#024

Westpac New Zealand Limited
Westpac on Takutai Square
PO Box 934
Auckland 1010

30 April 2017

BEPS – Interest Limitation Rules
C/- Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath,

Submission
BEPS – Strengthening our interest limitation rules: A Government discussion document

Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch (Westpac collectively) welcome the opportunity to submit on the Government discussion document "BEPS – Strengthening our interest limitation rules" (the Discussion Document) published in March 2017. Westpac appreciates both the opportunity to provide feedback on the Discussion Document and to continue to engage with officials in relation to the proposals.

Westpac is a member of the New Zealand Bankers Association (NZBA) and the Corporate Taxpayers Group (CTG) and supports the submissions provided by those bodies on behalf of their members. The following comments are intended to supplement the feedback provided by NZBA and CTG.

In summary we do not support the proposal outlined in the Discussion Document to limit the deductible interest rate on related party loans from a non-resident to a New Zealand borrower. We submit that at a minimum New Zealand banking groups should be excluded from the ambit of the proposals and that the rules should be refined so that they target the specific cases of abuse (as outlined in paragraph 1.4 of the Discussion Document, where it is acknowledged that only a minority engages in the behaviour these proposals are intended to target).

We have limited our comments to the proposals contained in Chapter 3 on the basis that most of the changes outlined in the Discussion Document do not apply to New Zealand banking groups given that the industry is already subject to a special thin capitalization regime.

We note the following in support of our submission:

Regulatory framework

The Discussion Document outlines the policy rationale for the proposals in paragraphs 3.3 to 3.14. In essence we understand that Inland Revenue Department (IRD) are concerned that the transfer pricing rules are ineffective to combat, in a related party scenario, tax aggressive behaviour and specifically the use of excessive and uncommercial interest rates for related party loans. The statements contained in these sections do not apply to Westpac and New Zealand banks more generally. This is due largely to the regulatory and commercial environment in which registered banks operate.

One of the primary tasks of the Reserve Bank of New Zealand (RBNZ) is to monitor and supervise registered banks in order to maintain the health and stability of the financial system. Under the RBNZ rules[1] a bank can only be registered where it meets criteria relating to its financial position, governance and ability to carry on business in a prudent manner (hereinafter referred to as conditions of registration) all of which preclude aggressive and uncommercial behavior including in respect of related party loan structuring.

[1] Further details of the extensive banking regulatory environment (based on Basel III principles) under which New Zealand registered banks operate are provided in the NZBA submission.

More specifically, a combination of the capital adequacy and liquidity frameworks in which New Zealand banks operate mean that the perceived behaviour used as justification for the proposals just do not exist in a banking context.

First, within the capital adequacy framework (BS2A and BS2B) a registered bank must maintain certain levels of regulatory capital. Currently the RBNZ prescribed minimum capital ratios for Common Equity Tier 1 (CET1), Tier 1 and Total Capital, are 7.0%, 8.5% and 10.5% respectively. CET1 must be made up of ordinary share capital and retained earnings (i.e. no debt element whatsoever). Ordinary share capital is universally accepted to be the most expensive form of funding, for any entity, predominately due to the risk of return given that ordinary shares rank last in the case of company liquidation. In respect of the other elements that can make up a banking groups regulatory capital (Additional Tier 1 and Tier 2 capital), while they can be debt in legal form, they must contain features in respect of subordination, tenor, discretion over interest payments and loss absorbency that mean from a regulatory perspective these instruments are more akin to share capital than ordinary debt funding. In such instruments, the interest rate will reflect the restricted rights of holders of an Additional Tier 1 or Tier 2 instrument and level of subordination in terms of ranking in liquidation. This is simply how the market operates from a commercial perspective, reflecting the balance between risk and return.

Secondly, the RBNZ's Liquidity Policy (BS13) impacts on the type and source of funding a New Zealand banking group can hold. The policy provides for a cap on any single party providing funding and for the purposes of the limits, related parties of a registered bank are treated as a single provider of that funding. BS13 therefore means that from a tax perspective the risk of excessive related party lending does not exist. Additionally, BS13 prescribes RBNZ disclosure requirements in respect of liquidity risk and liquidity risk management.

From both a capital efficiency and profitability perspective (noting that the weighted average cost of funding is a key driver of a banks net interest margin), it is in the New Zealand's banks interest to optimize its funding costs through diversification of funding sources. The features of regulatory capital and limits on related party funding create a natural bias for a bank to leverage its parent's ability to raise regulatory capital rather than "standard" unsubordinated debt not least because generally the offshore parent bank can raise regulatory capital at a much cheaper rate than a New Zealand bank could (we also refer you to the NZBA submission that outlines further reasons for the bias to utilising related party to meet a New Zealand banks regulatory capital requirements).

The New Zealand regulatory banking framework recognizes:

- the need for a bank to have an appropriate level of capital to cover its risks and maintain the health and stability of the financial system,
- that capital is expensive and that requiring too much capital will limit credit supply, and
- that different sources of capital are available which can reduce the overall cost of capital and thus allows (within prescribed limits) for different types of capital instruments to be issued.

Assuming rational economic behaviour, it can be expected that a New Zealand bank will optimize its capital structure to include Additional Tier 1 and Tier 2 capital. Further, that in sourcing such capital a New Zealand bank would look to leverage its offshore parents' market position. This reflects that the non-resident parent bank has deeper and greater access to capital markets than a New Zealand bank. This potentially reduces the cost of capital for a New Zealand bank. Accordingly, it is often the case that Additional Tier 1 and Tier 2 capital will be sourced from or through a related party entity (subject to BS13 liquidity requirements).

The Discussion Document proposes that the deductible interest rate be limited to the parent company's credit rating (plus a margin) as applied to unsubordinated debt with a maximum term of 5 years. If you accept the proposition that there is a preference for a bank to seek regulatory capital funding (which is heavily subordinated with an absolute minimum term of 5 years) from its offshore parent it then follows that the cap proposed will deny at least in part the interest expense on that instrument.

We do not agree with the comment at paragraph 3.17 that such an approach will ensure that the interest rate on related-party loans will therefore be roughly in line with the interest rate a borrower would agree with a third-party lender. As noted above, the features of regulatory capital required to be held by banks to the extent that this takes the form of debt (as Additional Tier 1 or Tier 2 capital) rather than pure equity mean that commercially such instruments will be priced accordingly. Any investor (whether it is a third party or related party) would seek a commensurate return to the level of risk inherent in such instruments.

The sourcing and allocation of funds of a bank are driven by factors that are not applicable to commercial and industrial companies. If the cap on related party interest rates proceeds as proposed, in our view it will inevitably increase the cost of capital in New Zealand (either as a result of the double taxation that will result from using Additional Tier 1 or Tier 2 instruments, or through such instruments no longer being viable and more expensive ordinary equity being required in their place to meet the RBNZ prescribed capital adequacy levels).

We understand that the concern that officials are seeking to address is the artificial weakening of a New Zealand entity's balance sheet that allows related party debt to be priced at a higher (contrived) rate. This issue does not and cannot exist given the regulatory banking framework (as the amount of related party funding is limited by BS13[2]) and the very nature of its business (being credit intermediation). Any artificial weakening of a bank's balance sheet would be value decretive as it would result in third party funders charging a higher cost. Therefore the perceived risk simply does not exist within the banking sector as the combination of regulatory constraints, market demands and the nature of business constraints mean that it would be counter-productive to the essence of a banking business to artificially weaken the balance sheet of a deposit taking entity.

As such, we do not believe that there is any basis for a general interest limitation rule to apply to the banking industry.

New Zealand banks are net deposit takers

The Discussion Document assumes that a group of companies will incur net third party interest expense, which may then be allocated around the various group entities. The allocation of group interest expense is meaningless in a banking context because banks are margin lenders and derive net interest income from a wide variety of external funding sources and markets. This point was specifically noted in the OECD's original discussion draft on BEPS Action 4:

> *"....taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore, a rule which caps net interest expense will have no direct impact on a bank or insurance company ..." (para 205)*

Further a New Zealand banks' ability to attract funding in both retail and wholesale markets is based on the strength of its balance sheet. Thus there is no rationale for a bank to weaken its balance sheet through excessive leverage. The premise, on which this proposal rests, of an artificially weakened balance sheet, is the antithesis of what occurs in the context of a bank which funds from the market.

The OECD has repeatedly acknowledged that there is a low risk in the banking sector in relation to excessive leverage. In this regard we refer you to the commentary in Chapter III of the OECD Report "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" published in December 2016, and in particular the comments at paragraph 510 in relation to a general limitation rule such as that proposed in the discussion document:

> *"In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a general risk at this point in time and so it is anticipated, in the majority of cases, countries will find this risk to be low. Excessive leverage in entities in a group with a banking or insurance company has been identified to be a greater risk. However because of differences in regulatory and tax rules between countries, there may be countries where this risk is adequately addressed. Where this is the case, there is no expectation that a country should apply a general interest limitation rule aimed at dealing with a risk that does not exist or is already addressed."*

As highlighted in this document and the NZBA's submission, there is no risk of excessive leverage in New Zealand banking groups due to the extensive and ongoing regulation of banks in Australia and New Zealand by the Australian Prudential Regulation Authority (APRA) and RBNZ.

Double Taxation

Westpac is concerned that in the case of bank debt, interest limitation represents a significant and unwarranted departure from accepted transfer pricing principles that apply across tax jurisdictions world-wide. Any rule that overrides the arm's length standard would give rise to a number of undesirable and

---

[2] For example as at 30 September 2016, total liabilities for the Westpac New Zealand Banking Group was NZD $86.3 billion, of which NZD $4.6 billion was related party. (See https://www.westpac.co.nz/assets/Who-we-are/About-Westpac-NZ/Disclosure-statements/Westpac-Banking-Corporation-Sept-2016.pdf)

arbitrary outcomes including double taxation. At a minimum this proposal is contrary to the transfer pricing principles espoused in New Zealand's extensive tax treaty network.

In this regard, we are concerned that it will not be possible to achieve mutual arbitration outcomes under a double tax agreement where, by way of example the IRD and Australian Taxation Office (ATO) disagree about the appropriate level of interest rate on related party loans.

Referring to the comments above in relation to the required nature of the type of arrangements that qualify as regulatory capital the interest rate cap will create artificial outcomes. The Australian parent bank will need to apply an arms length rate otherwise the ATO will reconstruct the terms of the arrangement to achieve this. Those terms will reflect market pricing for heavily subordinated, long term and in the case of Additional Tier 1, perpetual debt that will exceed the rate proposed by IRD. The tension between transfer pricing norms and the proposed interest limitation will lead not just to double taxation but also to greater uncertainty in pricing, more complexity in undertaking cross border transactions and additional compliance costs.

Conclusion

In summary we consider that the current tax and regulatory environment in which the New Zealand banking industry operates is more than sufficient to safeguard against the risk of excessive interest deductions by New Zealand banks. The extent of this regulation makes it unfeasible for Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch to manipulate related party loans in the manner that IRD are seeking to address. In point of fact, this has been acknowledged by OECD where in its Discussion Draft on BEPS Action 4 it was noted:

> *"existing regulatory requirements [might] act as an effective general interest limitation rule, and prevent excessive leverage in group entities..." (para 212)*

We believe that the proposal, if it were to proceed, will inevitably increase the cost of capital in New Zealand. Having regard to the conditions of registration, New Zealand banks do not have the options available to corporates in other industries to structure out of related party loans (and conversely these same rules prevent New Zealand banks from manipulating the terms of such loans). Tax rules should not interfere with normal banking commercial practice or run counter to the imperatives of banking regulation and the health and stability of the New Zealand financial system.

As such we consider the application of a general interest limitation rule to Westpac and the banking industry more generally as an unnecessary overreach.

As noted above we welcome the opportunity to discuss with you in more detail the comments raised in this submission.

Yours faithfully
Westpac New Zealand Limited

Jo Sawden
Head of Tax