InfraRed
Capital Partners

12 Charles II Street
London
SW1Y 4QU

T +44 (0)20 7484 1800
F +44 (0)20 7484 1801
www.ircp.com

Strictly private and confidential

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

12 May 2017

To whom it may concern,

InfraRed Capital Partners Limited, via its local Adviser, InfraRed Capital Partners (Australia) Pty Limited (together "**InfraRed**"), makes the following submission in relation to the Government Discussion Document titled "BEPS – Strengthening our interest limitation rules". The primary focus of this submission is the operation of the thin capitalisation regime and the proposed changes discussed in Chapter 5 as applied to government infrastructure procurements (ie. PPPs).

InfraRed makes this submission as an active equity investor in the New Zealand PPP sector, currently holding interests in the SecureFuture Wiri Group and the Wellington Gateway Partnership Group, delivering the Auckland South Correctional Facility and Transmission Gully Motorway projects, respectively.

Current state of play

The current thin capitalisation regime applies to any foreign investor that holds an equity interest of 50% or more of an asset or a group of foreign investors which in aggregate (in certain circumstances) hold 50% or more of the equity . Once inside the thin cap regime, the regime provides that the foreign investor may utilise tax deductible gearing in the NZ Project up to the greater of: (a) the safe harbour threshold of 60%; and (b) a level that is 110% of the level of gearing currently held in its World Wide Group. We interpret that the policy objective of this is to ensure that foreign investors do not gear local NZ entities disproportionately higher than entities that they invest in in other jurisdictions.

If the foreign investor is unable to satisfy this test then the interest on the excess portion of the project level debt is treated as non-deductible.

As an investor bidding for projects in the New Zealand market, it is important that tax rules:

i) are clearly understood so that their impact can be priced into the economic analysis
ii) apply in a consistent way so that they do not favour certain types of investor or structures
iii) do not make New Zealand uncompetitive when compared to other international markets competing for inward investment

Observations on current framework

The following observations highlight situations in which the above points are not always met:

- Project finance structures used to finance infrastructure projects typically have higher gearing levels than other arrangements (eg. corporate) and commonly exceed the safe harbour threshold. There are a number of reasons for this which include revenue credit quality, cost predictability and the generally tightly controlled nature of the structure (ie ring fenced). It is on this basis that arms-length third-party lenders are comfortable to lend at higher levels (up to 90%) on a non-recourse basis, compared to other structures. This maximisation of the cheapest form of private capital is a key feature in driving affordability/feasibility of these projects.
- The first order impact of the thin capitalisation rules is that it can drive the make-up of consortiums (to manage under the 50% non-resident threshold). This results in tax driving the level of participation in consortium with a corresponding reduction in participation and competition. This is sub optimal.
- Secondly, it can also drive the chosen investment structure (e.g. a company) which results in additional tax risks being imposed on consortium participants (e.g. loss continuity) which would not be the case if thin cap constraint did not dictate the investment choice. Again, this is sub optimal.
- Unless the investment (and its participants make up) can be structured so as to effectively fall outside the ambit of the thin capitalisation rules, the resulting participation by non-residents is further constrained. This is because in those circumstances, limb (a) of the thin cap test is generally failed, and so the project entity needs to satisfy limb (b) in order to avoid an interest deduction restriction, however, application of this test is not always simple in practice in project finance situations.
- Entities that invest in project finance structures are usually corporates or investments funds. As such the current thin capitalisation test requires you to compare the gearing levels of the project company to the gearing level in the corporate group or fund structure which does not seem an appropriate test in the context of a ring-fenced project finance structure. It is highly unlikely that the investing entity will be able demonstrate the required gearing levels (80%+ and as prepared on an accounting basis) to allow the underlying project company to utilise c. 90% gearing levels.
- Further, because the different projects in which the corporates / funds have invested will be in different phases of their lifecycle, a comparison of the gearing level of the project company to the gearing level of the investing entity is not appropriate. The thin capitalisation regime requires a minimum of an annual testing of the debt:asset ratio. An annual test that compares the gearing of say, a project entity in a build phase to a portfolio of projects companies which are in the operation phase will give different views on the level of gearing depending on the maturity of the project profile. Over the life of similar projects, comparable levels of gearing could be expected. However, an annual “snap shot” will not reflect this.
- Even if the debt:asset profile of the investor could be managed at the outset, the life of the assets means it is not possible to commit to that being the case for the life of the project.
- The measure of gearing is an accounting construct (Debt:Assets) so does not represent the same economic picture as simply looking at the amount of debt versus the amount of equity. Accounting practices also vary between different jurisdictions and legal structures (eg. partnerships vs trusts vs companies), as do account preparation dates. Additionally, the accounting treatment varies depending

on the amount of equity ownership in the underlying project (eg. consolidate or equity account). This further clouds the economic reality of the group.

- Additionally, determination of what entities to include in the World Wide Group can be complicated as investment funds may not prepare consolidated accounts.
- The impact of the above is that limb (b) does not provide the safety valve it should.

Impact on InfraRed's investment activity in New Zealand

The impact of the above is that InfraRed considers it is very difficult to satisfy the current thin cap test when applied to project finance structures in which InfraRed will take a 50%+ stake. This means that a significant portion of the third-party senior debt has to be treated as non-deductible, resulting in more tax being paid overall and earlier and increasing the cost of capital significantly. . This places the bid at a significant cost disadvantage versus a bid where a foreign investor does not have a 50%+ stake. Tax may therefore be a key factor in determining which investor delivers the lowest cost bid, which, we suggest, is not in the interests of the public sector procuring body.

Accordingly, when investing in NZ PPPs InfraRed is constrained in that it needs to remain under 50% of the project equity. This reduces the attractiveness of the various projects by reducing the absolute investment amount whilst the significant cost and time required to bid these projects remains fixed. Predominantly for this reason, InfraRed has declined recent opportunities to participate in smaller NZ PPPs (eg. schools procurements). This constraint also has second order impacts in constraining the liquidity of the projects, which will become more relevant as the New Zealand project profiles mature, i.e. secondary investors will not want to take 50%+ stakes in projects that have reached their operations phase.

InfraRed manages funds that invest in similarly geared PPP projects in the region and other markets globally. These funds do not seek to gear the NZ project entities disproportionately to project entities in other countries, however, for the reasons given above, it finds that it cannot meet the thin cap tests. This appears at odds with our perception of the underlying commercial rationale of the regime.

Overall, when InfraRed looks to invest in NZ it compares the forecast investment returns to those of investment opportunities in other regions. However, the way the thin cap rules currently operate has a negative impact on the returns from NZ investment opportunities making it harder to allocate capital to those opportunities.

Application to the Government Discussion Document

InfraRed supports the proposal for the safe harbour threshold to be able to be exceeded for infrastructure projects as a solution to the problems outlined above. As PPP projects are Government procured and financed on a non-recourse basis, the debt in these projects represents no BEPS risk

However, InfraRed does not support the view that related party debt is by definition "not arms-length". There is legitimate commercial rationale as to why an investor would hold equity and debt interests in a project or would seek to fund a project using shareholder funds rather than seeking external finance. Provided that the overall level of debt remains in line with the level that a third-party would lend to, and at a comparable rate, then InfraRed is of the view that this should remain deductible.There are currently a number of investors both in New Zealand and internationally who participate in the provision of both equity and senior debt pari passu with third party banks. In these instances, it is common that the equity providers do not all participate in the debt, and the provision of the senior debt by an equity party is effectively taking the role of a third party lender. InfraRed is of the view that in these types of arrangements interest on the related party debt should remain deductible.

InfraRed firmly believes that the ability to use arms-length debt in excess of the safe harbour threshold should not depend on the specific legal structuring of the deal; the utilisation of limited partnership structures or alternatively company structures. Any change in the rules should ensure that this is the case.

Next Steps

InfraRed remains one of the larger foreign equity participants in NZ and has a great level of interest in continuing to invest significant funds in NZ projects over the foreseeable future. We would be happy to further engage with and discuss the Government's proposals to provide further perspective on how they relate to InfraRed's investment activity in New Zealand.