

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – strengthening our interest limitation rules

Proposal

1. This paper seeks Cabinet approval to strengthen New Zealand's rules that prevent excess interest deductions being taken in New Zealand. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, have large interest deductions leaving little taxable profit in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

3. We recommend that Cabinet agree in principle to two major reforms to our interest limitation rules:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the rules that set the debt levels allowed in New Zealand for taxpayers with international connections (the thin capitalisation rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

4. We also recommend several minor improvements to the rules to ensure they are robust and fit for purpose.

5. These changes follow the Government discussion document *BEPS – strengthening our interest limitation rules (March 2017)*. In general, submitters on the discussion document acknowledged the need to respond to BEPS concerns but most did not agree with the specific proposals put forward.

6. Some of the proposals have been modified in response to these submissions. In particular, the approach for setting the allowable interest rate on related-party loans is different to that proposed in the discussion document. We anticipate that this new approach will address many, but not all, of submitters' concerns.

7. There are some technical elements to these reforms that could benefit from further discussion with stakeholders. We therefore request that authority be delegated to the Minister of Finance and the Minister of Revenue to finalise the reforms.

8. The forecast revenue from implementing these changes is \$45m in 2018/19 and \$90m per annum from 2019/20. Note, however, that one technical detail to be canvassed in the further discussion with stakeholders could reduce the forecast revenue by up to \$10m per annum.

Background

9. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, are able to take large interest deductions. This results in little taxable profit being left in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

10. Accordingly, in March this year the Government released the discussion document *BEPS – Strengthening our interest limitation rules*. There were two key proposals: one to strengthen how related-party debt is priced, and one tightening the rules governing allowable debt levels.

11. The discussion document also recommended several minor improvements to New Zealand’s interest limitation rules to ensure they are robust and fit for purpose.

Comment

12. The majority of multinationals operating in New Zealand have relatively conservative debt positions, and the Government is committed to making sure New Zealand remains an attractive place for them to do business.

13. However, there are some multinationals that deliberately attempt to minimise their tax payments in New Zealand by engaging in BEPS strategies, such as by having related-party debt with excessive interest rates. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

14. Accordingly, we recommend changes to New Zealand’s interest limitation rules, most significantly:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the thin capitalisation rules, which set the debt levels allowed in New Zealand for taxpayers either with foreign parents (the inbound rules) or foreign subsidiaries (the outbound rules) – in particular, setting the allowable debt level with reference to the taxpayer’s assets net of its non-debt liabilities.

Restricted transfer pricing

15. When borrowing from a third party (such as a bank), commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context, such as when a New Zealand subsidiary borrows from its foreign parent. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

16. Broadly speaking, transfer pricing a loan agreement involves determining (hypothetically) the interest rate a third party lender would be willing to lend at, given the terms and conditions of the related-party loan. It is a fact specific and resource intensive exercise and can be manipulated (for example, by adding terms and conditions to the related-party loan that are not frequently seen between unrelated parties). We note that commentators such as Richard Vann, a professor of tax at the University of Sydney, have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

17. For these reasons, the international consensus is moving away from using ordinary transfer pricing as the primary mechanism to limit the interest rates on related-party debt. The OECD, for example, has recommended that countries adopt a simple formulaic approach for limiting interest deductions, which would largely eliminate the advantage of using related-party debt with excessive interest rates (this approach was raised in consultation but was not supported by submitters as it would make a taxpayer's allowable interest deductions volatile. Instead, as outlined below, we are recommending that the current rules for setting allowable debt levels be buttressed by rules that ensure related-party interest rates are appropriate).

18. Accordingly, we recommend that the allowable interest rate for inbound related-party loans be determined under a *restricted transfer pricing* methodology. Inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have substantial third party debt featuring those terms and conditions.

19. The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

20. This *restricted transfer pricing rule* would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate that is the same as the interest rate facing the borrower's foreign parent would automatically be considered acceptable. This safe harbour would be attractive to many companies as it is both simple and provides certainty.

21. We note that the Australian Taxation Office has recently released administrative guidelines which outline a similar approach for limiting related-party interest rates (albeit Australia is implementing this approach as an operational policy, rather than a law change).

Private sector consultation

22. This *restricted transfer pricing rule* is different to the proposal suggested in the March discussion document. The original proposal was a hard rule to cap the interest rate a foreign parent could charge its New Zealand subsidiary based on the foreign parent's credit rating (an "interest rate cap").

23. We consider that the *restricted transfer pricing rule* is a more workable way of achieving essentially the same objective – ensuring the interest rate on related-party debt is in line with what would actually be paid on third party debt. While the methods (restricted

transfer pricing and the interest rate cap) are different in approach, the outcome of both will generally be the same – with differences only at the margin. Accordingly, both approaches have the same revenue impact.

24. Submitters on the March discussion document did not support the original proposal. Many submitters argued that a new approach for pricing related-party debt is unnecessary, noting that the Government proposed to strengthen the transfer pricing rules generally (in the other March discussion document *BEPS – transfer pricing and permanent establishment avoidance*).

25. Some submissions highlighted the consequences of adopting a blunt rule in the nature of the cap. These include concerns that:

- the cap is not a good proxy for an arm’s length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand’s largest foreign-owned businesses are owned by companies with no credit rating); and
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

26. It should be noted that the *restricted transfer pricing rule* we are recommending will address many, but not all, of submitters’ concerns because it is still a significant departure from using ordinary transfer pricing. Accordingly, we expect it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand’s Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur with any frequency because of the shift in the international consensus on what is acceptable in relation to the pricing of related-party debt.

Allowable debt levels in the thin capitalisation rules

27. New Zealand has rules to prevent the excessive use of debt by foreign-owned entities operating in New Zealand (inbound investment) and New Zealand-owned entities with international operations (outbound investment). Interest deductions are denied to the extent that the entity’s debt level with reference to its assets is determined to be excessive.

28. The March discussion document proposed changing this, so that a taxpayer’s maximum debt level is set with reference to the taxpayer’s assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

29. The core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. Under the current rules, where non-debt liabilities are ignored, companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment of non-debt liabilities also mean the rules apply unevenly across companies: companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

30. In addition, one of the objectives of the thin capitalisation rules (ensuring that a taxpayer is limited to a commercial level of debt) is undermined by the current treatment of non-debt liabilities. A third party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

31. Australia requires this same adjustment for non-debt liabilities.

Private sector consultation

32. This proposal was accepted by some submitters but opposed by others who argued, for example, that the proposal amounts to a substantial reduction in the amount of deductible debt allowable under the thin capitalisation rules. Overall, this proposal was much less contentious than the interest rate cap.

33. None of the submissions against the core proposal convinced us that the analysis above, suggesting that the non-debt liability adjustment is appropriate, is incorrect. Accordingly, we recommend that the proposed adjustment to the allowable debt level under the thin capitalisation rule proceed. That is, a taxpayer's allowable debt level under the rules should be set with reference to their assets net of their non-debt liabilities.

34. A near-universal comment from submitters was that certain non-debt liabilities – most significantly *deferred tax liabilities* – should be carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept. Accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. Submitters argued that this is often not the case – deferred tax liabilities are frequently technical accounting entries and do not reflect future tax obligations. Submitters also pointed to the rules in Australia, which do include a carve-out for deferred tax liabilities and assets.

35. We recommend further consultation on whether deferred tax should be carved-out from this non-debt liability adjustment. Many, but not all, deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future. Given the concerns raised by submitters, further consultation on this technical detail would be beneficial.

Other changes

36. We recommend five other changes to the thin capitalisation rules:

- a special rule for infrastructure projects (such as public private partnerships) that are controlled by a single non-resident;
- a de minimis for the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;

- removing the ability to use asset valuations for the thin capitalisation rules that differ from those reported in a firm's financial accounts; and
- removing the ability to measure assets and debts on the final day of a firm's income year.

37. These measures were all discussed in the March discussion document. Some were supported by submitters, while others were opposed. Where they were opposed, we are recommending changes to the proposals which will, in general, address submitters' concerns.

Rule for infrastructure projects

38. We recommend a special rule that allows all of a taxpayer's third party debt to be deductible even if the debt levels exceed the normal thin capitalisation limits, provided the debt is non-recourse with interest funded solely from project income.

39. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously.

40. This rule was well received by submitters; however, some technical issues have been raised which we will consult further on.

De minimis for the inbound rules

41. The thin capitalisation rules that apply to New Zealand-owned taxpayers with foreign operations (the outbound rules) has a de minimis (the rules do not apply if a taxpayer has interest deductions of less than \$1 million). The thin capitalisation rules that apply to foreign-owned taxpayers (the inbound rules) do not have a similar de minimis.

42. We recommend the current de minimis in the outbound rules be extended to taxpayers subject to the inbound rules, provided the taxpayer has only third party debt. This proposal is to reduce compliance costs for small foreign-owned entities that have a low risk of BEPS.

43. This proposal was generally supported by submitters.

Allowable debt levels for companies owned by a group of non-residents

44. At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level is the greater of:

- 60 percent; and
- 110 percent of its third party debt.

45. However, this means that a taxpayer with high levels of third party debt can be funded with almost no equity. For example, a project funded 90 percent with third party debt could have 9 percent shareholder debt and only 1 percent equity.

46. To address this, we recommend changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. This proposal was generally accepted by submitters.

47. The March discussion document proposed that this change be grandfathered, as the rules it relates to (for non-residents acting together) have only just taken effect. We recommend that the precise design of this grandfathering be subject to further consultation with stakeholders, with decisions on its final design being delegated to the Ministers of Finance and Revenue.

Asset valuations

48. In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative to its financial statement value, provided that would be allowable under generally accepted accounting principles.

49. While it is permissible to use an asset's net current value, the thin capitalisation rules set out what is required if taxpayers utilise this option. Accordingly, we recommend that this new net current valuation option be available only if certain criteria are met – such as if the valuation is from an independent expert valuer.

Agency consultation

50. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, and publicity

51. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

52. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

53. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

54. We recommend that the Cabinet Economic Growth and Infrastructure Committee:
1. **Note** that in March this year the Government released a discussion document called *BEPS – strengthening our interest limitation rules* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.
 2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing their overall effectiveness.
 3. **Agree** that the interest rate on inbound related-party loans should be set using a *restricted transfer pricing* rule, whereby the interest rate is set under transfer pricing but ignoring all surrounding circumstances, terms, and conditions that could result in an excessive interest rate unless similar terms apply to significant amounts of third party debt, and with the rebuttable presumption that the borrower would be supported by its foreign parent.
 4. **Agree** that a taxpayer's allowable debt level in the thin capitalisation rules should be set with reference to its assets less its non-debt liabilities.
 5. **Agree** that the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of \$1 million or less, be made available also to foreign-controlled taxpayers provided they have no owner-linked debt.
 6. **Agree** that an exemption should be provided from the thin capitalisation rules for certain infrastructure projects funded entirely with third party limited recourse loans.
 7. **Agree** that, when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.
 8. **Agree** that clear legislative requirements be developed for when taxpayers choose to value their assets for thin capitalisation purposes on a basis other than that used in their financial accounts.
 9. **Agree** that an anti-avoidance rule should be inserted into the thin capitalisation rules, to apply when a taxpayer substantially repays a loan just before the end of the year.
 10. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).
 11. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.
 12. **Authorise** the Minister of Finance and the Minister of Revenue jointly to take final decisions on the extent to which deferred tax liabilities are included in non-debt liabilities, up to a limit of reducing the level of expected revenue increases

anticipated by the BEPS measures as set out in recommendation 7 in the accompanying Cabinet paper *Tax Measures To Prevent Base Erosion And Profit Shifting* by up to \$10 million per annum

13. **Agree** that the results of the decisions in recommendations 3-12 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue