#015

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1 May 2017

BEPS – Strengthening our interest limitation rules

Dear Deputy Commissioner

Thank you for the opportunity to comment on the Discussion Document (DD). We appreciate that targeting base erosion profit shifting (BEPS) to ensure multinationals are paying an appropriate level of tax in New Zealand is a key focus for the Government.

We understand that Officials are particularly concerned with excess interest deductions arising from high-priced debt advanced by related parties. As we understand it, the concern arises because of the belief that some multinational groups (MNCs) structure cross-border related-party financing arrangements on non-commercial terms in order to justify a high interest rate being charged under transfer pricing principles, where such terms would not necessarily be available in the context of a third party financing.

In our view a number of the proposals are wider than necessary to deal with this concern, and will significantly increase the compliance burden for taxpayers, including many who currently operate in New Zealand through low risk structures. Officials may not have appreciated the significant adverse effect that the proposals are likely to have on every taxpayer that is subject to the transfer pricing and thin capitalisation regimes.

A summary of our submission points is set out below (all of which we have discussed with Officials in our meetings in recent weeks), with more detail provided in the Appendix:

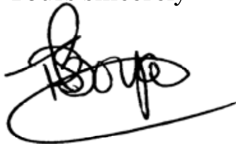
- a number of the proposals are not in line with the Government's published policy on inbound investment;
- the Government should await the outcome of (a) OECD work on pricing related-party debt, and (b) strengthening the transfer pricing regime, before it decides whether it still wants/needs to introduce an interest rate cap;
- if an interest rate cap is introduced, it should be in the form of a safe harbour in the transfer pricing rules, with taxpayers being given the choice to use accepted transfer pricing principles instead if they prefer (but perhaps with a higher threshold for the taxpayer to satisfy if not using the interest rate cap method);

- the proposed reduction in assets by non-debt liabilities is not needed, and for some industries could have a significant and adverse impact on thin capitalisation capacity. However, if proceeded with, at a minimum the proposed definition of non-debt liabilities for thin capitalisation purposes should contain exceptions for deferred tax and certain other items, similar to the Australian rules;
- the scope of the proposed de minimis exception for inbound investment should be extended;
- the proposed exception to thin capitalisation for infrastructure projects should be implemented, but needs further consideration. A similar exception for securitisation arrangements should be included;
- the ability for taxpayers to use net current asset values for thin capitalisation calculations should be retained;
- measurement of assets and liabilities for thin capitalisation purposes should continue to be able to be based on year end balances. If necessary, it could be altered to be the average of the start of year and end of year values; and
- the application date for any new policy changes should be the income year commencing after 31 March 2019 (or equivalent non-standard tax years) at the earliest.

As discussed with Officials, we would appreciate the opportunity to review and comment on draft legislation before it is released as part of a Bill, if possible, particularly in relation to the interest rate cap proposal, the definition of non-debt liabilities and the use of net current asset values for thin capitalisation calculations.

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely



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Appendix: Detailed submissions

1. General comments

Proposals are not in line with published Government policy on inbound investment

The Government's published policy with respect to inbound investment includes the following:

> "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. Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to New Zealand."[1]

The published policy sets out a framework that should be considered when making changes to tax policy, and emphasises the need to work through any changes carefully to ensure New Zealand's position as an attractive location to base a business is maintained.

We are concerned that some of the proposals in the DD, and the consultation process being adopted, seemingly conflict with this approach. This is for the following reasons:

- certain of the proposals are not in line with current and/or proposed international norms and OECD recommendations;
- a New Zealand solution to high-priced related-party debt is being considered before OECD work on the same issue is completed;
- certain elements of the proposals appear to be poorly designed given inevitability of double tax without any ability to seek relief under double tax agreements (DTAs); and
- the time for the consultation process has been very short (particularly bearing in mind focus of taxpayers on compliance obligations up to 31 March), proposed effective dates of the proposed law change could be sooner than is reasonably practical, and taxpayers risk not being given adequate time to consider and model the effect of the proposals.

Furthermore, there is no discussion in the DD around how NRWT fits with the proposed law changes, even though the policy framework specifically discusses the importance of NRWT in preserving New Zealand's tax base in relation to related-party debt. In a number of scenarios, it seems there will still be NRWT imposed on the full interest expenses, notwithstanding potentially materially larger amounts of that interest expense will be effectively denied under the proposed thin capitalisation changes. We do not consider this effective double taxing is appropriate.

Application date should be no earlier than 1 April 2019

We understand that targeting BEPS is a key focus for the Government and an early effective date for the proposals may be its preference. In our view, the proposed application date should be no earlier than a taxpayer's first income year after 31 March 2019 (or the equivalent non-standard tax year). The changes proposed in the DD will not just affect those few corporates who may be viewed as having

[1] "New Zealand's taxation framework for inbound investment", Policy and Strategy, Inland Revenue and the Treasury, June 2016.

adopted aggressive tax practices but a significant number of additional taxpayers, including those who currently have in place advance pricing agreements (APAs) with Inland Revenue on the pricing of inbound related-party debt. We consider it is reasonable to allow taxpayers time to consider how best to deal with these issues, and to rearrange their affairs in an orderly manner if they decide it is necessary. It will be in the interest of continued foreign investment from overseas to allow properly for this.

2. *Limiting interest on related-party loans (DD Chapter 3)*

The Government should await the outcome of OECD work on pricing related-party debt and effect of changes to transfer pricing before introducing an interest rate cap

We understand and acknowledge Officials' concerns that the current transfer pricing rules may not be effective to deal with unrealistically high-priced related-party debt, and therefore have proposed the interest rate cap to deal with the issue. In our view, the Government should not introduce an interest rate cap at this stage, given that:

- we expect it is a small number of corporate taxpayers that are engaging in the practices that Officials are concerned about;
- we understand that the OECD is undertaking more work this year in the area of pricing of related-party debt – paragraph 8 of the OECD's Action 4 Paper[2] states that work on transfer pricing guidance for related party financial transactions is being carried out and will be completed in 2017 – this work remains necessary following work already completed under Action 4 (see our further comments on Action 4 below); and
- the Government intends to strengthen transfer pricing rules, (a) to ensure pricing reflects economic value creation rather than strictly reflecting the legal form of an arrangement, and (b) to give Inland Revenue the ability to recharacterise transactions between related parties that would not have been entered into with third parties. To a large extent, the concerns around high-priced debt will be dealt with if the current proposals to strengthen New Zealand's transfer pricing rules are introduced.[3] This is because, following the proposed transfer pricing changes:
  - a loan will be subject to transfer pricing on the basis of its economic substance rather than its legal form where the two differ;
  - a loan will be able to be reconstructed to ensure it is aligned with a commercially rational arrangement that would be agreed by independent businesses operating at arm's length; and
  - the onus will be on the taxpayer to prove the interest rate is arm's length and would have been entered into with a third party.

In our view, the most likely outcome of these changes is that going forward any loans between related parties will no longer have the types of terms that Inland Revenue is concerned are used to justify unrealistically high interest rates. For this reason, and because OECD work in this area is continuing, it

[2] OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update (**Action 4 Paper)**, page 15.
[3] BEPS – Transfer pricing and permanent establishment avoidance – A Government discussion document, Chapter 5 (March 2017).

is too early for the Government to introduce an interest rate cap under our domestic thin capitalisation regime. Furthermore, New Zealand should be slow to adopt a solution that Officials recognise has not been adopted anywhere else globally.

Concerns around unrealistically high-priced debt should be dealt with in the transfer pricing regime as a "safe harbour" and not the thin capitalisation regime

The interest rate cap is proposed as a change to New Zealand's thin capitalisation regime. In our view, the transfer pricing regime and not the thin capitalisation regime is the appropriate place to address this type of concern. This is because the transfer pricing regime is concerned with ensuring that debt is priced appropriately applying the arm's length principle, whereas the thin capitalisation regime regulates the amount of debt that a New Zealand borrower can have. The issue of high-priced debt is a pricing issue and it is therefore more appropriate if it is dealt with in the transfer pricing regime.

In our view, introducing an interest rate cap is a fundamental shift away from the arm's length transfer pricing principle that underpins the pricing of cross border related-party transactions across the world. As part of the BEPS project, the OECD considered alternatives to the arm's length principle to price cross-border related party transactions. However, it was determined that alternative measures, such as a formulaic apportionment, would require development of an international consensus on a number of issues that would be too difficult to achieve. In addition, formulaic apportionment could be subject to manipulation and may result in transactions not being priced according to economic reality. Accordingly, the arm's length principle (adjusted to reflect economic realty and not just solely focused on legal form) was determined to be the most effective and efficient way to price transactions under transfer pricing rules going forward.

However, if New Zealand is to take this formulaic approach to capping related party interest rates, then an interest rate "cap" should be no more than a "safe harbour" available to taxpayers under the transfer pricing regime, which if the safe harbour was applied, would mean that the interest rate on related-party debt would not be challenged by Inland Revenue. This would allow a taxpayer to continue to apply arm's length principles under New Zealand's transfer pricing regime if it exceeds the interest rate cap but the taxpayer takes the view that this can be justified (but perhaps with a higher threshold for the taxpayer to satisfy if not using the interest rate cap safe harbour).

The reasons why we think this approach would be preferable for taxpayers, while still meeting Officials' concerns, are set out below.

(a) Compliance should be simple

Compliance should be made as easy as possible for taxpayers, and costs of compliance should be minimised.

It should be relatively simple to apply the interest rate cap where the ultimate parent has a credit rating, and we can see the superficial appeal of such an approach. However, where a parent does not have a credit rating, establishing the terms on which the parent would have been able to borrow may be very difficult – it will require consideration of a hypothetical situation, based on information outside the control of the New Zealand borrower, and it is likely to be costly and time-consuming for the New Zealand borrower to undertake this exercise.

If the hypothetical credit rating exercise is required to be undertaken in respect of multiple overseas companies (e.g. if the credit rating of main operating company is also required to be determined), the difficulty and compliance costs will increase accordingly.

Introducing the interest rate cap as a safe harbour measure would allow a taxpayer to make a choice as to how to proceed, acknowledging that if it chooses not to apply the interest rate cap safe harbour, it is at increased risk of challenge from Inland Revenue.

(b) The parent's cost of funding may not reflect the New Zealand borrower's true cost of funding

In many cases it may be appropriate for debt of a New Zealand borrower to be priced using the credit rating of its ultimate parent as an approximation for the real cost of funding for the New Zealand borrower. However, there are many situations where parts of a group will have third party borrowing at a higher rate than what the parent would be able to obtain. For example:

- in very large groups, local subsidiaries often effectively operate independently – the parent does not necessarily step in to guarantee debt of all subsidiaries, and banks do not price based on an assumption that a parent would support a failing subsidiary – for example, a client of ours was considered by banks to be a significant credit risk due to solvency issues following a number of previous restructures, and banks were only willing to fund at interest rates that were unacceptably high regardless of the company being part of the large MNC;
- groups may operate through regional hubs – for example, a European group may have an Asian regional group that operates relatively independently and without support from the European group;
- a subsidiary that is not material to the parent or to the group operations overall, and which consequently may have a significantly lower credit rating than the parent, in many cases will obtain third party lending at a higher rate and without parent support;
- the parent may not be a 100% parent – if for example the parent holds 51% and other shareholders have a significantly lower credit rating, a bank is most unlikely to price debt based on the parent's credit rating;
- the subsidiary and the parent may be in different industries, or a subsidiary may operate in only one of the numerous industries of the group – if the industry of the borrower is riskier than the remainder of the group, a bank would charge a higher interest rate;
- taking into account foreign exchange risk and hedging costs may lead to a different commercial decision regarding lending than simply looking at the parent's cost of funds;
- certain industries (e.g. infrastructure) have complex financial instruments due to the nature of the business, which cannot be matched to what the parent's cost of funding would have been.

In these circumstances and others where the New Zealand borrower actually has third party borrowing, this is the best evidence of what the New Zealand borrower's cost of funding is, and interest deductions for related-party debt priced by reference to these actual third party borrowings should be permissible. If an intermediate company in the group has third party borrowing and on-lends to a New Zealand subsidiary this is also legitimate evidence of the New Zealand borrower's true cost of funding and the interest deductions should be permissible.

A taxpayer who decides not to apply an interest rate cap safe harbour and instead apply transfer pricing principles will do so knowing that it faces an increased risk of challenge from Inland Revenue (and potentially a high evidential threshold to support the interest rate). Where a taxpayer does not want to face this risk, it could apply the safe harbour instead. Inland Revenue could gather information from taxpayers as to whether they have applied the interest rate cap or a higher rate by adding a question into the International Questionnaire or requiring the information to be provided through the Basic Compliance Package process. Our expectation is that if this approach were adopted, a significant number of taxpayers would simply apply the interest rate cap. A taxpayer would only choose to apply a higher rate if that the higher rate was clearly justifiable on arm's length principles, in light of Inland Revenue focus on this area and consequential likely scrutiny.

Finally, we note Officials' concerns about the possibility that a New Zealand borrower may be able to borrow excess levels from third parties, thereby lowering its creditworthiness. Our observations in response to this are as follows:

- a third party lender is not going to advance funding to a borrower that the lender does not see as supportable from a commercial perspective, so this alleged concern seems misplaced;
- a bank's lending will be senior to related-party lending so the level of related-party lending will not affect the amount or price at which a bank will lend; and
- the level of third party debt relative to the worldwide group is already dealt with in the thin capitalisation regime.

(c) Risk of double tax should be able to be minimised and relief should be available

A risk of double tax arises in respect of a cross-border financial arrangement where two jurisdictions have rules resulting in interest income and interest deductions that do not match. At present, this risk is mitigated if the two jurisdictions have entered into a DTA – if one jurisdiction increases income based on arm's length conditions, the other jurisdiction must allow for a compensating transfer pricing adjustment.[4] The taxpayers have access to the mutual agreement procedure where they are not satisfied that the relevant competent authorities have applied the DTA appropriately.

We acknowledge that this risk of double tax already exists where interest deductions are effectively denied under New Zealand's current thin capitalisation regime and the same issue would arise with an EBITDA test. However, in these cases, the debt is <u>priced</u> in both jurisdictions by applying the arm's length principle under each jurisdiction's domestic transfer pricing regime and applicable DTA. Accordingly, while we acknowledge that not all jurisdictions will apply the arm's length principle to result in the exact same price for a related-party transaction in all cases, the taxpayer should have the ability to obtain double tax relief under the DTA and to ensure consistency of approach across the 2 jurisdictions.

Introducing the interest rate cap as a transfer pricing safe harbour rather than an absolute rule would still allow a taxpayer who is concerned by this issue to choose to price related-party debt using arm's length principles and accept a higher risk of Inland Revenue challenge and / or tax adjustment. However, the taxpayer will retain access to double tax relief mechanism through the application of the DTA, and through the mutual agreement procedure if necessary.

[4] Article 9, OECD Model Convention with respect to Taxes on Income and Capital.

(d) Adopting the interest rate cap as a safe harbour is consistent with OECD work on Action 4

Allowing taxpayers an option of continuing to price debt on an arm's length basis is consistent with the OECD's work on BEPS involving interest deductions as set out in the Action 4 Paper. In relation to this:

- The OECD noted that thin capitalisation rules limiting the level of debt (as per New Zealand's rules) would need a further mechanism, such as an arm's length test under transfer pricing, to address BEPS concerns where an excessive rate of interest is applied to a loan (paragraph 58). In our view, applying an arm's length test (considering the actual substance of the amount and terms and with the onus on the taxpayer, as per proposed law changes) alongside New Zealand's existing regime, would deal with the issue of excessive interest.
- The OECD appears to have dismissed a rule based on the level of debt plus a further mechanism in favour of the EBITDA approach because such a rule would "add a step to the operation of a rule and increase complexity" (paragraph 58). These are practical considerations rather than any type of acknowledgement that that arm's length pricing is inappropriate as a matter of policy. In New Zealand's context, we already have a rule based on the level of debt that as Officials note is well understood. The concerns raised by the OECD are therefore less relevant for us.
- The OECD expressed a concern (paragraph 12) that interest limitation rules based on arm's length considerations as to the amount and terms of debt (such as the Australian arm's length debt test alternative to their safe harbour, and the UK's equivalent, where in both cases the main focus in applying the rules is on the *amount* of debt rather than the *price* of debt) may not be effective by themselves to prevent BEPS. However, these comments are in relation to a fundamentally different test to the interest rate cap proposals – they are simply saying that an arm's length test on its own does not deal with Action 4 concerns. There is no statement to the effect that using arm's length principles to price debt are not appropriate.

  In fact, the OECD says the opposite – countries may adopt an arm's length test alongside the best practice approach – the amount of interest claimed would be in accordance with the arm's length principle, but this amount is then subject to limitation under the EBITDA approach. This type of approach makes sense because (i) an EBITDA approach is based on <u>net</u> interest expense of an entity, which may borrow under a number of loans and also advance funds - it is not a "per loan" approach, and (ii) an entity that is profitable but lowly geared would not necessarily be subject to any limitation. In both of these situations, a mechanism for pricing each individual loan remains necessary.
- The OECD states that an advantage of an arm's length rule (albeit in a different context as explained above) is that it recognises that entities may have differing levels of interest expense depending on their circumstances (paragraph 12).

Our recommended approach of applying the interest rate cap as a safe harbour, assuming the Government is determined to proceed with some form of interest rate cap (which we do not agree with), would allow for these comments around policy design to be accommodated in appropriate cases. We acknowledge concerns around resource constraints associated with the application of the arm's length principle (although this applies to all cross-border related party transactions so making an exception to just inbound funding does not address the actual resourcing issue). However, as mentioned above, only taxpayers who can clearly justify their position will price using arm's length

terms, and Inland Revenue will be able to easily identify relevant taxpayers, thereby mitigating this issue. Furthermore, in our submission in relation to transfer pricing proposals, we have stated that increased qualified resourcing in Inland Revenue's transfer pricing team is needed.

A taxpayer should be able to obtain certainty through obtaining an APA or a Determination

A taxpayer who decides to price related-party debt based on arm's length principle rather than the interest rate safe harbour should be able to obtain certainty through applying for an APA. Another alternative could be giving taxpayers the ability to apply for a Determination (as permitted in other contexts under the financial arrangement rules) that may be published in a sanitised form.

Interaction with other tax rules and tax treaties needs to be made very clear

Any denial of a deduction should not be considered anti-avoidance which does not benefit from protection under a DTA, unless section BG 1 applies. If the arrangement is challenged under section BG 1, this would be as per the current setting. If Officials' view is that this proposed interest rate cap is an anti-avoidance rule which overrides DTAs, the relevant domestic legislation needs to make it very clear how this is achieved.

Similarly, how any new rule applies in the context of New Zealand's other domestic tax rules around interest deductions should be made clear, and Determinations under the financial arrangement rules will need to be updated.

Maximum loan term for an interest rate cap safe harbour rule should be longer than five years

Many of our clients have third party loan terms of longer than 5 years. Terms of loans up to 10 years are common and in some cases are even longer. Generally speaking, our clients aim to match liabilities with expected life of assets. For example, industries such as forestry, infrastructure and mining tend to seek funding with a term longer than 5 years because the expected life of their important assets is usually over 5 years. Companies seeking funding to invest in manufacturing operations will also often seek long term funding.

From our discussions on this issue, we understand Officials will reconsider what a more appropriate loan term for calculating an interest rate cap may be under the proposals.

Transitional rules will be needed in relation to APAs

A number of taxpayers have spent significant time, effort and costs obtaining APAs from Inland Revenue which include confirmation of interest rates, for the purpose of achieving certainty. Transitional rules for existing APAs should be considered so that New Zealand's attractiveness and perception of political stability regarding taxation of overseas investment is not diminished.

Treatment of non-debt liabilities (DD Chapter 4)

Proposal requiring calculations to include non-debt liabilities should contain exceptions

We do not support this proposed reduction of asset base by non-debt liabilities. We do not think it is necessary and we note that the change will have a significant effect on many taxpayers in types of businesses and industries that traditionally carry higher levels of provisions or other non-current liabilities which do not materially impact on the borrowing ability of the company. Officials should consider the following:

- If the rationale for the changes is to better reflect what a borrower would be able to borrow from a third party, more work is required to determine what the third party would actually take into account. Usually banks will not overly focus on the level of non-debt liabilities unless the relevant creditors have better priority over specific assets than the banks. For example, deferred tax liabilities should be excluded from the calculations, as per the Australian equivalent rules.[5] Some of our clients have significant deferred tax liabilities that should not be relevant to their thin capitalisation position. For example, significant deferred tax balances can arise if (a) companies have valuable intellectual property that is amortised for accounting but not for tax purposes, and (b) in the forestry industry, where asset values grow significantly over years but tax is not due until sale of the trees. There are many more examples. Other liabilities should also be excluded if they are not funding a taxpayer's balance sheet, and other items such as provisions for dividends and preference shares. A number of other types of provisions, while correct from a technical accounting perspective, would have limited impact on the borrowing ability of the company.
- A number of industries are likely to be significantly disadvantaged under these rules – for example, industries with significant rehabilitation requirements or other unique features such as securitisation / securities lending / retirement village arrangements; industries with significant creditor balances and other provisions. If the proposals proceed we recommend that specific carve outs for some of these industries or scenarios will be needed. Retirement village operators, for example, often receive significant non-interest bearing cash deposits from the licences of retirement units (as payment for the right to occupy) but which technically are shown as liabilities on their balance sheet.
- Taking non-debt liabilities into account will introduce volatility to taxpayers' thin capitalisation calculations. The volatility will broadly be equivalent to the volatility recognised as a problem with an EBITDA-based test, and therefore protection from volatility (such as ability to carry denied interest deductions forwards and backwards) should be considered.
- Taking non-debt liabilities into account could put taxpayers into a negative equity position. For example, one of our clients which has recently become subject to the thin capitalisation regime due to the "acting together" rule has negative equity due to a significant deferred tax liability and therefore under the proposals would have all interest deductions disallowed – this does not seem an appropriate outcome.
- Several of the examples in Chapter 4 are not commercial or realistic as they would risk the company failing the company law solvency test.
- To give just a couple of examples of the effect of including non-debt liabilities, one client's current thin capitalisation ratio is 49.5%, and it would become 56.6% taking into account non-debt liabilities, even though the company is not particularly highly leveraged and all debt is third party bank debt. Another client's ratio would move from 40% to 93%, if the proposal for asset values (discussed below) is also adopted.

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[5] Income Tax Assessment Act 1997 – section 820-682.

Other matters (DD Chapter 5)

Scope of proposed de minimis exception for inbound investment should be extended

We support the introduction of a de minimis for inbound thin capitalisation rules. However, the proposal to introduce a de minimis in cases where there is no owner-linked debt is unlikely to be useful in practice. The de minimis should instead apply to all cases where the inbound thin capitalisation rules apply. This would be in line with the OECD's proposals as referenced in the DD.

Carve out for infrastructure projects with third party funding needs further consideration

We support a proposed carve out for infrastructure projects. However, further consideration should be given to the following:

- there may be situations where the asset holding entity is different, but related to, the funding entity, e.g. a limited partnership holds the assets and a related party entity secures the required third party funding. The exception should still apply providing that the third party funding is on-lent to the related entity (even though technically the funding may be owner-linked debt);
- the entity will generally not own the asset at the end of construction phase, so how the proposals as to valuation of the assets will need to take into account the service charge the entity has received;
- the rate should apply to an offshore infrastructure entity that is globally funded by third party borrowing where it can allocate funding to a New Zealand infrastructure project;
- an exemption should be included (similar to Australia) for securitisation vehicles and arrangements which by their nature are highly geared.

Ability to use net current asset values should be retained

We understand Officials are concerned that asset valuations used for thin capitalisation purposes but not for financial reporting purposes may not be subject to a reasonable level of independent valuation or scrutiny. We understand this potential concern, but as we have discussed with you, it could be addressed in ways other than restricting asset values to those included in financial statements. The DD, at paragraph 5.25 states "…we consider that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets".

This is incorrect. Your Tax Information Bulletin: Volume Seven, No.11, Page 19 (March 1996) correctly said (when the thin capitalisation rules were first introduced) – "…it is recognised that the valuations for financial reporting purposes are likely to have been adopted for other than tax reasons". Consequently it was concluded that a taxpayer should be able to use net current value if that taxpayer could have adopted it for assets under GAAP (now IFRS) but has chosen not to.

Net current values (or fair value) are permissible under IFRS 13 but taxpayers instead choose not to adopt them for financial reporting purposes for non-tax reasons. These reasons include:

- in the context of worldwide groups that prepare consolidated accounts at the ultimate parent level, groups choose not to go to the additional expense of preparing entity accounts in the New Zealand group on a net current value basis and instead simply adopt historical cost;
- many entities within a group are not required to prepare individual entity financial statements;

- using net current value for financial reporting purposes can give rise to volatility in earnings ratios presented to shareholders which companies prefer to minimise, even though the changes in market value of the assets is a fact of life.

If the ability to use net current value is not retained, taxpayers will, for tax reasons, adopt net current value for financial reporting purposes despite it making no sense for commercial reasons. This change of accounting policy in financial statements under IAS 8 can be made (i.e. it is elective) if the result is more reliable or relevant. This will particularly be the case when there is a significant difference between historical cost and fair value.

As we have discussed with Officials in our meetings, we strongly submit that the ability to use net current values for thin capitalisation purposes needs to be retained.

Officials' concerns could be addressed by requiring valuations being adopted for thin capitalisation purposes to be supported by a valuation from a registered valuer, or a similarly qualified independent person.

Measurement of assets and liabilities should continue to be able to be end of year values (but perhaps average of start of year and end of year)

We understand Officials' concerns that the value for an asset or a liability can be manipulated if a value at a single point in time is used. We think this concern is already dealt with by the existing specific thin capitalisation rules regarding temporary differences. But if this is not enough then as we have discussed with you, continuing to be able to use year end values is very important, and a proposal that the average of opening and closing values is used would be more acceptable. This is preferable to quarterly or daily measurement because:

- the majority of taxpayers currently have no other need to value assets and liabilities quarterly or daily – the increased compliance burden and financial cost that would be imposed in obtaining such values (which often are only properly determined at year end) should not be underestimated;
- valuation outside the financial reporting cycle is inconsistent with the proposal referred to above that values used in financial statements should be used; and
- some balance sheet items are only measured annually – for example, asset impairment – it would not be possible to properly take these into account if measurement was required quarterly or daily.

Outbound thin capitalisation rules

Further consideration regarding the potential impact under the outbound thin capitalisation rules for New Zealand groups (especially SMEs and emerging fast growth businesses). If they have to apply most of these proposals, then the impact and compliance costs could be very material to New Zealand groups which the New Zealand Government should be wanting to support.