#014

Ernst & Young Limited
100 Willis Street
Wellington 6011 New Zealand
PO Box 490 Wellington 6140

Tel: +64 4 499 4888
Fax: +64 4 495 7400
ey.com/nz

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

21 April 2017

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Strengthening our interest limitation rules

We support the consultative approach adopted by the Government in its adoption of measures associated with the G20/OECD-led Base Erosion and Profit Shifting ("BEPS") project.

BEPS – Strengthening our interest limitation rules forms part of an interconnected package, alongside *BEPS – Transfer pricing and permanent establishment avoidance* and *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.* The package is a powerful combination, which will put New Zealand at the forefront of worldwide approaches to BEPS implementation.

This submission should therefore be read alongside our submissions on the other elements of the package.

Overall approach to New Zealand's interest limitation rules

Overall, we accept the case for the Government revising aspects of our interest limitation rules, given it has consistently expressed support for the OECD's work.

We do not support the proposed limit on interest rates on related party loans as this will lead to double taxation in many cases and is incompatible with the arm's length principle. The combination of the proposed limit on interest rates and proposed changes to the thin capitalisation rules are a duplication and overreach.

When making final decisions, it is essential for the Government to give weight to the following:

- New Zealand already has robust interest limitation rules, which are in the main well policed by Inland Revenue. EY's study regarding gearing levels shows no evidence that multinational businesses pay less tax than New Zealand owned equivalent entities. We agree it is preferable to put forward specific proposals without abandoning our current framework.

- Any responses should be proportionate to the scale of the problem in New Zealand – that is, only limited reform is required. The Government should consider whether any measures should be targeted at highly geared outliers rather than applying to the vast majority of moderately geared entities.

- The potentially punitive impact on New Zealand taxpayers of an interest rate cap for New Zealand tax purposes only, where such a cap is not respected or reflected in foreign lending territories.

- The need for a coordinated international approach, with New Zealand staying within international norms.

- The interest rate cap methodology has not been adequately considered. It does not take into account currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing.

- The importance of foreign investment for the New Zealand economy, consistent with New Zealand's taxation framework for inbound investment published in June 2016.

- The importance of minimising compliance costs, uncertainty and the potential for disputes over the meaning of any rules or between revenue authorities.

We agree that an interest limitation rule based on the level of interest relative to earnings – typically based on earnings before interest, tax, depreciation and amortisation ("EBITDA") – is not the best approach for New Zealand. The volatility of interest rates, earnings and difficulties associated with loss making companies argue against an EBITDA-approach. We also note that EBITDA-style rules do not work well for commodity based economies, given that New Zealand companies are price-takers in volatile world markets.

Limiting the interest rate on related-party loans

We oppose the implementation of the interest rate cap. Our submissions may be summarised as follows:

- The proposed changes to the transfer pricing rules, including the ability for the Commissioner to reconstruct transactions, will adequately address issues with the pricing of cross-border associated party lending. We consider that the proposed changes to the transfer pricing regime perform substantially the same role that the interest rate cap is intended to achieve, without some of the costs and negative aspects of an interest rate cap outlined below. Accordingly, we would suggest strengthening the transfer pricing rules as a first approach, and consider an interest rate cap at a later date only if the combination of new and existing transfer pricing rules fails to achieve the desired outcome.

- The proposed cap, being a unilateral New Zealand approach to interest rate quantum, will inevitably lead to double taxation for multi-national groups. If the proposals are implemented, the Government will need to substantially increase the resources available to the Competent Authority to deal with a number of mutual agreement procedures ("MAPs") and disputes.

- The interest rate cap will frequently lead to transfer pricing outcomes that are not arm's length and not taken by our treaty partners. This represents a fundamental and, in our view unnecessary, shift in approach from that of alignment and harmonisation in respect of international tax favoured by the OECD and strongly supported by New Zealand.

- The interest rate cap is a novel approach which is untested in other jurisdictions. Given the significance of the other proposed changes, and the extent to which they already address concerns about the pricing of multinationals' debt, we submit that implementation of the interest rate cap should be deferred until the impact of the other proposals has been fully seen.

- The interest rate cap methodology does not take into account the likes of currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing. A good example is a regulated business like an insurer. The ultimate parent senior unsecured five year debt cost is not a proxy for the group cost of borrowing. In such an example, the majority of the group debt has appropriate regulatory recognition, is heavily subordinated and for a long minimum term. Countries such as the United Kingdom are extending, rather than restricting, deductions for such debt.

Further detail is provided in Appendix A, ordered consistently with the discussion document.

Treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities but note:

- This will lead to a material increase in gearing levels for some multinationals, particularly those with large provisions, trade creditors or deferred tax liabilities.
- The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.
- The proposal to move to quarterly, or daily, calculations will increase compliance costs and should not proceed.
- There should be an arm's length debt option as there is in Australia.
- Existing loans have been entered into under current law in good faith and should be grandparented for an extended period.

Further detail is provided in Appendix B.

Further consultation

The consultation period following release of the discussion documents has been short. To that end, our submission is intended to flag issues which we consider require further analysis, and, where appropriate make recommendations on the approach. We look forward to continuing to engage in discussion on the proposals throughout the coming policy-making and legislative stages.
We understand that these submissions may be the subject of a request under the Official Information Act 1982, and consent to the submissions being made publicly available.

We would appreciate the opportunity to discuss our submissions in person. Please contact David Snell (david.snell@nz.ey.com, +64 21 845 361) in this regard.

Yours sincerely

Aaron Quintal
Partner – Tax Advisory Services
Ernst & Young Limited

Appendix A – Limiting the interest rate on related-party loans

Proposal should not proceed (paragraphs 3.1 to 3.16)

The proposal to limit the interest rate on related-party loans should not proceed as it will lead to double taxation as other jurisdictions will continue to rely on the arm's length principle, and is likely to increase compliance costs.

The combination of the proposed limit on interest rates and proposed changes to the thin capitalisation rules are a duplication and significant overreach. The interest rate cap methodology has not been adequately considered and in many cases is a significantly inaccurate proxy for the group cost of borrowing.

Proposals to strengthen the transfer pricing and thin capitalisation rules will be a better means for ensuring arm's length terms and conditions on related party loans than an interest rate cap.

We understand that the Government has concerns regarding high-priced related party debt, and that transfer pricing rules have in its view not always been effective. In our view, however, transfer pricing rules are ineffective in only a very limited number of cases. These should be better addressed through targeted measures, many if not all of which are proposed in the suggested amendments to New Zealand's transfer pricing rules.

Double taxation is inevitable under the proposed interest rate cap given that this is a New Zealand specific rule applying to cross border arrangements. It will not lead to deductions in line with arm's length pricing. It will frequently, if not always, lead to double taxation as the lender cannot reduce the interest rate below an arm's length amount. Other jurisdictions will see this "thin capitalisation" measure as undermining or positively moving away from the arm's length principle in loan relationship matters and more MAP cases will result.

Of course, a lender could seek to reduce the interest rate charged to the amount determined by the interest rate cap, but may risk that lower interest amount being adjusted by the lender's tax authority as being non- arm's length. We consider this approach by lenders to be unlikely.

The interest rate cap methodology does not take into account the likes of currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing. A good example is a regulated business like an insurer. The ultimate parent senior unsecured five year debt cost is not a proxy for the group cost of borrowing. In such an example, the majority of the group debt has appropriate regulatory recognition, is heavily subordinated and for a long minimum term. Countries such as the United Kingdom are extending, rather than restricting, deductions for such debt.

The combination of the above implications produces the risk of deterring inbound investment beneficial to New Zealand.

Transfer pricing is factual and subjective because by nature there is no one answer to the problem it seeks to solve. As the discussion document notes, there are many factors affecting the price of debt, which an interest rate cap would ignore.

It would be more efficient and equitable to rely on robust and updated transfer pricing law and protocols to ensure that commercial levels of debt and terms of the debt instrument are taken into account in debt pricing. We note that this has been the Australian approach and is generally considered to have proven effective.

In our view, none of the arguments provided in the document suggest that the imposition of a wholly arbitrary interest rate cap is the appropriate means to deal with excessively priced related party debt. Capping the interest rate limits a lender's ability to re-coup their cost and earn an appropriate return for risk.

The proposed interest rate cap is neither objective (since it ignores many terms of intercompany loans which may be entirely commercial) nor certain (as it will lead to considerable uncertainty where the result is an interest rate which, from the perspective of the lender, is not arm's length).

Suggested alternative - Proposed transfer pricing and thin capitalisation rules should be given a chance to take effect (paragraphs 3.5 to 3.7)

The document does not discuss in what respect debt is considered to be overly priced into New Zealand.

Our experience is that most inbound related party debt is senior unsecured debt for terms less than five years and genuinely priced at what a bank could lend. Only a small minority of loans would be priced as subordinated debt and/or for terms greater than five years. These loans will generally have longer terms for sound commercial reasons, with investments such as forestry or public private partnerships dependent on long term finance.

Many factors influence the pricing of a loan. These factors are present in both related party and third party lending. Like third parties, related parties often have sound commercial reasons for any "non-vanilla" terms in their loan agreements. The transfer pricing rules allow for some flexibility in pricing what can ultimately be very complex, but commercially rational, third party loans.

We accept that the transfer pricing rules have historically only allowed the Commissioner to challenge whether the amount (being the interest rate) is an arm's length amount (paragraph 3.6). This has limited the Commissioner's ability to challenge other terms of the lending, but will be addressed by the new reconstruction provisions in the updated transfer pricing rules. [1]

It is considered that the proposed amended transfer pricing rules should go a long way to alleviating if not eliminating current challenges around the ability to assess and challenge debt pricing. Such rules should be given a chance to succeed, before introducing a novel instrument in contravention to the arm's length principle. The document highlights the tension between the interest rate cap and transfer pricing at paragraph 3.49: that problem would be eliminated were the interest rate cap not to proceed.

Indeed, we consider there is a risk that the proposed interest rate cap renders the amended transfer pricing rules obsolete in practice with respect to loan relationships. The point being that challenges are naturally drawn to the "path of least resistance" approach of asserting a rate cap over applying improved transfer pricing rules to genuine commercial arrangements.

Related party and third party borrowings compared (paragraphs 3.8 to 3.12)

The Government states that when borrowing in a third party situation there is pressure to drive the borrower to seek to lower interest rates by offering security or not borrowing to an extent such that it will impact credit rating. We have concerns with this approach:

[1] In addition to those conferred by the general anti-avoidance rule, for example those relied upon by the Commissioner in *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

- Inland Revenue tends to argue that security to ensure realisation in case of default makes little difference to the rate offered by a bank.

- Most New Zealand companies have no formal credit rating. Although conscious of their creditworthiness, they will not be influenced by defending a given rating.

- Transfer pricing reforms proposed in *BEPS – Transfer pricing and permanent establishment avoidance* will reinforce the arm's length debt test for pricing purposes. Both the terms and conditions will need to be commercially justifiable.

- Factors increasing the riskiness of a loan between unrelated parties may be less relevant in a related party context, but they are not irrelevant. Transfer pricing allows for these relevant risks to be balanced in a fact-specific way.

- The proposition that "the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with related-party debt or equity" in paragraph 3.10 is not always accurate. Consider for example a parent entity which funds a majority-held New Zealand subsidiary through a mix of debt and equity. There may be other shareholders which own a small parcel of shares as well. The subsidiary also has a range of other debtors which might rank preferentially to the parent's own debt, or might rank after. If the company is later liquidated, the debt is less risky vis-à-vis the equity investment, and the risk associated with the debt will vary depending on its terms, and the relative terms of the debts owed to third parties.

- The document notes that "some related-party loans feature unnecessary and uncommercial terms" (paragraph 3.11). Under the transfer pricing reforms proposed in *BEPS – Transfer pricing and permanent establishment avoidance* the Commissioner could reconstruct such a transaction if it was not commercial.

- The document notes that it can be difficult to challenge arrangements where the taxpayer can identify a comparable arm's length arrangement (paragraph 3.12). However, if the taxpayer can identify a comparable arm's length arrangement, then by definition the taxpayer's arrangement is arm's length.

Compliance costs will increase (paragraph 3.13)

The highly factual and subjective nature of transfer pricing can make the rules complex and uncertain, leading to high compliance costs. While we agree with this statement, we do not see that it leads to an interest cap as the preferred approach. Compliance costs arise for debt structures as for any other transfer pricing arrangements. Royalty transfer prices, for example, can be compliance cost intensive.

The proposed interest rate cap is likely to increase compliance costs. Loans between a foreign parent and a New Zealand subsidiary will now need to be priced twice – once from the perspective of the foreign parent, for which the foreign tax jurisdiction will require an analysis under orthodox transfer pricing principles (i.e., using the New Zealand subsidiary's credit profile as a starting point), and once from a New Zealand perspective using the parent's credit profile as a starting point. An analysis still has to be done to benchmark the interest rate even if the parent has a credit rating. If it does not have a rating, then a rating analysis has to be done. Companies could even choose to obtain a credit rating solely for tax purposes, at considerable compliance cost.

At present a single analysis is done for both borrower and lender to find the arm's length amount.

Moreover, the different interest rates which would result under the two different analyses will in many cases give rise to double taxation, which will only increase the likelihood of disputes with Inland Revenue.

The proposed interest rate cap ignores the specific requirements of several industries

Some industries require a more fact-specific response to pricing their lending than an arbitrary interest rate cap. For example, the forestry industry has a particular requirement for loans extending over a long (but fixed) period. Further, in this industry it is commercial practice to defer cash flows to the end of the loan period (for example, as a Payment In Kind, or "PIK" loan). This can result in a higher interest rate, but is a necessary response to the commercial factors behind investment in forestry (that is, the long time period to forest maturity). The proposed interest rate cap could make these loans untenable and discourage investment on usual commercial terms for the industry.

In other cases, funding may be provided in a form to meet regulatory requirements to hold loss-absorbent capital as a proportion of balance sheet size and risk. Funding in this form may have certain equity-like features relating to loss absorbency and interest deferral which are mandated by regulators. These equity-like features are mandated by regulation, are not designed to deliver profit stripping by way of high interest and are essential in supporting certain capital intensive regulated industries.

Our comments on design issues below should be read on the basis that our primary submission for the interest rate cap not to proceed is declined.

Proposal is based on flawed premise (paragraphs 3.17 to 3.19)

A cap will not bring interest rates on related-party loans in line with the interest rate the borrower would agree to with a third-party lender.

Our experience is that a New Zealand subsidiary will typically have a credit rating well below (not just one notch below) that of its ultimate parent. The rate at which a New Zealand subsidiary could borrow from a bank is considerably different than the parent's cost of funding, especially in the absence of an explicit parental guarantee. This is why, in the absence of tax, multinational enterprises will often borrow at the parent company level and finance offshore subsidiaries through related party funding.

Interest rate cap based on parent credit rating (paragraphs 3.23 to 3.37)

An interest rate cap should assume a greater than one notch difference below that of the senior unsecured rating attributable to the ultimate parent. It is difficult to provide any guidance on the appropriate difference as this will vary on a case-by-case basis. Pricing based on senior unsecured debt does not meet the arm's length standard.

Please note this section is drafted on the basis that an interest rate cap is introduced. Our primary submission is that such a cap should not be introduced given this adopts a one size fits all approach, ignoring the commercial arrangements entered into. Our comments below should not be taken as inconsistent with this primary submission.

We do agree that a hard interest rate cap would not be well-targeted, and does not take account of the facts and circumstances to which an approach through the transfer pricing regime is much better suited. A cap based on parent credit rating is preferable to a hard cap.

However, one notch suggests that the New Zealand subsidiary is "highly strategic" to the group (Standard & Poor's grouping methodology 2013 suggests a highly strategic subsidiary would have a rating one notch below group rating). Standard & Poor's define "highly strategic" as being "almost integral to the group's current identity and future strategy; the rest of the group is likely to support these subsidiaries in almost all foreseeable circumstances". In our experience, very rarely would that be the case for New Zealand subsidiaries. Moody's is even more conservative for notching for this "implicit support" than Standard & Poor's.

The discussion document calls for submissions on what the appropriate margin would be. Assuming that there are at least some subsidiaries of foreign multinationals in New Zealand which could meet the requirements of Standard & Poor's "nonstrategic" category (that is, of "no strategic importance to the group; these subsidiaries could be sold in the near to medium term") then Standard & Poor's guidance suggests these entities are generally rated at their own standalone credit profile and therefore receive no implicit parental support.

Where the shareholder debt into New Zealand is subordinated to actual senior bank debt, it seems unreasonable and not arm's length to price it as senior unsecured debt (paragraph 3.24). A bank loan to the New Zealand subsidiary would invariably price lower than subordinated shareholder debt to the New Zealand subsidiary.

Para 3.25 notes that *"We consider it unlikely that a multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational's cost of debt, since this would lower its overall profits."*

It is worth considering why higher borrowing costs in New Zealand may be justified. The group's cost of borrowing may be lower because, for example, it may have many subsidiaries with low standalone credit risk (for example, in countries with high sovereign credit ratings, or that are consistently very profitable). By contrast the New Zealand entity might be a much higher credit risk; for example, it could be a start-up in a different industry, in a smaller, more isolated market.

If the parent itself borrows from a bank, the bank does not take any less risk. The parent may get a lower interest rate because it has a collection of lower risk investments which will more than offset the risk of the New Zealand investment to the New Zealand bank. The parent is effectively offering collateral greater than just the New Zealand subsidiary, and so there is some diversification of the risk. The group's risk is not representative of the New Zealand subsidiary's risk.

International comparison (paragraphs 3.38 to 3.39)

That no other country has proposed an interest rate cap suggests the cap should not proceed.

We are concerned at this novel approach. A coordinated multilateral approach will be the most efficient way to resolve inconsistencies in cross border taxation: departure from international norms proved unsustainable with regards to our controlled foreign company and foreign investment fund rules.

Treatment of guarantee fees (paragraphs 3.44 to 3.45)

Guarantee fees have commercial value, which should be reflected by the proposals.

A guarantor is taking on real liability, as shown by the impact on the availability and pricing of funds when an explicit written guarantee from a bone fide guarantor is in place.

To ensure this meets the arm's length standard, the OECD Guidelines then recognise that parent is then taking on the credit risk for the New Zealand subsidiary and needs to be remunerated through a guarantee fee.

In other words, that the multinational's cost of funds is lower than what an independent lender would offer the New Zealand subsidiary is no reason to depart from the arm's length standard.

Limiting guarantee fees to the margin allowable under the interest rate cap breaches arm's length principles. The guarantee fee would, in almost all cases, be very small under these proposals given there would only be a one notch difference between the interest rate cap and actual borrowing rate. This has no resemblance to arm's length principles.

We would also welcome comment as to whether the guarantee benefit would be a 50:50 split of the margin, per current practice.[2]

De minimis approach to be retained (paragraphs 3.46 to 3.48)

The de minimis should be increased as a compliance cost reduction measure, perhaps to cover groups where the principal of all cross-border related party loans is less than $20 million.

Retention of the de minimis is welcome as a practical measure. There is a strong case for it to be increased, perhaps to $20 million, if these proposals are to be implemented. In many cases the de minimis position reflects a much higher interest rate than would be achieved under these proposals.

Anti-abuse rule (paragraphs 3.51 to 3.52)

The general anti-avoidance rule should not apply to situations where taxpayers exercise break clauses in loans to take advantage of changing interest rates or borrowing margins.

Taxpayers are entitled to arrange their affairs in such a way as to maximise their commercial outcomes in ways which suit their circumstances. Exercising a break clause in a loan agreement does not amount to tax avoidance.[3]

Transitional rules (paragraphs 3.54 to 3.55)

Existing related-party, cross-border financing arrangements should be exempt from the interest cap for a period of five years following enactment.

The absense of any transitional rule for existing loans would mean that every loan will need to be repriced based on the parent company credit rating for New Zealand tax purposes. It seems unlikely that the lender's jurisdiction would be prepared to accept a lower, non-arm's length, return from investment into New Zealand, unless that jurisdiction does not tax foreign sourced interest income. Double tax is therefore a strong possibility, in addition to the compliance costs of repricing.

We propose an extended transitional period, of perhaps five years, to allow for the majority of existing finance arrangments to reach maturity.

[2] See http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html#11, accessed 18 April 2017.
[3] As discussed with Carmel Peters and Steve Mack on 24 March 2017.

Interest rate cap inconsistent with arm's length principle (paragraphs 3.56 to 3.60)

The proposed interest rate cap contravenes the arm's length principle. It will not "generally produce a similar level of interest expense as would arise in arm's length situations". It will inevitably lead to double taxation, often in circumstances where arm's length pricing has been implemented.

Nor do we agree it consistent with OECD Guidelines that as a general rule there will be no conflict between domestic anti-avoidance provisions and a DTA. OECD Guidelines take this approach only to the extent that domestic thin capitalisation rules do not create pricing that is below arm's length.

The interest rate cap also appears to be incompatible with our domestic legislation confirming that DTAs override domestic legislation (section BH 1(4)).

Para 3.58 notes that *"the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Consequently it should also be consistent with the arm's length principle"*

We submit that the proposal is not consistent with the arm's length principle.

OECD Guidelines discuss thin capitalisation in the context of Article 9 (Associated enterprises). We interpret the Guidelines to mean that thin capitalisation provisions are not considered to contravene Article 9 (requiring arm's length pricing) provided that they do not go so far as to create pricing that would be below arm's length. That is, thin capitalisation rules approximate arm's length borrowing levels. This rate cap will undermine the arm's length principle in the vast majority of cases and hence will result in other countries raising issues in terms of Article 9 (leading to double taxation and invoking MAP).

We note that the discussion document does not address the issue of New Zealand companies lending to foreign subsidiaries. We understand from our discussions with officials that the Government does not intend to apply the interest rate cap in reverse (i.e., for loans to overseas associated parties, taxpayers are expected to continue to apply orthodox transfer pricing principles and price the loans on the basis of the arm's length standard). This demonstrates the interest rate cap is not aligned to the arm's length standard; the Government is seeking to tax business profits neither in accordance with its international commitments through the OECD nor consistently with its long established framework for taxing the income of foreign residents.

Further, the discussion documents do not propose any limitation on the interest rate paid to *third parties* in New Zealand. According to the arm's length standard, the interest rate paid on related party debt should be aligned to what would be paid to independent third parties. The fact that there could be a different outcome if the New Zealand subsidiary borrows from a bank versus borrowing from related parties indicates that this proposal is not aligned to the arm's length standard.

Further, for many New Zealand companies, the rate at which a bank would lend to the New Zealand subsidiary on a standalone basis can be very different to the parent's cost of funding. We submit that it is wrong to assume that implicit support narrows the gap between parent and subsidiary credit ratings in all cases. A typical approach is for the New Zealand subsidiary to borrow from a New Zealand bank, but have the parent guarantee the debt (to achieve something close to the parent's cost of funds). The fact the OECD endorses the payment of a guarantee fee to the parent in such a circumstance is precisely because an interest rate anchored to the parent's cost of funds is not arm's length.

We anticipate the interest rate cap would be a limit, enacted as domestic legislation, reducing the deduction available in New Zealand to something less than arm's length.
Section BH 1(4) of the Income Tax Act states that double tax agreements have an overriding effect on the Inland Revenue Acts. Given that Article 9 of New Zealand's double tax agreements ("DTAs") requires an arm's length outcome (i.e., "conditions between the two enterprises in their commercial or financial arrangements… differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another"), the proposed interest rate cap is incompatible with section BH 1(4). Has the Government considered how it will ensure the proposal actually has effect? Reliance on the incorrect statement that the interest rate cap will produce an arm's length result is extremely risky.

Such a movement away from the arm's length principle in loan relationship matters represents a significant shift in New Zealand tax policy, where an OECD-aligned, harmonisation approach has generally been favoured in international tax matters. It is considered that implementation of an interest rate cap in the manner suggested necessarily leads to a dilution if not outright rejection of the arm's length principle where related party lending is concerned. New Zealand would effectively have separate rules for loan relationships (interest rate cap) and other intra-group arrangements (enhanced transfer pricing rules aligned with OECD recommendations).

The point made above around double tax should be emphasised here. This is a natural and inevitable result of a territory-specific pricing approach that contradicts that generally accepted in counterpart territories.

Appendix B – Treatment of non-debt liabilities and other matters

Debt levels of foreign-owned multinationals

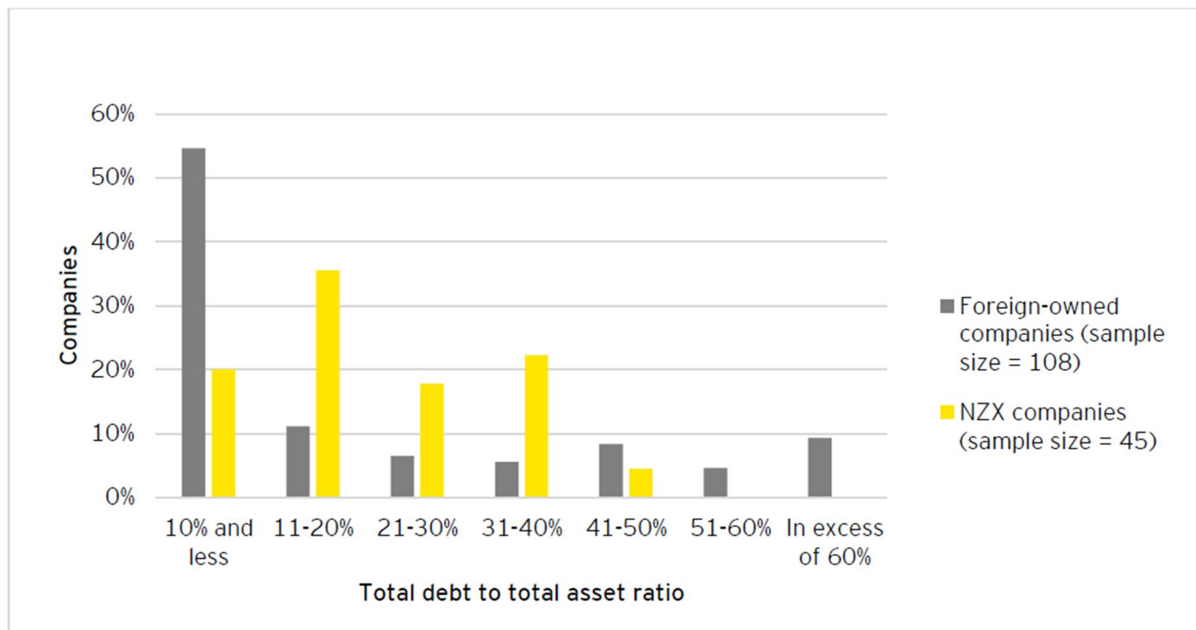
> We agree that, in principle, a firm's assets net of its non-debt liabilities is an appropriate base for thin capitalisation rules. The proposals will, however, have a significant effect, with paragraph 4.27 underestimating their impact.

It is important to highlight the current thin capitalisation rules already work well, and that multinationals are mostly moderately geared.

In August 2016, EY released a report, *New Zealand corporate debt levels of foreign multinationals – the elusive case for more tax restrictions?*, which reported EY's market research into the debt levels carried by New Zealand subsidiaries of foreign companies.

Our research shows that most foreign-owned multinationals stay well within the 60% safe-harbour of debt to asset ratio. The average total debt to total asset ratio was just 20%. By comparison, New Zealand based companies also had average total debt to total assets of 20%.[4]

The following chart summarises the results of the analysis.



Our report also considered in more detail whether an EBITDA-style test would be appropriate in New Zealand. Given that the discussion document does not specifically address the practicability of an EBITDA-style test in New Zealand, we do not intend to address this in detail here. Further commentary can be found in our report.[5]

---

[4] We should note the report is not weighted by entity size. It would be possible for a small number of large, highly geared, outliers to have a material impact on the level of interest deductions claimed. This possibility strengthens arguments for targeted measures rather than wide ranging reforms.

[5] http://www.ey.com/nz/en/services/tax/ey-is-the-tax-crackdown-on-multinationals-justified

In the period since the release of the discussion documents, it has not been possible to undertake an in-depth study on the effects of the proposed changes to the thin capitalisation regime. That said, we have revisited the 108 foreign companies from our 2016 survey and performed a high-level calculation, charting the impact of the new thin cap rules. Our findings can be summarised as follows:

- The debt percentages of all 108 companies increases (where the companies have positive net assets), which is to be expected;
- 23 companies in our sample (i.e., approximately 22% of those surveyed) would be moved from a conservative debt position to an "at risk" debt position (that is, a debt ratio greater than 40%); and
- 11 companies in the sample group (or 10% of the sample) would find themselves moving from inside the safe harbour to now breach the 60% debt level.

The results show that the proposed changes to the thin capitalisation have will have considerable bite.

Non-debt liability definition (paragraph 4.22)

Non-debt liabilities should not include deferred tax liabilities. The definition of interest-free loans requires clarification.

The definition of non-debt liabilities is based on the Australian definition. Deferred tax should be excluded from that definition.

Deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS.[6] Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

We would also appreciate clarification on the definition of interest-free loans as a non-debt liability. Would an interest-on-demand shareholder loan be treated as interest-free?

Grandparenting existing arrangements (paragraph 4.28)

Existing financing arrangements should be grandparented for a period of five years following enactment.

We disagree with the statement that companies will have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time (paragraphs 5.22 to 5.23). This logic applies equally to all multinationals.

[6] Under IFRS entities account for deferred taxes using the New Zealand Equivalent to International Accounting Standard 12 (NZ IAS 12), "Income Taxes." NZ IAS 12 follows a balance sheet approach as opposed to an income statement approach.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature. This is consistent with the proposed application of non-resident withholding tax or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Act. We also note the lengthy transitional arrangements proposed for measures in connection with employee share schemes. The financial impact of disallowing interest deductions can outweigh changes to withholding taxes or the taxation of employee share schemes.

Asset valuations (paragraphs 5.24 to 5.26)

> The ability to use net current asset values allows businesses to use a better proxy for the market value of assets than is sometimes reflected in the financial statements. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained. We see no case for removing an accurate measure of asset value.

We disagree that the valuation method chosen for financial reporting purposes will always be the one that most fairly represents the value of a company's assets (paragraph 5.25). Allowing appropriate values for high value, but hard to value, assets is essential to the working of an asset-based thin capitalisation regime.

Allowing companies to continue to choose to use the net current value of its assets as an alternative to the financial statement values, where this would be allowable under GAAP, appears fair and reasonable. No case has been made for this change.

Experience in Australia suggests that restrictions over the accounting options available regarding asset valuations are of particular concern for industries with substantial intangible assets, where the reported figures in financial statements can significantly underplay an asset's true value. Examples include technology and mining companies.

Measurement date for assets and liabilities (paragraphs 5.28 to 5.30)

> The ability to choose between valuation at year-end, on a quarterly basis, or daily should be retained. The concern around the use of year end calculations is unfounded. An alternative could be to allow the use of the average of opening and closing calculations as is done in Australia.

We have seen no evidence of companies manipulating year-end thin capitalisation calculations. In our experience, often it is not until year-end financial statements are being prepared that thin capitalisation is considered. In the event that a company were to be found manipulating year-on-year calculations then the anti-avoidance rules could be utilised to cover this situation.

In our experience, the daily calculation method is rarely used so in reality the proposal is for quarterly calculations. Reliance on quarterly valuation methods will increase compliance costs. This will particularly be the case for assets requiring formal valuation as part of year-end accounting under IFRS.

Should the Government feel there is a particular problem regarding loans entered into and repaid during the course of the year, it could seek to apply the GAAR and/or develop a targeted extension to section FE 11 of the Income Tax Act 2007. From our perspective, it would be very difficult to envisage an "artificial" year-end balance sheet manipulation structure that achieves a temporary thin capitalisation benefit that would be robust in the face of a challenge on section BG 1 grounds.

Increasing compliance costs for all multinationals to deal with a rare problem which can be targeted effectively by other means is not justified.

Arm's length debt option

There should be an arm's length debt option, as in Australia.

The proposed changes to the thin capitalisation rules largely align the New Zealand methodology with that of Australia. An omission is the arm's length debt test rules that Australian taxpayers can use if their Australian debt levels exceed the safe harbour.[7] The Australian precedent should be followed in New Zealand.

[7] Reviewed in 2015 by the Australian Board of Taxation, which recommended its retention.