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Response to

Inland Revenue

on the

Government discussion document:

BEPS – Strengthening our interest limitation rules

28 April 2017

bnz

1.0 INTRODUCTION

1.1 This submission has been prepared by Bank of New Zealand ("BNZ") in response to Inland Revenue's ("IR") discussion document, 'BEPS – Strengthening our interest limitation rules', released on 3 March 2017 ("Discussion Document").

1.2 BNZ welcomes this opportunity to provide a response to IR's Discussion Document. While BNZ is wholly supportive of actions to counter aggressive tax planning and tax avoidance, BNZ remains of the view that any legislative reform to counter aggressive tax planning must be appropriate for, and targeted at, the mischief it is intended to address. Many of the proposals contained in the discussion document have broad reach and are, in a number of cases, insufficiently targeted. A consequence of this is that compliant taxpayers who are currently paying a "fair amount of tax" will be affected, and in the case of the proposed interest rate cap, will be potentially exposed to double taxation.

1.3 BNZ is a member of the Corporate Taxpayers Group ("CTG") and the New Zealand Bankers' Association ("NZBA") and has been involved in the submissions each group has made on the discussion document. While BNZ is in total alignment with the submissions made by the CTG and the NZBA, BNZ wishes to make an additional submission on specific aspects of the proposals.

2.0 EXECUTIVE SUMMARY

2.1 The Discussion Document notes that it is a minority of firms that have borrowed from their foreign parents at high interest rates. If the issue is confined to a minority of firms, then a targeted response would be more appropriate. The introduction of the proposed reconstruction provision in the recently released discussion document on Transfer Pricing and Permanent Establishment Avoidance ("TP Discussion Document") should provide IR with sufficient tools to deal with those specific situations where excessive interest deductions are being claimed.

2.2 The proposed interest rate cap would significantly increase the potential for double taxation and does not allow for competent authority resolution when the other jurisdiction requires a higher rate of interest to be charged under its transfer pricing rules, based on the international standard arms-length principle.

2.3 If the interest rate cap proposal does proceed, banking regulatory capital should be excluded. The subordinated nature and longer terms for which regulatory capital debt is issued is a direct consequence of the rules mandated by the Reserve Bank of New Zealand ("RBNZ"), and/or the Australian Prudential Regulatory Authority ("APRA"). Debt that is issued for banking regulatory capital purposes is patently not issued so as to engineer excessive interest deductions and so should not be subject to the proposed interest rate cap. For banking regulatory capital, it is appropriate that the interest rate permitted for tax purposes is based on an arms-length rate of interest as that is what is required by RBNZ.

2.4 If the interest rate cap proposal proceeds, the definition of related party debt should be defined such that debt raised from third parties by a subsidiary of a New Zealand bank and then on-lent to the registered bank is not caught by the interest rate cap.

2.5 If the interest rate cap proposal proceeds, it should only operate as a safe-harbour, such that if a taxpayer chooses to be subject to the interest rate cap, full transfer pricing documentation supporting the arms-length price would not need to be prepared. However, the international standard arms-length principle should be retained for taxpayers who are prepared to carry out a transfer pricing exercise to establish an arms-length interest rate.

2.6 If the proposal proceeds, withholding tax should only apply to the extent that a tax deduction has been claimed. This would result in greater consistency with other recent legislative changes seeking to align the imposition of withholding tax with the deduction of interest costs by the borrower.

3.0 SUBMISSIONS

The proposed interest rate cap disregards the arms-length principle

3.1 BNZ does not support the proposed interest rate cap as it is a significant departure from the arms-length principle and will result in tax outcomes that are inconsistent with the real commercial and economic substance of the underlying arrangements.

3.2 The stated objective of the rule is to ensure pricing of related party debt is roughly in line with the interest rate the borrower would agree with a third party lender. In our view an interest rate cap does not necessarily achieve this. The proposal to base the interest rate on the senior unsecured corporate bonds rate assumes that all debt issued by the group would be senior unsecured debt, whereas there may be good commercial reasons for subordinated debt to be issued. Banking regulatory capital is a case in point.

3.3 The proposed interest rate cap also assumes that the interest rate a subsidiary would be able to agree with a third party financier is only marginally different from what the subsidiary's global parent could agree. This effectively treats a multinational group as a single commercial entity, and in doing so, any fundamental differences that exist between entities within a group, such as the nature of the businesses they conduct, the commercial risks faced and the markets in which they operate are disregarded. Under the proposal, the international standard arms-length approach to setting the interest rate on intragroup loans is abandoned in favour of a blunt approximation of the group's average cost of funds. BNZ considers that the arms-length principle should be preserved in setting interest rates on related party loans.

3.4 There is limited justification given in the Discussion Document for the departure from the arms-length principle. The primary reasons offered are that it can be difficult for IR to challenge uncommercial arrangements under the transfer pricing rules and that the highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply. While BNZ accepts that transfer pricing rules can sometimes be difficult to apply, that of itself is not good reason to abandon the arms-length principle which is a core concept in established transfer pricing and international taxation.

3.5 The OECD report "Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports" continues to support the arms-length approach to transfer pricing while acknowledging that application of the principle may be prone to manipulation. Rather than abandoning the principle, the OECD guidance authorises the disregarding of arrangements between associated enterprises for transfer pricing purposes when the transactions lack commercial rationality. This approach is included as a proposal in the recent Inland Revenue Discussion Document: "BEPS – Transfer pricing and permanent establishment avoidance", which proposes disregarding legal form if it does not align with the actual economic substance of the transaction.

3.6 In BNZ's view, the introduction of a reconstruction provision that enables the Commissioner to disregard transactions where the legal form does not align with economic substance ought to be sufficient to deal with the minority of multinationals setting excessive interest rates on related party loans. The proposed interest cap aims to counter the same mischief, only it is less targeted. BNZ does not consider there to be a compelling reason to have multiple tools to combat the same perceived mischief.

3.7 Finally, the fact that the Discussion Document excludes out-bound intercompany loans from the proposed interest rate cap serves to highlight that the interest rate cap is not a principled approach to setting interest rates on intercompany loans. If Government and the Commissioner are happy that the proposed interest rate cap ensures the interest rate on a related party loan is

"roughly in line with the interest rate the borrower would agree to with a third-party lender"1, then the approach should apply to both inbound and outbound loans.

Reconstruction provisions for uncommercial arrangements is a more targeted approach

3.8 The base erosion and profit shifting behaviour that the proposed interest rate cap is targeting is, according to the Discussion Document, that there is a "minority that engages in more aggressive tax practices"2 where "some firms have borrowed from their parents at high interest rates, resulting in large interest deductions in New Zealand"3. The Discussion Document does not suggest this is a widespread problem, rather, that a minority of firms are taking excessive interest deductions.

3.9 If a minority of taxpayers are setting excessively high interest rates on intercompany loans, the most appropriate response is a targeted anti-avoidance measure. A targeted response should be preferred over a rule that applies broadly to all taxpayers as the broad approach will adversely affect valid, justifiable transactions as well. This is a particular concern due to the high potential for double taxation (see below) that will arise under the proposed interest rate cap.

3.10 A sufficiently targeted anti-avoidance measure has been proposed in the TP Discussion Document in the form of a reconstruction rule. The Discussion Document acknowledges that the proposed reconstruction rule strengthens the existing transfer pricing rules against aggressive tax practices. However, it goes on to argue that stronger transfer pricing rules are inadequate because sufficient commercial pressures do not exist in a related party context and that as a consequence, unnecessary and uncommercial terms feature in some related party loans.

3.11 The operation of the proposed reconstruction provisions in the TP Discussion Document is not dependent in anyway on there being a commercial tension within a related party funding transaction. Acknowledging that the reconstruction proposals are still only proposals, BNZ does not expect that the presence or absence of commercial pressures in a related party funding arrangement would have any bearing on the ability of IR to invoke a reconstruction provisions. Conversely, the reconstruction provisions would seem to be specifically targeted at those related party funding transactions where, through the absence of commercial pressures, the terms of the funding arrangement are unreasonable and uncommercial.

3.12 The fact IR is able to identify the features it considers are uncommercial and unnecessary means there should not be a concern with identifying those funding arrangements it considers result in excessive interest deductions.

Double taxation

3.13 The proposals do not address the double taxation that will result when the interest rate cap applies to deny an interest deduction in New Zealand but where the overseas jurisdiction requires the loan to be priced at an arms-length.

3.14 An example of this would be where banking regulatory capital is obtained from an Australian parent company and that capital is in the form of subordinated debt. The Australian transfer pricing rules would require standard arms-length principles to apply such that the interest rate on the debt is a market rate of interest, having regard to the credit rating of the New Zealand bank and the subordinated terms of the loan etc. In order to comply with the Australian transfer pricing rules, the loan would likely be priced at a rate higher than the interest rate allowed by the

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[1] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 3.17
[2] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 1.4
[3] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 1.4

proposed interest rate cap. This means an interest deduction will be denied in New Zealand but that same interest will remain taxable in Australia.

3.15 In addition, there does not appear to be any ability for an affected taxpayer to engage the mutual agreement procedures contained in New Zealand's tax treaties when there is a tension between the interest rates that each jurisdiction deems to be appropriate. BNZ strongly recommends that this position is reviewed and that IR ensures mutual agreement procedures are available to mitigate the double taxation risks.

3.16 A consequence of the double taxation outcome that will result is that the hurdle rate for investment into New Zealand increases. In the context of the Australian owned banks operating in New Zealand, this will transpire as an increase in borrowing costs for New Zealand businesses and homeowners.

Withholding tax implications

3.17 As proposed, New Zealand withholding tax (or Approved Issuer Levy) would continue to apply to the actual interest payments made regardless of the amount of interest deemed to be deductible for New Zealand tax purposes.

3.18 BNZ expects IR will take the position that it is appropriate for withholding tax to apply as there is still a transfer of value from the subsidiary to the offshore parent, i.e. there is effectively a dividend. However, if that argument is to hold, the withholding implications should mirror what would occur if a dividend was declared and paid. Under many of New Zealand's double tax treaties such a dividend would not be subject to New Zealand withholding tax.

3.19 BNZ submits that withholding tax should only apply to the deductible interest amount. This is consistent with other recent legislative changes to align the deductibility of interest and the impost of withholding tax.

Banking regulatory capital

3.20 BNZ submits that banking regulatory capital should be excluded from the interest rate cap. Banking regulatory capital has many of the features it does (i.e. subordination, longer terms, convertibility) purely because of the regulation imposed on New Zealand registered banks under RBNZ's prudential supervision framework. This is in contrast to the Discussion Document's contention that such features are used primarily to drive up the interest rate on related party funding.

3.21 The capital adequacy framework in New Zealand is based upon the Basel capital framework developed by the Basel Committee on Banking Supervision. The framework incorporates minimum capital ratios, defines what qualifies as qualifying capital, includes internal capital adequacy assessment processes, and includes a disclosure regime. It is highly prescriptive.

3.22 A consequence of the highly prescriptive nature of the capital adequacy rules, along with a relatively shallow debt market in New Zealand means that New Zealand registered banks do, and will, have subordinated related party debt. The debt is typically deeply subordinated, may be for terms exceeding five years and may include conversion features however these are purely to meet the requirements of the prudential regulatory regime, and not for the purposes of obtaining an excessive interest deduction in New Zealand.

3.23 To highlight this point, the following is an extract from Subpart 2B of the Reserve Bank of New Zealand Capital Adequacy Framework (Standardised Approach) - Document BS2B, issued November 2015, which defines the criteria for classification as Additional Tier 1 capital:

To qualify as Additional Tier 1 capital, an instrument must satisfy the following criteria:

(a) ....

(b) The instrument represents, prior to any conversion or write-off (refer subpart 2E and subpart 2F), the most subordinated claim in the liquidation of the registered bank after Common Equity Tier 1 capital. Nothing in this provision shall prevent one Additional Tier 1 instrument being subordinated to another Additional Tier 1 instrument.

(c) The paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of any member of the banking group or a related entity, or subject to any other arrangement that legally or economically enhances the seniority of the holder's claim vis-a-vis bank creditors. The instrument may not be subject to netting or offset claims on behalf of the holder of the instrument.

(d) The principal amount of the instrument is perpetual (i.e. there is no maturity date). However, the instrument may be callable or redeemable at the initiative of the registered bank after a minimum of five years from the date on which the registered bank irrevocably receives payment for the instrument. Despite anything in this subpart, an instrument may:

(i) provide for the registered bank to have a right to call or redeem the instrument within the first five years of issuance as a result of a tax or regulatory event. Instruments issued after 1 January 2016 must include as a term of the instrument that the instrument may not be callable as a result of a tax or regulatory event if that event was anticipated at the time of the issue of the instrument or if the event is minor (or words to that effect) ...

3.24 The requirements above mean that in order to qualify as Additional Tier 1 Capital, the debt must be, subordinated, unsecured and perpetual; all features the Discussion Document highlights as being used by multinational groups to artificially drive up interest rates on related party debt. In the context of banking regulatory capital, however, there is no real choice in the form of the debt that is being issued.

3.25 RBNZ also requires that related party debt that qualifies as regulatory capital is issued at an arms-length interest rate. As a rule, such debt would be priced based on the prevailing market interest rate on instruments with similar terms on the day the debt is issued. The proposed interest rate cap would put New Zealand registered banks in a position where two regulators impose directly competing rules in relation to the setting of interest rate on related party debt. It is therefore, not appropriate for banking regulatory capital to be captured by the proposed interest rate cap.

3.26 If the interest rate cap did apply, a consequence of disallowing interest deductions on banking regulatory capital would be an increase in the cost of funds to the New Zealand banks. Absent a change in the regulatory capital regulations, banks would still have limited choice in the types of regulatory capital they raise and would need to continue to issue related party debt that is subordinated, perpetual and/or convertible. The cost of the interest denial will inevitably flow on to the interest rates New Zealand registered banks charge to New Zealand businesses and homeowners.

3.27 Banks will typically hold a prudential buffer over and above the minimum capital requirements to ensure that the minimum capital ratios are not breached unexpectedly. It could be argued that in the absence of an interest rate cap banks would load-up on Additional Tier 1 capital issued to the Bank's parent company. However, Additional Tier 1 capital is more expensive than other forms of funding that does not qualify as regulatory capital. Holding excessive amounts of regulatory capital adversely impacts the New Zealand banks' financial performance as cheaper funding can be obtained. RBNZ imposes as a condition of registration on New Zealand banks the requirement for the board of directors of the New Zealand bank to act in the best interests of the New Zealand bank. This is outlined in the Reserve Bank of New Zealand Document BS14 – Corporate Governance:

Acting in best interests of the bank

(1) The aim of the conditions discussed above is to ensure as far as possible that the board collectively will, in practice, take decisions in the best interests of the bank, without undue influence from parties whose interests may diverge from the bank's. There is also a condition which prohibits the registered bank from having in its constitution a provision permitting a director, when exercising power or performing duties as a director, to act other than in what he or she believes is the best interests of the bank.

(2) Although a director of a company, when exercising powers or performing duties as a director, is normally required under the Companies Act 1993 to act in good faith and in what the director believes to be the best interests of the company, section 131(2) of the Companies Act allows a director of a subsidiary to act in a manner which he or she believes is in the best interests of its holding company even though it may not be in the best interests of the subsidiary, if expressly permitted by the subsidiary's constitution. Therefore this condition of registration prohibits the registered bank's constitution from allowing a director to act other than in the bank's best interests.

3.28 This requirement, to act in the best interests of the New Zealand bank, means that the board of directors could not agree to a course of action that involved a New Zealand bank having a preference to expensive related party debt where other alternative funding options are available.

3.29 Finally, as all the major retail banks in New Zealand are Australian owned, the argument that interest rates on intercompany regulatory capital might be set with a purpose of inflating interest deductions in New Zealand to the overall benefit of the worldwide group simply does not hold. The corporate tax rate in New Zealand is 28% while the corporate tax rate in Australia is 30%. Even if it were possible to inflate interest rates to achieve a tax advantage to the group (and it is not, given the regulatory conditions), it would not make economic sense to generate excessive interest deductions in the lower tax jurisdiction.

Related party definition

3.30 If the interest rate cap proposal proceeds, BNZ submits that the definition of related party debt should be amended to exclude debt raised from third parties by a subsidiary of a New Zealand registered bank and on-lent to the New Zealand bank. This is necessary because it is common for New Zealand banks to have a subsidiary that issues debt to the external market which is on-lent to the New Zealand bank. In these situations, there is a clear market interest rate for the debt (the rate on the debt issued to the external market) and it is that market interest rate that should be permitted for tax purposes.

3.31 Such an approach would be consistent with an underlying premise of the interest rate cap which is to treat the group of companies as a single economic entity rather than independent entities dealing at arms-length.

Interest rate cap should operate only as a safe-harbour

3.32 BNZ submits that the proposed interest rate cap should only operate as a safe harbour.

3.33 BNZ agrees with comments in the Discussion Document that it can be a complex and resource intensive exercise to establish what is an arms-length interest rate for an intercompany loan. This holds true for taxpayers and IR. Therefore, BNZ can see some merit in introducing an interest rate cap as a safe-harbour.

3.34 Under a safe-harbour approach, taxpayers who do not wish to undertake full transfer pricing analysis to determine an arm's length price would be free to apply a rate that meets the interest rate "cap". However, a taxpayer would be able to exceed this safe harbour if an arms-length interest rate (applying the transfer pricing rules) is higher than the interest rate cap.

3.35 The main benefit of this is approach is that the arms-length principle is preserved, and taxpayers would have a choice as to whether the benefits of undertaking a transfer pricing exercise to validate a higher arms-length interest rate exceeds the cost of doing so. It would also partially address the concerns BNZ has with the double taxation issues as a taxpayer would not be limited to the capped interest rate if there was a significant risk of double taxation under that approach (i.e. where the other jurisdiction required a higher interest rate under its standard arms-length based transfer pricing rules).

3.36 It would also mean that IR could focus its compliance / audit resources on those taxpayers who wish to use a rate over the safe-harbour but still allow taxpayers to use a greater interest rate where it is appropriate to do so on an arm's length analysis.

4.0 CONCLUSION

4.1 BNZ is pleased to provide this submission and the information it contains. BNZ is available to discuss any issues raised.

4.2 Should IR have any questions in relation to this submission, please contact:

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