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By email

LTIB first draft
c/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
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Submission on Inland Revenue's Draft Long-term Insights Briefing

Introduction

1. Thank you for the opportunity to submit on Inland Revenue's Draft Long-term Insights Briefing: Tax, Foreign Investment and Productivity (**Draft LTIB**).

2. The Draft LTIB is primarily concerned with the broad tax settings affecting foreign investment, including questions as to the tax rate, depreciation rates and thin capitalisation settings. These settings will affect the cost of capital for investment into New Zealand, as the Draft LTIB explains.

3. This submission focuses on how legislative design, and the way tax settings are implemented, may also affect incentives for firms to invest into New Zealand. As the Draft LTIB states (at [3.20]):

> Complexity of legislation and compliance costs may … have a negative impact on investment, especially if these cause foreign investors to question whether it is worth finding out if investing into New Zealand would be a good idea. If different rules apply to different types of firms, this can add to the complexity.

Summary of submission

4. It is appropriate for the Draft LTIB to recognise the complexity of tax legislation, and associated compliance costs, as potentially having a negative impact on foreign investment. We elaborate on that proposition in this submission, drawing on what we have observed in practice in advising foreign investors.

5. We submit that the Long-term Insights Briefing, when finalised, should:

   (a) recognise generally (as paragraph 3.20 of the Draft LTIB does) that the way tax laws are implemented and the legislation drafted may have a negative impact on foreign investment;

(b) note that, other things being equal, legislative rules and tests that depart from international norms or conflict with principles set out in double tax agreements to which New Zealand is party, will be more likely to have such a negative impact; and

(c) note that tax regimes such as the hybrid and branch mismatch rules (**Anti-hybrids Rules**), which make the tax treatment of amounts paid by a New Zealand branch or entity dependent upon an investigation of chains of payments within a multinational group and the tax treatment of those payments outside New Zealand, impose especially high compliance costs on New Zealand businesses and may disincentivise investments from particular countries.

Examples illustrating effect of complexity of legislation and associated compliance costs on foreign investment

Approach

6. We acknowledge that it may be more difficult to model the impact on foreign investment of the complexity of legislation and associated compliance costs than (for example) the impact of tax rates or thin capitalisation limits. It is, nonetheless, possible to identify that there is likely to be such an impact, and value in documenting this impact in the finalised Long-term Insights Briefing.

7. In many recent tax law reform initiatives, prescriptive or bright-line rules have been proposed in place of the enforcement of existing less prescriptive rules. It has been argued that the existing law is difficult for Inland Revenue to enforce, and that more prescriptive rules will be less resource-intensive for Inland Revenue. This was one aspect of the justification for enacting the restricted transfer pricing rules (**Restricted TP Rules**), which we discuss below.[1]

8. The argument that more prescriptive rules will be less resource-intensive has a superficial attractiveness, at least from Inland Revenue's viewpoint. The cost of fact-intensive disputes is highly visible, even if the number of cases that are disputed is a tiny fraction of all cases in which the rules are applied. On the other hand, if the costs to taxpayers of complying with the more prescriptive rules is greater than their costs would have been under the existing law, that cost is unlikely to be visible (at least from Inland Revenue's viewpoint), yet that increased compliance cost may affect all taxpayers who have to apply the rules, not just the fraction who would otherwise find themselves in dispute.

9. Seeking to better understand what features of legislative design drive higher compliance costs for taxpayers is therefore likely to be of value. It may help to guide decisions as to how future tax reforms should be implemented, and should help to counter the superficial attractiveness of the assumption that rules that are less resource-intensive for Inland Revenue are necessarily the lowest compliance cost option for New Zealand as a whole.

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1 Taxation (Neutralising Base Erosion and Profit Shifting) Bill, Commentary on the Bill, at pages 10 and 11. Eg, at page 11: "It can be difficult for Inland Revenue to challenge such arrangements under the transfer pricing rules as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and a similarly high interest rate." And, at page 11: "Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue."

10. In this submission, we discuss two examples (being the Restricted TP Rules and the Anti-hybrids Rules). Both examples concern rules that affect the tax treatment of cross-border transactions and therefore have the potential to affect foreign investment into New Zealand.

Example one: Restricted TP Rules

11. The Restricted TP Rules (sections GC 15 to GC 19 of the Income Tax Act 2007) apply to certain cross-border related party debt. The rules can require that debt to be priced ignoring certain features (such as subordination or a term exceeding five years), and based on an assumed credit rating rather than the borrower's actual credit rating. Consequently, the rules will commonly result in the permitted rate of interest for New Zealand tax purposes being less than the arm's length rate determined under ordinary principles.

12. This outcome gives rise to at least two difficulties for foreign investors contemplating an investment in New Zealand that involves cross-border related party loans. Both difficulties arise from the fact that New Zealand's Restricted TP Rules depart from international norms:

(a) The first difficulty is that the Restricted TP Rules expose investors to the possibility of double taxation. If New Zealand allows a deduction for (say) 5%, but the lender is required to recognise income based on the actual arm's length rate (say, 6%), the 1% difference is in effect taxed twice. It also results in additional advisory costs in New Zealand and the other relevant jurisdiction.

(b) The second difficulty is the cost to the prospective investor of understanding New Zealand's Restricted TP Rules. Prior to the enactment of the Restricted TP Rules, an advisor explaining the effect of New Zealand's transfer pricing rules to a prospective investor could do so easily: the rules limited a deduction to an arm's length amount. Sophisticated investors were familiar with this internationally recognised concept. The arm's length principle has, in particular, been reflected in double tax agreements, which foreign investors rely on as a source of predictability as to the tax consequences of a cross-border investment. Explaining the Restricted TP Rules to such an investor, however, is obviously more difficult and therefore more costly (in terms of advisory costs as well as management time required to understand unfamiliar rules). In addition, in our experience, investors tend to be less comfortable working with regimes that depart from international norms to which they are accustomed.

Example two: Anti-hybrids Rules

13. The Anti-hybrids Rules in subpart FH of the Income Tax Act 2007 were intended to implement recommendations in two OECD reports to counter mismatches in the characterisation of entities or transactions as between the tax laws of different countries. Such differences in the characterisation of an entity or transaction are not uncommon, especially in arrangements involving the United States of America (which is one of New Zealand's largest trading and investment partners).

14. The Anti-hybrids Rules are highly complex. Aspects of the rules refer to, and must be read with, the OECD reports, which together run to more than 500 pages. Not all countries have

implemented the OECD reports, and those that have done so have sometimes included exceptions or other measures to reduce complexity and compliance costs. New Zealand, in contrast, has sought to implement the reports comprehensively. Unlike the arm's length principle in the transfer pricing context, there is no international norm as to the tax consequences of hybrid arrangements.

15. One rule that is especially complex is section FH 11, the imported mismatch rule. The imported mismatch rule may disallow a deduction for an otherwise deductible payment by a New Zealand entity if that payment is relevantly connected with a hybrid mismatch that arises in one or more other countries that do not have their own rules to counteract hybrid mismatch arrangements. Section FH 11 therefore may result in disallowance of a deduction for a payment made by a New Zealand subsidiary in a multinational group because that payment can be traced or linked to some other payment, elsewhere in the group, which results in a hybrid mismatch between two other countries.

16. The rule can therefore require New Zealand resident entities that are part of a multinational group to trace payments for which a deduction is claimed in New Zealand within the group, and to obtain information regarding the tax treatment of those other payments that do not involve New Zealand. We are aware of New Zealand businesses having decided not to contract with related entities in jurisdictions in which a hybrid mismatch might arise, even though the lowest cost (pre-tax) option is to do so, in order to avoid the compliance costs and risks associated with the imported mismatch rule. Such practices, if common across an industry, will likely result in increased costs to consumers.

Conclusion

17. The examples outlined above illustrate that rules that are complex, especially in a way that departs from international norms, or that are especially onerous to comply with, have the potential to be a barrier to foreign investment into New Zealand. It is appropriate that the finalised Long-term Insights Briefing record that these features of tax legislation may have such an effect, so that that can be taken into account in considering the legislative design for future tax reforms and the merits of simplification measures in relation to existing rules.

Yours faithfully
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