KPMG
10 Customhouse Quay
PO Box 996
Wellington 6140
New Zealand
T: +64 4 816 4500

Our ref: 170418BEPSIntLimitation

BEPS - Strengthening our interest limitation rules
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

19 April 2017

Dear Madam

KPMG submission on BEPS - Strengthening our interest limitation rules

KPMG is pleased to make a submission on the *BEPS – Strengthening our interest limitation rule* discussion draft (the "Document").

Summary of our submission

Our detailed submissions are attached. In summary:

- We endorse the rejection of an EBITDA based test for limiting interest deductions.
- We do not believe the interest rate cap proposal should proceed. The proposal seeks, in substance, to avoid globally agreed approaches to determining an arms-length interest rate. Any concerns about interest rates on related-party cross border funding should be should be resolved through orthodox transfer pricing analysis.
- If an interest rate cap proposal proceeds, the starting point for the analysis should be the standalone credit rating of the New Zealand borrower, notched up for parental affiliation and credit support, rather than notching down the ultimate parent's credit rating.
- We do not support a deemed maximum loan term of 5 years (or any maximum loan term) for setting interest rates. This is inconsistent with genuine commercial arrangements for which long term funding needs to be secured.
- Taxpayers should be able to rely on year-end values for asset and liabilities for calculating compliance with the debt to asset thin capitalisation safe harbour test. Removal of the year-end valuation option will impose compliance costs on the vast majority of compliant taxpayers for little gain.

In the Document and the accompanying discussion draft *BEPS – Transfer pricing and permanent establishment avoidance* there is an acknowledgement that the transfer pricing issues discussed are complex and resource intensive. We agree. However, the response appears to be legislate away complexity for Inland Revenue, such as with the interest rate cap proposal.

This is not the right approach in our view and risks uncertainty and double taxation for taxpayers (e.g. if the foreign jurisdiction does not accept the NZ interest rate cap as many are likely to). These issues are complex because the underlying transactions involving cross-border goods, services and financial flows are often complex. Deeming a simple answer does not address the core issues.

Instead, we strongly support Inland Revenue (and Government) investing in additional resourcing to meet these demands. This includes skilled investigators with sound commercial knowledge and transfer pricing experience. Both documents draw extensively on the current practice in Australia. We note the Australian Taxation Office is actively increasingly its resourcing in these complex areas and we believe it is imperative that Inland Revenue does the same.

Further information

Please contact us, John Cantin on (04) 816 4518, Bruce Bernacchi on (09) 363 3288, or Darshana Elwela on (09) 367 5940 if you would like to discuss our submission.

Yours sincerely

J H Cantin

John Cantin
Partner

Bruce Bernacchi
Partner

KPMG's detailed submissions on the Document

Chapter 1 – Scope of review

Proposal

The proposals in the Document will apply to both foreign owned firms operating in NZ (i.e. inbound investment) and New Zealand firms with offshore operations (i.e. outbound investment in subsidiaries).

Submission

The proposals should be restricted to inbound investment only, until a considered approach to outbound investment can be developed.

Comment

We consider that the Document's base protection concerns do not exist with respect to outbound investment. For a start, we would expect Inland Revenue to have better information on cross-border funding arrangements where the parent lender is in the NZ tax base. This should allow Inland Revenue to evaluate the relevant transfer pricing risks more easily and efficiently than for inbound loans. This is also consistent with the different safe harbour thresholds, under the thin capitalisation rules, for inbound and outbound investment (where the threshold for limiting interest for outbound investment is higher).

If the proposals do proceed, we submit that inbound investment should be the sole focus of the proposal until a considered approach to outbound investment issues can be developed.

Chapter 2 - The New Zealand approach to thin capitalisation

Proposal

The Document does not consider whether New Zealand should change to an EBITDA-based rule. However, it considers that the current rules are working well and the preferred approach is to address specific problems rather than abandon the general framework

Submission

We agree that the current thin capitalisation approach is appropriate and submits that an EBITDA based rule for New Zealand be explicitly rejected.

Comment

As outlined in the Document, there are significant disadvantages to an EBITDA based test for limiting interest deductions, including the potential for interest deductions to be denied due to poor trading conditions and other factors that are outside the control of the business. In our view the disadvantages of an EBITDA-based rule outweigh any tax base protection advantages. We believe the current NZ group debt thin capitalisation safe harbour test, combined with the 110% worldwide group test, strikes the right balance.

For avoidance of doubt, our support for the current approach does not extend to the interest rate cap proposal in the Document, for the reasons discussed later in this submission. We would however welcome the opportunity to discuss alternative measures to prevent excessive interest deductions being taken against the NZ tax base. In our opinion developing a fair alternative should be the focus and the introduction of an EBITDA style test should be clearly rejected.

Chapter 3 - Limiting the interest rate on related party loans

Proposal

The Document proposes to cap the deductible interest rate on related party loans from a non-resident parent to a New Zealand borrower based on the credit rating of the parent. The Document explicitly states that this should not apply to outbound (from New Zealand) loans. For ease of reference, we have referred to this as the "interest rate cap" proposal in our submission.

Submission

We do not support the interest rate cap proposal. Interest rates on inbound related-party loans should be determined in accordance with normal transfer pricing principles, with appropriate resourcing of Inland Revenue's transfer pricing capability to resolve difficult issues.

Comment

Unprincipled approach

The justification given for an interest rate cap is that "while in principle transfer pricing should limit the interest rate, these rules are not always effective". This is the extent of the analysis in the Document in support of the interest rate cap proposal. In our view, it is insufficient to justify the implementation of a very blunt instrument.

We submit that the better response is appropriately resourcing Inland Revenue's transfer pricing capability to deal with these and other complex transfer pricing matters, not implementing arbitrary solutions like an interest rate cap. There is nothing to suggest that the relevant concern – high interest rates in conjunction with high gearing – cannot be managed through orthodox transfer pricing principles. This is what Australia and other countries do. The fact that New Zealand will be an outliner if the proposal proceeds – as no other country takes this radical approach to limiting interest deductibility – should be cause for concern.

Further, the interest rate cap is aimed at achieving a transfer pricing result which Inland Revenue already argues for, i.e. pricing inbound related party debt at little more than what a foreign parent can raise debt at has been Inland Revenue's stated position in a number of transfer pricing disputes. However, this has been framed in the Document as being a thin capitalisation measure, when it is clearly not. (Paragraph 3.49 of the Document which confirms the cap will not be subject to general transfer pricing adjustments confirms this – if these were separate issues, transfer pricing should not be impacted by the application of the cap.) This has wider implications, which we discuss below. The cap is at odds with the general tone of the other proposals in the Document, which seek to bring New Zealand further into line with OECD guidance on transfer pricing and the arm's length principle.

Inland Revenue will be able to argue it both ways – i.e. to arbitrarily limit high price inbound debt, while arguing that outbound loans should have normal transfer pricing rules applied (i.e. without an interest rate cap). This is conceptually flawed. It is at odds with the application of the arm's length principle. There should be no distinction in how the arm's length principle applies based on whether the loan is inbound or outbound. In our view, the proposal is unprincipled as a result.

"Dressing up" the proposal as a thin capitalisation anti-avoidance measure does not change the substance of the proposal. It is a derogation from the globally agreed arms-length principles.

This mis-labelling to justify a derogation, amongst other proposals in the BEPS documents, is a worrying trend. It is counter to principles of transparency and certainty.

The interest rate cap proposal echoes the OECD's proposal to allocate the global interest costs of a multinational across the jurisdictions it operates in. That proposal did not proceed because it required re-thinking of fundamental concepts – e.g. allowing deductions in excess of the amount actually incurred in New Zealand (if the allocation basis supports this) or allowing non-arm's length arrangements to allocate interest expense around the global group. For the same reasons that the interest apportionment proposal has not proceeded, the interest rate cap proposal should not proceed.

Double taxation risk

This proposal will naturally lead to a greater risk of double taxation. Foreign lenders will be required, under the transfer pricing laws that apply in their own jurisdictions, to charge an arm's length interest rate. If this rate is higher than what the proposed cap allows as a deduction in New Zealand (which would no doubt be a common occurrence) foreign lenders may be subject to income tax in their home country on the full interest rate charged, but would not be able to claim a full deduction in New Zealand. Further, NZ will also charge non-resident withholding tax on the full interest rate.

Such an outcome is possible under existing thin capitalisation rules, but foreign lenders can mitigate this by not leveraging up their New Zealand operations beyond the NZ safe harbour threshold of 60%. However, with an interest rate cap, any amount of debt funding (over the existing $10 million transfer pricing safe harbour for interest rates) will be subject to the cap, meaning even a relatively small amount of lending can result in a mismatch between global transfer pricing principles and New Zealand's thin capitalisation regime. Further, if the result is driven by a thin capitalisation adjustment in New Zealand, as opposed to application of arm's length transfer pricing principles, this means there is no recourse to Competent Authorities for resolution. This further supports the case for a transfer pricing solution to this issue.

Consistency with Australia and global practice

We note that throughout both the Document, and the accompanying discussion draft "*BEPS – Transfer pricing and permanent establishment avoidance*", there are repeated references to the Australian position. This is generally reasonable as Australia is one of our largest trading partners and comprises the lion's share of New Zealand taxpayers' related party cross border activities. (We have reservations regarding some of Australia's measures, particularly, where they depart from the global consensus – see our deemed PE submissions) However, the interest rate cap proposal is a substantial departure from the Australian position and given the substantial amount of cross border activity between the two nations, there is the very real risk of potential double taxation given the Australian Taxation Office's corresponding position on Australian transfer pricing.

Given the significant degree of co-operation between the Australian Tax Office and Inland Revenue, we would expect that trans-Tasman interest rate pricing issues should be relatively straightforward for the two revenue authorities to resolve using orthodox transfer pricing principles. The prevailing Inland Revenue view, which has been echoed in the accompanying discussion draft *"BEPS – Transfer pricing and permanent establishment avoidance*", is to encourage the use of Advance Pricing Agreements (APAs) to gain certainty. The interest rate cap proposal runs contrary to that view – its aim is to reduce administrative costs for Inland Revenue, at the expense of greater uncertainty and double taxation risk for taxpayers.

Further, a key objective of Inland Revenue's Business Transformation programme is more regular reporting of business information by taxpayers. This should mitigate some of the concerns raised around timely access to information to resolve transfer pricing and other complex tax issues.

Finally, other jurisdictions experience similar challenges, yet none have sought to introduce the concept of an interest rate cap in response to transfer pricing complexity. New Zealand should not be a "leader" in this respect. Particularly, as the introduction of a blunt and "unique" approach for limiting interest deductions is likely to be perceived unfavourably by our trading and investment partners. We believe this is ultimately likely to be detrimental for a small capital importing nation such as New Zealand. New Zealand should be making policy decisions that accommodate and encourage foreign investment, not penalising genuine funding arrangements by imposing arbitrary restrictions on how much interest can be claimed on debt funding.

One of our key competitive advantages is the ease with which companies can do business and the certainty of our tax and regulatory environment. That is, we do not generally do things which are outside of the international norm. We are too small a country to introduce laws that are unique. Where we have tried to be different, this has often been at an economic cost and has required reversion to the norm. The interest rate cap proposal risks a repeat of the original incarnation of our CFC rules, which saw New Zealand's rules described by many as the "Star Trek" approach to international tax reform. That is, the absence of an active/passive distinction in our CFC rules meant we boldly went where no-one had gone before in the design of a CFC regime, supposedly confident that other countries would soon follow. They did not and the regime was belatedly amended. New Zealand needs to learn from that experience.

For avoidance of doubt, we are not saying that BEPS concerns around excessively high interest rates on inbound related-party loans should be ignored. We believe the transfer pricing rules are the appropriate toolkit to deal with such concerns, and our experience with Inland Revenue is that these issues are well litigated in transfer pricing disputes.

The interest rate cap could be used as a safe harbour

While not our preference, the interest rate cap proposal could be included as an additional safe harbour for transfer pricing compliance.

It would reduce compliance costs for taxpayers that elect to apply it, as well as investigative time and effort for Inland Revenue. It would still allow taxpayers the ability to demonstrate that their interest rates are arm's length under normal principles. Not only would this better align the treatment of inbound and outbound debt, it would allow taxpayers to better manage their tax positions in other jurisdictions, and would still enable the use of Competent Authority processes to mitigate the risk of double tax.

Chapter 3 - Cap based on parent credit rating plus an appropriate margin

Proposal

To base the proposed cap on the interest rate that the borrower's ultimate parent could borrow at on standard terms.

The maximum deductible interest rate:

— where the ultimate parent of the borrower has a credit rating for senior unsecured debt, would be the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin.

— where the ultimate parent has no credit rating, would be the interest rate that would apply if the parent raised senior unsecured debt on standard terms, plus a margin.

The allowable margin would be limited to that which could be derived from appropriate bond yields one credit rating notch below that of the senior unsecured rating attributable to the ultimate parent.

Submission

If our above submission that the interest rate cap proposal should not proceed is rejected, the interest rate cap for a borrower that has an identifiable ultimate parent should be determined as follows:

- Step 1: the borrower's standalone credit rating should be determined using a globally recognized credit rating methodology (such as Standard & Poor's) without any account of parental affiliation.
- Step 2 the borrower's credit rating calculated under Step 1 should be increased by up to three notches, up to a maximum of one credit rating notch below that of the ultimate parent.

Comment

Proposal is inconsistent with principles of company law

Using the ultimate parent's credit rating as the starting point to derive an interest rate on New Zealand inbound debt is not desirable, regardless of the inclusion of an appropriate margin.

For a start, it is contrary to company law, endorsed in New Zealand courts, that treats subsidiaries as separate legal entities to their parent. It is in essence "piercing the corporate veil" by deeming a subsidiary to have almost no separate legal existence to its parent company.

More importantly, it implies that the New Zealand subsidiary has a similar business profile to that of the parent, which is often not the case. In general, the New Zealand operations of foreign multinationals are often several multiples smaller and will typically comprise a single function or asset, or at the very most a less diverse set of functions or assets when compared to the ultimate parent.

The existing transfer pricing approach for related party loans used by Inland Revenue, which starts with the borrower's credit rating is more in line with the arm's length principle. Not only does it give regard to the credit quality of the specific borrower, but it provides flexibility to notch the borrower's stand-alone credit rating upwards to reflect the specific circumstances of that company and its position in relation to the wider group. This approach is also more consistent with the credit rating analysis we would expect to see undertaken by a bank or other third party lender in practice. Further, such an approach does not preclude a credit rating being consistent with that of the ultimate parent should the facts and circumstances support such a finding.

Standard & Poor's guidance on credit ratings

Standard & Poor's "*Group Rating Methodology*" considers that no uniform approach exists when assessing a credit rating for a subsidiary in light of its parent's rating. Further, "*…no single factor determines the analytical view of the relationship with the business venture in question. Rather, these are several factors that, taken together, will lead to one characterisation or another*". This expressly indicates that such a "notching" process will depend largely on the facts and circumstances of the multinational in question, and that a uniform one notch downgrade from the parent's credit rating is not consistent with market and arm's length practice.

Further, Standard & Poor's also suggest that for a subsidiary to generally be rated the same as its ultimate parent or one notch below its ultimate parent, the subsidiary must either be considered:

- Core (i.e. integral to the parent group's current identity and future strategy); or

- "Highly Strategic" (i.e. almost integral to the parent group's current identity and future strategy).

Given the relative size of the New Zealand economy, with the possible exception of Australasian groups, generally it would be a gross exaggeration to describe the New Zealand subsidiaries of foreign multinationals as either core or highly strategic.

At best, we believe most New Zealand subsidiaries could be considered "strategically important" under the Standard & Poor's methodology, which describes such entities as *"less integral to the group than high strategic subsidiaries. The rest of the group is likely to provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support."* For strategically important subsidiaries, Standard & Poor's recommends generally increasing the stand-alone credit rating calculated for the subsidiary by three notches.

Further, increasing a subsidiary's credit rating by three notches is also consistent with global jurisprudence and, in particular, the decision in *Canada v. Generic Electric Capital Canada Inc.* ("GE Capital").

We consider that our alternative approach, if the interest rate cap proposal proceeds, will provide a result that is more reflective of arm's length and commercial principles, thereby enabling multinationals to better manage their global transfer pricing positions. In addition, we consider that our submission strikes the appropriate balance in allowing Inland Revenue to manage some of the key issues arising in its transfer pricing financing disputes.

Chapter 3 – Cap for borrowers with no identifiable parent

Proposal

Where a New Zealand borrower has no identifiable parent, the appropriate interest rate cap for related-party debt is to be determined based on the rate at which the New Zealand borrower could issue senior unsecured debt, with no margin.

The Document considers that there are two options to address the concern that the NZ capital structure may be manipulated:

- determine the borrower's credit worthiness based on an arm's length amount of debt, as determined under transfer pricing rules (this is the approach taken in Australia); or
- deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

Submission

If the interest rate cap proposal proceeds, where a New Zealand borrower has no identifiable parent, the appropriate interest rate should be determined with reference to the stand-alone credit rating for the borrower in relation to senior unsecured debt using an arm's length amount of debt.

Comment

We welcome the approach proposed in this instance insofar as it supports an assessment of the cost of borrowing by using the NZ borrower's stand-alone credit rating as the starting point.

We consider that basing such an assessment on an arm's length level of debt, as determined under transfer pricing methodologies, is the most principled approach.

This approach has been endorsed in Australia and, if adopted in New Zealand, would minimise the risk of double tax in the event of dispute. Further, consistent with our comments above, applying an arm's length level of debt is likely to result in the derivation of an interest rate that better satisfies the arm's length test in counter-party jurisdictions, thereby further minimising the potential for double taxation and disputes.

The alternative, treating related party debt as equity even where a NZ subsidiary's total debt (including the related-party debt) is within an arm's length level, is inconsistent with established market practice for establishing the debt capacity of capital structures. Notwithstanding limited exceptions, companies across all industries are funded by a combination of debt and equity. Whether debt is provided by third parties or shareholders should have no bearing as to the arm's length debt level of a company To ignore related party debt is therefore tantamount to taking a position that entities should be funded through equity and/or bank debt only, which is unrealistic.

Further, any assessment by a bank of an appropriate credit rating would take into account their estimate of an arm's length level of debt for the borrower, to ensure that they have adequately captured the borrower's risk of default, as well as ensuring that covenant levels have been appropriately set. As a consequence, observed market practice generally allows for an arm's length level of debt to be factored into any assessment of a credit rating.

Chapter 3 – Guarantee fees

Proposal

Guarantee fees will be limited to the margin allowable under the interest rate cap.

Submission

The treatment of guarantee fee should have regard to our submission above on the calculation of the interest rate cap for borrowers with an identifiable parent.

Comment

The allowable guarantee fee should be set by reference to normal transfer pricing principles. However, per our submission above that the cap should be calculated by reference to the NZ borrower's standalone credit rating being increased by three notches, up to a maximum of one credit rating notch below that of the ultimate parent, the treatment of guarantee fees should follow.

Chapter 3 - De minimis exclusion from the interest rate cap

Proposal

Where all cross-border related party debt is less than NZ$10 million, ordinary transfer pricing rules will apply, allowing a specific margin above the benchmark rate to be used.

Submission

We support the interest rate cap not applying in the above circumstances.

Comment

The de minimis is a sensible compliance cost reduction measure for companies with small amounts of inter-company debt.

Chapter 3 – Application of the General Anti-Avoidance Rule

Proposal

While a specific anti-abuse rule is not proposed, taxpayers breaking loans may be subject to application of the general anti-avoidance rule.

Submission

The application of section BG 1 in these circumstances needs to be carefully considered, as not all loan re-sets will be to take advantage of rising interest rates or borrowing margins.

Comment

The Document notes that breaking a loan may defeat the intention of the proposal and be subject to a section BG 1 challenge by Inland Revenue if done to take advantage of a higher interest rate environment.

Care needs to be taken as there may be genuine commercial reasons why borrowers and lenders will look to refinance early and/or renegotiate loan terms prior to the original maturity date. The general anti-avoidance rule should therefore only be applied where there is a clear purpose of avoiding the interest rate cap proposal.

Chapter 3 - Maximum loan term of 5 years

Proposal

For the purpose of determining the appropriate interest rate on a related party loan, any loans with a term of longer than five years will be treated as having a term of five years.

Submission 1

This proposal should not proceed.

Submission 2

If our primary submission is not accepted, there should be carve outs for:

- long term infrastructure projects, such as debt funding for Public Private Partnerships;
- finance leases; and
- life financial reinsurance.

Comment

While we acknowledge that commercial loans terms generally do not exceed five years, there will be sound commercial reasons for some loans having longer terms. Typically this will be because the loan will be funding an asset or project with a life in excess of five years and security of funding for the asset/project is desirable throughout the entire period. Independent lenders will also generally be willing to lend if the lending is effectively secured against a tangible asset. Therefore, we do not support an artificial requirement for the interest rate to be based on a loan term of 5 years, where the actual term is longer (and potentially significantly longer).

In the event that our principal submission is not accepted, exceptions should be made for infrastructure projects and finance leases.

In the case of infrastructure projects, these are inherently long term (10 years plus) in nature and project owners and operators will want to ensure continuity of funding throughout the life of the project. This is particularly important as the NZ Government is actively pursuing Public Private Partnerships (PPPs) to fund key New Zealand infrastructure needs. To the extent that non-resident capital is required to fund PPP investments, the proposal will simply pass the cost back to Government (and ultimately the NZ taxpayer) as this will impact the rate of return on such projects.

In the case of finance leases, the deemed loan from the lessor to the lessee would be caught by the interest rate cap proposal. Where a finance lease has been entered into on normal commercial terms, pricing of the lease should be able to be undertaken with reference to the actual lease term, rather than a 5 year cap.

In the case of life financial reinsurance, the "loan" term will vary with the performance of the underlying book. Life insurance business and reinsurance is typically written over a long term view of how the policies will perform. A five year limit is uncommercial. (Further, the interest rate will reflect commercial perceptions of risk of the book rather than perceptions of credit worthiness. This further justifies an exclusion.)

Chapter 3 – Consistency of the interest rate cap proposal with New Zealand's tax treaties

Proposal

The interest rate cap is considered consistent with New Zealand's double tax agreements (DTAs) including the articles referring to the arm's length principle

Submission

The analysis in paragraphs 3.58 and 3.59 is contradictory. The proposed cap cannot both be consistent with the arm's length principle and override it.

Comment

Paragraph 3.58 and other parts of the Document state that the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Paragraph 3.59 states that the interest rate cap is a domestic anti-avoidance rule.

However, the interest rate cap cannot both be consistent with the arm's length principle and override it. We consider that it is not consistent with our DTAs.

This highlights the unprincipled nature of the proposal – it is being promoted as something that it is clearly not. This is simply an attempt to justify an override of DTAs.

For completeness, we disagree with the characterisation in 3.58. If this really was the case the interest rate cap would not be necessary. If the interest rate is arms-length it should be deductible. We consider the characterisation at 3.59 to be closer to what is being proposed. However, it is difficult to see the rue as an anti-avoidance rule if the interest rate is arms-length. The "anti-avoidance" label applied by Officials seems to be no more than a complaint that transfer-pricing for related party debt may be difficult. That is not a principled position for the proposals. (See also our transfer pricing submissions.)

Chapter 4 – Treatment of non-debt liabilities

Proposal

Non-debt liabilities (other than interest-free shareholder loans) will be deducted from an entity's gross assets when calculating the thin capitalisation safe harbour test. The result will be that the thin capitalisation safe harbour test will measure assets net of non-debt liabilities.

Submission

Deferred tax liabilities should not be deducted from gross assets.

Comment

We agree that it is appropriate to deduct non-debt liabilities, such as trade credits and provisions, from gross assets in measuring compliance with the thin capitalisation safe harbour test. This would make the calculation more akin to a debt to equity test (which is commonly used internationally) and align more closely with the thin capitalisation regime in Australia.

However, there should be no adjustment for deferred tax liabilities. The Document states that non-debt liabilities can be used to artificially inflate balance sheet gross assets to allow an entity to pass the safe harbour test (e.g. through the use of trade creditors to buy a significant amount of assets just before year end). It provides no support for such a statement. We consider that such a practice is rarely found in practice. There are commercial constraints to such acquisitions. Materially, the company must pay the trade creditors. The concerns are overstated. See further for our comments on the measurement date proposals.

Assuming this concern is valid, it does not exist with respect to deferred tax liabilities. They typically arise due to timing differences between accounting and tax income and expenditure recognition rules and to different assumptions being used for financial reporting and tax purposes. They arise therefore due to the tax rules themselves as opposed to any structuring. They are not a de facto means of financing the ownership of assets. Deferred tax liabilities should therefore be excluded from non-debt liabilities deducted from an entity's gross asset balance.

Chapter 5 – Infrastructure projects controlled by single non-residents

Proposal

Single non-resident investors will be able to breach the 60 percent safe harbour test in respect of third-party funding for infrastructure projects that meet certain criteria.

Submission

While we support the exemption for single non-resident controllers, we believe the exemption should be aligned with that for "non-resident owning bodies".

Comment

Where the NZ investment is by a group of non-residents acting together (i.e. the group meets the non-resident owning body definition), there is presently the ability to exclude third party debt from the application of the thin capitalisation rules. This is without regard to the nature of the underlying investment. We believe the proposed exemption for single non-resident controllers should be similarly broad. (We believe this is further buttressed by the proposal to exclude any related-party debt from both calculations.)

Chapter 5 – Removal of the year-end measurement option

Proposal

Taxpayers will only be allowed to measure compliance with the thin capitalisation safe harbour tests using the average of daily or quarterly values for asset and liabilities. The year-end measurement option will be removed.

Submission

The proposal should not proceed. Taxpayers should continue to be able to use year-end values for assets and liabilities in determining compliance with the capitalisation safe harbour tests.

Comment

The Document states potential abuse of the year end valuation option as justification for its removal. Further, the Document refers to the current specific anti-abuse rule being in-effective.

We are not aware of any specific examples of abuse of this rule, let alone that such abuse is widespread or that Inland Revenue has unsuccessfully attempted to apply the specific rule.

We assume that taxpayers are considered to be "gaming" the rules by, for example, by paying down related-party debt prior to balance date and then re-financing at the start of the following year. We are not convinced that this is an example. The payment would need to be sourced from either debt or equity. If it is debt, the thin capitalisation rules would still apply. If it is equity this is more likely to be long term equity for which no deduction is available. On these assumptions it is difficult to see why the specific rule would apply. If there is more, past history would suggest that Inland Revenue would seek to apply the general anti-avoidance rule to deny interest deductions. It may be able to apply the existing anti-abuse provision.

It would seem to us that strengthening the specific rule rather than penalising the vast majority of (fully compliant) taxpayers with increased compliance costs is a better approach. However, as Officials specific concerns are unclear, we are not in a position to comment on what those amendments should be.

The use of year end values is a pragmatic feature of New Zealand's thin capitalisation rules as it allows taxpayers to use the balances in their financial statements, which they will have already had to produce and in many cases will have been audited. Quarterly or daily management accounts, which would necessarily be what the averaging calculations will be based on, do not undergo the same degree of scrutiny and review as year-end figures for many taxpayers.

Such accounts also do not necessarily apply the full valuation and other judgements that are applied to year-end financial statements. This may under or over value assets at each of these measurement dates. They will provide no more accurate measure than a year end test. The result would be the use of less reliable data or the introduction of costly rules requiring the production of more robust daily or quarterly financial data.

We further note that the proposal to include non-debt liabilities as a deduction to assets will constrain the ability of companies to excessively gear their New Zealand operations. To the extent that, for example, acquiring assets through trade credit at year end is a real concern, that problem is already dealt with by the non-debt liabilities proposal. We consider that the trade-off for that proposal is to retain the year-end valuation option.