

Furthermore, we note that the OECD proposals are not mandatory and they are driven by European interests and principles.

We consider it appropriate for New Zealand to rely on the transfer pricing rules to price related party debt. If debt pricing is a significant issue the Government should increase its investment in, or transfer resources to, the transfer pricing area as part of Inland Revenue's Business Transformation.

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Chapter 3: Limiting interest rate on related party loans

Proposal: Is the proposed cap broadly the right approach?

The Government is not convinced that the transfer pricing rules are the most effective way to prevent profit shifting using high-priced related party debt.

Submission

The proposed interest rate cap is not the right approach to address concerns about high-priced related party debt.

Comment

CA ANZ acknowledges concerns that related party loans and interest deductions can be used to shift profits, as can pricing of other related party transactions. However, it seems clear from the available evidence and Inland Revenue's own research that the vast majority of related party debt does not result in base erosion or profit shifting. Most groups use related party debt because this is the easiest and most convenient method of financing business activities.

The comment at paragraph 3.17 that the interest rate cap "should generally produce a similar level of interest expense as would arise in arm's length situations" is concerning and plainly wrong in respect of the interest rate cap methodology proposed.

The notion of capping the borrower's interest rate at the rate that their ultimate parent could borrow at does not reflect commercial reality.

Often the parent and New Zealand subsidiary will be involved in significantly different operations. Generally, the New Zealand operations – functions and assets – will be an order of magnitude smaller than the multinational parent's functions and assets and most likely more constrained. In other words, the subsidiary company's role is likely to be narrower than the parent's. Many New Zealand subsidiaries, by virtue of profitability, industry or country specific or local market factors, will have a much lower standalone credit rating relative to their parent. Intrinsically, the ultimate foreign parent is not the correct benchmark.

Inefficient allocation of capital

As well as additional compliance costs, an interest rate cap could result in an inefficient allocation of capital because:

1. the proposals require parent companies to credit enhance their subsidiaries to one credit rating notch below the parent; or
2. depending on the actual credit rating of the subsidiary, third party debt may be preferred over related party debt even if, under the proposals, third party debt is more expensive than related party debt.

The subtext of the analysis in the Discussion Document, which is unclear in parts, suggests that related parties will include terms and conditions in loans between each other that will have the effect of overstating the interest rate as compared to what an arm's length scenario would provide. There is also a perception by Inland Revenue that, because the interest rate is within the control of related parties, it is a relatively straight forward or simple process to overstate the interest rate. The interest rate cap is seen as a way of addressing those issues without having to consider the appropriateness or otherwise of subordination, or not, of those terms and conditions.

The proposal, at paragraph 5.41 of the Discussion Document "BEPS - Transfer Pricing and Permanent Establishment Avoidance", to amend the transfer pricing rules to refer to arm's length "conditions" will address the issues that the Government is concerned about. We are surprised that this Discussion Document does not consider the effect of the other proposals released at the same time because they will have a material effect on the interest rate. This is what is happening in Australia. The Australian Tax Office is using transfer pricing methodologies to challenge the terms and conditions of related party loans. It also has an arm's length debt test.

In our view the effect of the overall package of measures and particularly the effect of the transfer pricing rule changes will be to obviate the need for the interest rate cap.

Double taxation

CA ANZ is deeply concerned that, as presently formulated, the proposals will give rise to significant elements of double taxation.

We consider the proposal will create a real risk of groups not being able to achieve an appropriate deduction for their related party interest expense and will create the potential for double tax to arise. This double taxation is not at the margins. Rather it will arise in almost all instances where a subsidiary's credit rating is more than one notch below its ultimate

parent company's own credit rating and the loan counterparty is in a jurisdiction with modern transfer pricing rules.

The double tax issue is most likely to arise because a foreign country will require an arm's length interest rate whereas New Zealand will operate to deny a deduction. We suggest consideration should be given to whether an exclusion from the interest rate cap proposals for countries with a modern transfer pricing regime (that could take the form of a grey list or white list) is appropriate. There does not seem much point in denying what is an arm's length interest rate when the other country is going to tax the interest in full.

Single entity

An interest rate cap based on the parent's credit rating seems to assume that a group is in effect a single entity and ignores the fact that groups are made up of separate legal entities, and the transactions between them are real both legally and contractually.

These contractual arrangements will still be taken into account when pricing the loan in the parent's home jurisdiction, under normal transfer pricing principles. As discussed below, given the nature of New Zealand business operations, it is unlikely that a New Zealand subsidiary will enjoy a credit rating one notch below its parent, with the consequence that there may be a mismatch between the New Zealand treatment and the treatment in the parent's jurisdiction.

Compliance costs

The proposal will also add considerable compliance cost to businesses, particularly as the approach proposed, the interest rate cap, is unique to New Zealand. Furthermore, the level of disputes with lender countries is likely to increase, particularly as the New Zealand adjustment will arise under our thin capitalisation rules, limiting the ability for Competent Authority resolution (which would be available if the dispute was in relation to differences in transfer pricing approaches).

Transfer pricing rules

In our view the transfer pricing rules are a better way of tackling the problem than an interest rate cap. The proposals to strengthen the transfer pricing rules should assist with ensuring that excessive interest costs are not allocated to the New Zealand tax base. We question the need for an interest rate cap approach in these circumstances.

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Proposal: Should cap be based on parent credit rating or something else?

To limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower to the interest rate that the borrower's ultimate parent could borrow at on standard terms. That is, where the ultimate parent of the borrower has a credit rating for senior unsecured debt, the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin. Government considers that the interest rate a multinational could obtain is a reasonable approximation of the multinational's cost of funds.

Submission

If the interest rate cap proposal is implemented, logically the parent company credit rating is a starting point. The issue is not so much whether the interest rate cap is based on the parent company's credit rating but which adjustments should be made to that credit rating.

Comment

The proposed approach makes an adjustment based on five year senior debt. The interest rate cap should not be based solely on the parent company's credit rating but on its credit rating and several other factors. An interest rate cap should not be based on only one factor.

In our view, basing the interest rate cap on the parent company credit rating is incorrect. State Owned Enterprises are a good illustration. Under the proposed approach the credit rating of SOEs would be one notch below Sovereign. Based on Inland Revenue analysis the failure of Coalcorp would not have happened. Parent company support is not implicit even in a Government context.

Proposal: What is the appropriate margin?

A margin be added to the interest rate at which the borrower's ultimate parent could borrow on standard terms.

Submission

If, contrary to our submission, the interest rate cap is implemented, the margin should be at least greater than 2 credit notches. Ideally, the margin should accord to debt on arm's length terms and conditions.

Comment

The incoherence of the proposal in a policy sense is demonstrated by the fact Officials have confirmed that, if the situation were reversed, and outbound debt was subject to foreign

interest limitations, New Zealand's expectations will not be influenced and an arm's length amount would be levied on the loan and treated as taxable income in New Zealand. Accordingly, an interest rate cap cannot by definition make an arm's length interest rate unless the company did more to enhance the credit. New Zealand cannot have it both ways.

Design of cap

Proposal: Borrowers with no identifiable parent

When a New Zealand borrower has no identifiable parent, the appropriate cap for related party debt will be determined based on the rate at which the New Zealand borrow could issue senior unsecured debt.

The Discussion Document considers that there are two options to address the concern that a New Zealand company may be loaded with uncommercial levels of debt to push down its creditworthiness:

1. 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); or
2. deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

Submission

If the interest rate cap proposal is implemented, the appropriate cap for a borrower with no identifiable parent should be based on the rate at which the New Zealand borrower could issue senior unsecured debt using an arm's length amount of debt as determined under the transfer pricing rules.

Proposal: "meaning of related party"

For the purposes of the interest rate cap, a loan that originates from a member of the firm's worldwide group, member of a non-resident owning body or an associated person of the group or body will be treated as being from a related party.

Submission 1

We support the proposed definition of "related party".

Submission 2

We recommend consideration be given to allowing taxpayers to be excluded from the related party debt rules when a loan is provided on an arm's length basis without any reference to the related party.

Comment

We consider that, because there is no mischief, taxpayers should not be subject to the related party debt rules when a loan is provided on an arm's length basis without reference to the related-party. For example, a parent company is in the business of lending and lends to a related party on the same terms and conditions as a third party without regard to the fact the borrower is related.

Proposal: treatment of guarantee fees

Guarantee fees cannot be greater than the margin allowable under the interest rate cap.

Submission

The treatment of a guarantee fee should be consistent with the approach to setting the interest rate cap.

Proposal: De minimis

To reduce compliance costs for smaller firms, the ordinary transfer pricing rules will apply where the principal of all cross-border related-party loans is less than $NZ10m.

Submission

We support the proposal to include a de minimis. Consideration should be given to increasing the de minimis threshold for countries with a modern transfer pricing regime (that could take the form of a grey list).

Proposal: Override of transfer pricing rules

The interest rate cap will override the general transfer pricing rules.

Submission

We do not support the proposal for the interest rate cap to override the general transfer pricing rules.

If the interest rate cap is implemented, it should be part of the transfer pricing rules, not an override.

Comment

The interest rate cap is not a thin capitalisation measure. Rather it is a transfer pricing measure. We are concerned that the implications of the proposed changes to the transfer pricing rules have not been factored into these proposals.

Proposal: No specific anti-avoidance rule

A specific rule will not be introduced to prevent taxpayers from breaking loans to take advantage of increasing interest rates or borrowing margins. The general anti-avoidance rules could be used.

Submission

We support the proposal not to introduce a specific anti-avoidance rule.

Comment

The proposals are anti-avoidance rules and we do not believe it is appropriate to have a further anti-avoidance rule.

We are disappointed with the way the Discussion Document describes the circumstances in which the general anti-avoidance rule might apply. The example at paragraph 3.51 is not supported by any analysis and does not reflect the hallmarks of anti-avoidance. We would be very concerned if that depth of analysis is sufficient for investigators to raise assessments against taxpayers for changing loans. The example at paragraph 3.51 does not reflect commercial reality when a loan term may be broken to take advantage of a longer term benefit.

Proposal: Maximum loan term

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.

Submission

The proposal should not proceed.

Comment

The loan term, on which the interest rate is priced, should reflect the commercial conditions underlying the funding arrangement and/or nature of the asset being financed (e.g. infrastructure).

There is no commercial or policy basis for concluding that it is unusual for a commercial loan to be longer than 5 years. We note the following bond issues all have terms longer than 5 years:

- Z Energy
- Genesis Energy
- KiwiBank
- Auckland Airport
- Vector Ltd
- Meridian Energy
- Air New Zealand

Furthermore, certain Government bonds are issued for 10 years or more.

Proposal: No transitional rule

There will be no transitional rule for existing related-party cross border financing arrangements.

Submission 1

The proposal is acceptable for inbound investment provided the application date is sufficiently prospective so taxpayers can reexamine and reorganise their loans and this is expressly contemplated in the legislation and interpretative documents.

Submission 2

The Government should consider carrying out a separate review of the outbound rules.

Proposal: Consistency with New Zealand DTAs

The interest rate cap is consistent with New Zealand's double tax agreements, including articles relating to the arm's length principle.

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Submission

We disagree with the assertion that the interest rate cap proposal is consistent with New Zealand's double tax agreements.

Comment

We understand the Government's position is that the interest rate cap proposal is consistent with the arm's length principle or, to the extent it goes beyond a strict application of the arm's length principle, is a domestic anti-avoidance rule and therefore is not subject to our double tax agreements (DTAs). It is plainly evident that these proposals do not create an arm's length interest rate. Therefore the only basis for overriding the DTAs is avoidance. We suggest the proposals are re-examined.

In an environment where there is a significant amount of work being undertaken to address hybrid mismatches that involve double deductions, non-inclusion or double non-inclusion, we do not believe it is appropriate for the Government to put out a proposal that makes double tax more likely than not.

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Chapter 4: Treatment of non-debt liabilities

Proposal: assets to be measured net of non-debt liabilities

To require an entity to deduct its non-debt liabilities (e.g. provisions, deferred tax) from the gross asset value.

Submission 1

In broad terms we support the proposal. However, we believe the measurement rules are not correctly defined.

Submission 2

Further more detailed work should be undertaken, with consideration being given to the issues referred to below.

Submission 3

Provisions that do not involve the diminishing of funds, such as deferred tax, should be excluded.

Comment

Paragraph 4.24 implies that the proposal to deduct non-debt liabilities is based on the Australian approach. However, we note that the Australian exclusions that make the rule workable have not been included. We suggest provisions that do not involve the diminishing of funds should be excluded, for example, deferred tax.

We recommend the proposals be examined further. From a public policy perspective, a measurement rule that will closely align arm's length volume of debt with an organisation's ability to borrow on an arm's length basis would be appropriate. We do not consider the proposals achieve that.

We suggest consideration be given to the following issues:

- the effects of the proposal will be uneven across industries. For example, those with high provisions and liabilities, such as distributorships and insurers, will be most affected. We recommend consideration be given to including industry specific concessions to minimise anomalies;

- lenders focus on cash flow as well as an entity's balance sheet. Paragraph 4.11 fails to recognise this issue;
- the valuation of assets will be important because not all organisations are subject to financial reporting rules which allow for and encourage the recognition of intangibles; and
- thin capitalisation is compromised when assets are undervalued.

Finally, we also recommend that the effect of the hybrid proposals be considered when establishing what counts as debt and what does not.

Proposal: No grand-parenting proposed

No grand-parenting for existing arrangements.

Submission 1

The proposal is acceptable provided the implementation date is sufficiently prospective to allow taxpayers to review and rearrange their affairs.

Submission 2

The Government should reconsider the application date, particularly in relation to outbound investments.

Comment

The implementation date could be a 2 year moving average to mitigate the effect of short term fluctuations.

Proposal: Industry specific rules – are they required for insurers, miners, SMES

Specific rules are not necessary for any industry.

Submission

We recommend you consult directly with industries that have significant levels of provisions such as insurance, long term construction, SMEs and 'tech' industries and those entities that have balance sheets that are evolving or based on future cashflows, for example start-ups and crowdsourced activity.

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Chapter 5: Other matters

Proposal: De minimis for inbound thin cap phased out same as for outbound

To extend 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.

Submission 1

We support the proposal to extend the de minimis rules to apply to inbound entities.

Submission 2

Consideration should be given to simplifying the inbound and outbound de minimis rule to $2m of interest deductions.

Proposal: Infrastructure projects controlled by single non-resident

To allow the 60% safe harbour to be exceeded in relation to public-benefit projects that meet a number of specified criteria, because such projects are considered unlikely to present any BEPS risk.

Submission

We consider the targeted exemption is appropriate but the effectiveness of the proposed exemption will be very dependent on how the exemption will work in practice.

Proposal: Non-residents acting together – restriction

To amend the rules for entities controlled by a group of non-residents acting together. If an entity exceeds the 60% safe harbor, any owner-linked debt will be non-deductible.

Submission

We support the amendment. The amendment will provide certainty to investors.

Proposal: Asset valuations - removing net current value method

To remove the net current valuation method from the list of available asset valuation methods.

Submission 1

We oppose the removal of the net current valuation method.

Submission 2

If more robust valuations are needed, we recommend the net current valuation rules be amended to achieve this objective.

Comment

We believe the removal of the net current valuation method is inappropriate and the reasons put forward are not persuasive. The ability to use net current asset values allows an entity to use a better proxy for the market value of assets if such market values are not reflected in financial statements. Not all taxpayers are subject to financial reporting rules.

The removal of the net current valuation method will

- affect those who do not have cash generating assets on the balance sheet;
- create issues for SMEs;
- add complexity; and
- increase compliance costs.

Proposal: Measurement date for assets and liabilities – removing option to measure on last day

To no longer allow entities to value their assets and liabilities on the last day of their income year. Instead, taxpayers will be expected to value their assets and liabilities either on a daily or quarterly basis.

Submission

We do not support the proposal to remove the option that allows taxpayers to value their assets and liabilities on the last day of the income year.

We suggest that, as an alternative, consideration should be given to allowing taxpayers to value their assets and liabilities based on a moving average.

Comment

The removal of the option that allows entities to value their assets and liabilities on the last day of their income year is impractical. Taxpayers will not want to incur the significant compliance costs involved in measuring their assets on a daily basis for tax purposes. It is also highly unlikely that they will have sufficient information for daily valuation of assets and liabilities.

If Government is concerned about taxpayers bed and breakfasting loans, anti-avoidance rules are more appropriate than increasing compliance costs for all.

Proposal: Remedial re trusts and owner-linked debt

To amend s FE 18(3B) so it operates clearly in relation to trusts.

Submission

We support the proposal to amend s FE 18(3B) to ensure it operates clearly in relation to trusts.

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