AMP CAPITAL

27 April 2017

BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir/Madam

Submission on Discussion Document: BEPS – Strengthening our interest limitation rules

The following submission has been prepared by AMP Capital Investors (New Zealand) Limited (AMP Capital New Zealand) on the Discussion Document: BEPS – Strengthening our interest limitation rules. AMP Capital New Zealand is a specialist investment manager that manages a number of funds that are Portfolio Investment Entities (PIEs), as well as private equity investments. Our submission focuses on the potential affect of the interest limitation proposals contained in the discussion document on some of the investments that we manage on behalf of investors.

Background

New Zealand has a broad base, low rate tax system with limited exceptions. We understand what you are trying to achieve which is ensuring that the New Zealand tax base is protected and non-residents pay their fair share of tax here, as appropriate. However, the necessity to collect tax from non-residents needs to be balanced with the fact that New Zealand is heavily reliant on foreign direct investment and must remain an attractive place for non-residents to invest[1].

The proposals outlined in the discussion document will affect non-residents investment into New Zealand. In particular as they create tax mismatch and a high risk of a double taxation impact. This in turn will affect investor's returns. Non-resident investment in New Zealand is highly likely to reduce post investor's returns being impacted. Our comments on the proposed approach and the specific interest limitation proposals set out in the discussion document are detailed below.

Overall approach

The proposed interest rate cap is a unique approach and is uncalled for due to the recommended strengthen transfer pricing rules. The overall outcome of the interest rate cap proposal for inbound entities (New Zealand entities owned by non-residents), is a potential tax mismatch and a high risk of double taxation. This is best outlined through an example;

- A New Zealand company has a loan from its Australian owner,
- In New Zealand deductions are available to the company for the interest on the loan, say at 5% under the proposed interest cap,
- In Australia the non-resident owner is required to use an arms length interest rate under its transfer pricing rules, say at 7% which is returned as income,

There is a tax mismatch between the jurisdictions and double taxation of 2% as outlined above. The double taxation will affect the non-resident's shareholders or investor's returns from their investment. There is also the unknown factor of what actions will be undertaken in the non-residents owners' jurisdiction by its tax authority for the effect of the interest rate cap in New Zealand. The purpose behind

[1] Page 4, point 2.1, Discussion document – BEPS – Strengthening our interest limitation rules

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the BEPs actions was to eliminate these types of international tax issues or mismatches not potentially create them.

There is no comment in the discussion document about how outbound investment (New Zealand entity with an offshore subsidiary) would be treated. Do they continue to use the arms length basis for transfer pricing, if yes how is this justified given the proposed interest rate cap for inbound investment?

Further, if introduced the interest rate cap will create inequity between New Zealand entities owned by New Zealanders and those owned by non-residents due to the double taxation outlined above. We expect that this inequity would result in reduced future non-resident investment in New Zealand. This would cause a higher cost of capital for New Zealand entities and infrastructure projects. These results are at odds with the statement made that New Zealand is heavily reliant on foreign direct investment and must remain an attractive place for non-residents to invest[2].

Marginal cost of debt

The statement "at the very least the marginal cost of debt should be no more than the marginal return from further investment" has been made in point 2.7 of the document. Where is the back up or justification for this statement? Is this some sort of economic theory or does this occur commercially?

Effectiveness of transfer pricing rules

It has been stated in the document that we are not convinced that the strengthened transfer pricing rules will prevent profit-shifting through the use of high-priced related party debt[3]. Has an exercise been undertaken to:

- Determined the scope that would be available for related parties to use high priced debt under the proposed amended transfer pricing rules, and
- Modelled the actual risk, if any, and
- Considered solutions for removing any scope available for the use of high priced debt?

Further, it has been stated that it is difficult to challenge a high level of related party debt loaded into a New Zealand subsidiary which depresses a subsidiary's credit rating and is used to justify a higher interest rate, as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and similarly high interest rates[4]. If taxpayers can find commercial comparatives for transfer pricing purposes that match their circumstances, would this not point to the fact that commercial lenders are not just undertaking the pure third party financing, which your proposals refer to. If this is the case, are these proposals creating an artificial environment which does not mirror actual commercial reality?

Interest cap

We reiterate that in our view the proposed interest rate cap is a novel approach and it is unnecessary due to the recommended strengthen transfer pricing rules. The overall outcome of the interest rate cap proposal creates inequity between New Zealand entities owned by non-residents and those owned by New Zealanders. In the future we expect that this inequity would result in reduced non-resident investment in New Zealand which would cause a higher cost of capital for New Zealand entities and projects.

It is proposed that the cap on the interest rate is based on what the borrower's ultimate parent could borrow at on standard terms. The details are light on how an ultimate parent would be determined. We question whether it's appropriate to use the ultimate parents borrowing terms approach as:

- in large groups the parent entity can be a number of entities removed from the New Zealand entity,
- the ultimate parent entity could have a different risk profile to the New Zealand entity, and
- either the parent or the borrower entity or both could be subject to rules, regulations or restrictions which affect their borrowing profiles.

It is suggested that where an ultimate parent is controlled by a non-resident owning body then the interest rate cap will be based on the rate the New Zealand borrower could issue senior unsecured debt on

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[2] Page 4, point 2.1, Discussion document – BEPS – Strengthening our interest limitation rules
[3] Page 8, point 3.7, Discussion document – BEPS – Strengthening our interest limitation rules
[4] Page 9, points 3.11–3.12 Discussion document – BEPS – Strengthening our interest limitation rules

standard terms. Limited comments have been made on what is a non-resident owning body. Thus it is difficult to determine if non-resident private equity investors or managed funds would fall within the non-resident owning body concept and the possible impacts of this. Further, there would be a cost for taxpayers subject to this approach in determining what their interest rate would be.

It has been proposed that related party loans with terms longer than five years will be treated as having a five year term when determining an appropriate interest rate[5] due to it being unusual for commercial loans being committed for longer than five years. We have experience of commercial loans being written for periods of longer than five years. If applied, this rule would unfairly penalise New Zealand borrower entities through capping the terms of related party debt to an artificially determined period of time.

Infrastructure projects

We support the proposal that an entity can exceed the thin capitalisation 60% safe harbour ratio for infrastructure projects. However, the exemption should be extended regardless of whom controls the entity that is a single non-resident or multiple non-residents. Infrastructure entities generally require large amounts of capital which cannot necessarily be funded by one non-resident owner. Often potential non-resident owners such as managed funds will be restricted in amount they can invest or lend due to their investment guidelines, so more than one non-resident investor may be required.

Non-residents acting together

There is a proposal to change the way the thin capitalisation rules applying to entities controlled by a group of non-residents acting together. For such entities, where they exceed the 60% safe harbour any non-resident owner-linked debt will be non-deductible[6]. What is the reason behind denying interest on owner-linked debt where the 60% threshold is breached? Surely any denial of interest should be linked to the proportion of the breach, rather than making it all non-deductible.

Measurement date for assets and liabilities

It is proposed that the measurement periods for assets and liabilities for thin capitalisation would be the end of each quarter or the end of every day in the income year[7]. This approach would introduce significant costs for taxpayers subject to these rules, in relation to systems required for the calculations and obtaining the appropriate data. Generally systems that produce daily calculations such as unit pricing for the managed funds are complex and costly. Further, the IFRS accounting data e.g. fair valuing of assets, needed for these calculations are commonly not produced quarterly or daily. To require this information only for tax purposes would impose a significant cost and burden on taxpayers. We recommend that the current ability to measure assets and debts on the final day of an entities income year is retained.

Please feel free to contact the writer on [redacted] if you would like to discuss any of the points outlined above.

Yours sincerely

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[5] Page 16, point 3.53, Discussion document – BEPS – Strengthening our interest limitation rules
[6] Page 26, Discussion document – BEPS – Strengthening our interest limitation rules
[7] Pages 29-30, Discussion document – BEPS – Strengthening our interest limitation rules