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Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

Improving the effectiveness of the thin capitalisation rules

Proposal

1. This paper seeks the agreement of the Cabinet Economic Growth and Infrastructure Committee to extend and refine the scope of the thin capitalisation rules that apply to foreign-controlled (non-resident) investment in New Zealand.

Executive summary

2. New Zealand has thin capitalisation rules in place to ensure that non-resident investors do not over-allocate debt to their New Zealand operations and take excessive interest deductions. This helps to ensure that they pay their fair share of tax in New Zealand.

3. These rules currently apply only to New Zealand companies that are controlled by a single non-resident investor (traditional multinational companies). The rules do not apply in situations where groups of non-residents invest in New Zealand in a co-ordinated manner, either by express agreement or through a person such as a private equity manager. Non-residents acting together in this way often have the same level of control over the New Zealand investment as a single non-resident would.

4. An officials' issues paper released in January 2013 proposed to expand the current thin capitalisation rules in order to ensure that they apply more broadly, making the rules more difficult to circumvent. The proposals in this paper are two of the proposals contained in the issues paper.

5. This paper recommends that the scope of the thin capitalisation rules be expanded to apply to a New Zealand investment, where non-residents hold an interest of 50% or more and they act together. Where taxpayers are brought into the ambit of the thin capitalisation rules through this proposal, it can be difficult or impossible to calculate the worldwide group. In this case, the worldwide group would be deemed to be the New Zealand group.

6. It is also recommended that the thin capitalisation rules be amended to exclude debt linked to shareholders when calculating the level of debt of a taxpayer's worldwide group. In practice, this should have little or no effect on taxpayers currently within the scope of the thin capitalisation rules. However, this change is required in order to ensure that the new rules operate effectively.

7. Additional technical proposals were included in the issues paper to make the thin capitalisation rules more effective overall. Officials are continuing to work through issues raised by submitters in respect of these and I request that authority be delegated to the Minister of Finance and me to finalise these proposals.

8. It is recommended that the new rules should apply from the start of the 2015/16 income year. I do not propose any specific transitional or grandparenting rules to delay the application of the new rules to existing investment. This is to ensure consistent application to different types of taxpayers.

9. The proposals in this paper are expected to raise $1m in the 2014/15 fiscal year, $9m in the 2015/16 fiscal year, and $10m per annum in later years.

Background

10. A review of the thin capitalisation rules is part of the Government's Tax Policy Work Programme for 2012/13.

11. New Zealand's thin capitalisation rules were put in place to prevent the excessive use of debt by New Zealand companies controlled by non-residents. In general, tax deductions for interest expenses are denied once the company's debt exceeds 60% of its total assets (60% safe harbour). An interest deduction will not be denied when the debt to asset ratio of a taxpayer exceeds 60%, as long as it is less than 110% of that taxpayer's worldwide group's debt to asset ratio (110% worldwide group test).

12. I note that thin capitalisation rules, by restricting the level of deductible debt a non-resident can use, can in certain cases discourage foreign investment in New Zealand. My view, however, is that this is to be balanced against ensuring that foreign investment as well as domestic investment in New Zealand pays a reasonable level of tax on income earned in New Zealand.

13. Under the current rules for inbound investment, the thin capitalisation rules only apply in the case of a single non-resident controller. As such, the rules appear to be effective in the standard case of a large multinational company that is listed on a stock exchange, with subsidiary operations in New Zealand.

14. However, there are a number of situations where the thin capitalisation rules are not applying in the way that might have been intended, such as in the case of private equity investment. Private equity investors often work together, either by explicit agreement or because they were being co-ordinated by some party such as a private equity manager. This means that shareholders often mimic the behaviour of a single non-resident controller and are thus readily able to co-ordinate on the level of debt and substitute shareholder debt for equity.

15. This ability to substitute shareholder debt for equity can reduce the amount of tax paid in New Zealand. This is because interest is deductible, but dividends paid to shareholders are not.

16. On 14 January 2013, an officials' issues paper on the review of the thin capitalisation rules was released following consideration by Cabinet (CAB Min (12) 44/34). Inland Revenue received 15 external submissions on the issues paper, with the majority from professional services firms and other professional bodies. A few submissions were received from parties affected by the proposed changes.

17. Submitters broadly supported officials' views that certain aspects of the thin capitalisation rules are in need of reform, but raised concerns with respect to the technical design of the policy. Officials are continuing to work through these technical design issues.

Comment

18. I consider that the objectives for this review of the thin capitalisation rules to be:

- to create a level playing field, so all types of non-resident investors that can substitute between debt and equity are caught by the thin capitalisation rules;
- to improve the integrity of the tax system by ensuring that New Zealand collects its fair share of tax on New Zealand investments of non-residents;
- to reduce the fiscal risks associated with the thin capitalisation regime;
- to strike a reasonable balance between economic impact (such as incentives to invest into New Zealand) and additional tax revenue; and
- to ensure that any changes to the thin capitalisation rules do not add undue complexity and compliance costs for taxpayers;

19. The methods for avoiding the thin capitalisation rules are well-known under the current rules. This has the effect of advantaging some forms of investment over others with respect to their tax treatment. The changes to the thin capitalisation rules I am proposing would minimise this unfairness. Submitters have argued that this would have a negative impact on the value of some existing non-resident investment in terms of reduced returns.

20. While taxing non-resident investment reduces incentives to invest here, this must be balanced against non-residents paying their fair share of tax – to ensure New Zealand can capture some of the benefits of that investment. Various reviews, such as the Tax Working Group (2009) and McLeod Review (2001), have considered the tax treatment of non-resident investment and concluded that it should be subject to some reasonable level of taxation. The thin capitalisation rules play an important role in achieving this objective.

21. In summary, the changes to the thin capitalisation rules would strike a balance between providing a competitive economic environment for foreign investment and ensuring that New Zealand collects its fair share of tax on these investments.

22. I propose that any changes to the thin capitalisation rules have an application date of the beginning of the 2015/16 income year. This would allow taxpayers to review their financing structures and make any required changes before the new rules are in place. The new rules should, in general, continue to allow deductions for genuinely external debt, which is the type of debt that is most difficult to restructure. This would largely eliminate the case for delayed application or grandparenting of existing investments.

23. I recommend that two changes should be made to the thin capitalisation rules. These recommendations are to:

- extend the application of the thin capitalisation regime so that it also applies to any group of non-residents if they are acting together and have a combined ownership of a New Zealand investment of greater than 50%; and to

- tighten the application of the inbound thin capitalisation rules by excluding any debt linked to shareholders from the calculation of the worldwide group's debt-to-asset ratio.

24. There are a number of outstanding design issues relating to the design of these two proposals, as well as the technical application of the thin capitalisation rules and their effectiveness. These technical issues are described in paragraphs 39–41. I recommend that the Minister of Finance and I be delegated authority to finalise the detail of these design and technical issues.

Application of the thin capitalisation rules to groups of non-residents acting together

25. I propose that the thin capitalisation rules be extended to apply to groups of non-residents who hold a combined interest of 50% or more in a New Zealand investment and act together.

26. The concern with the current rules is that such investors mimic the behaviour of a single non-resident controller, but are not constrained by the thin capitalisation rules in respect of the amount of interest deductions they are able to take. They are often readily able to co-ordinate on the level of debt and substitute shareholder debt for equity.

27. The result of this proposal is that highly indebted investments controlled by groups of non-residents acting together may have some of their interest deductions denied, either under the 60% safe harbour threshold or the 110% worldwide group test.

28. Non-resident investors who fall within the scope of the thin capitalisation rules because of this 'acting together' proposal may have difficulty in determining their worldwide group for the purposes of the 110% worldwide group test. For some investment structures this may be impossible. As a result, non-resident investors acting together would instead be required to use their New Zealand group's debt-to-asset ratio, rather than that of the worldwide group in order to calculate their 110% worldwide group's debt-to-asset tratio.

29. Many submitters were concerned with how 'acting together' would be defined in legislation. The main issue raised was that a broad definition, or alternatively leaving it as an undefined term, would create significant uncertainty for investors. This may have the effect of reducing the attractiveness of New Zealand as a destination for investment because the uncertainty would lead to increased compliance costs and lower rates of return.

30. Officials are continuing discussions with interested parties to determine an appropriate definition for 'acting together' that achieves the desired policy outcome without creating excessive uncertainty for taxpayers.

Excluding debt linked to shareholders from the worldwide group's debt-to-asset ratio

31. I also propose that when a taxpayer is calculating their worldwide group's debt-to-asset ratio for the 110% worldwide group test in the inbound thin capitalisation rules, they would be required to exclude any debt linked to shareholders.

32. This proposal would apply to all taxpayers subject to the inbound thin capitalisation rules, regardless of whether the investment is controlled by a single non-resident or a group of

non-residents acting together. In practice, this would have little or no effect on the worldwide debt-to-asset ratio for investments controlled by single non-residents. This is because the majority of shareholder debt would be consolidated out at the worldwide level.

33. The intention of this proposal is to ensure that the worldwide group test will only be used when it is meaningful, and funding is genuinely external.

34. Submitters argued that shareholder debt is the norm for certain industries and so should remain included in the worldwide debt-to-asset ratio. I do not agree with this proposition because this would result in the 110% worldwide group test being ineffective for non-resident investors acting together.

35. Another issue raised by submitters concerns the possibility of excluding from the worldwide ratio, external debt that is secured over or where repayment is guaranteed by assets that are not part of the worldwide group. They were concerned that this would overstate the value of such a guarantee or security. Officials are working through this issue and will report back to me with their findings.

Public Private Partnerships (PPPs)

36. One concern raised by submitters was the potential impact on public private partnerships (PPPs). While the proposals would apply to PPPs as they involve groups of non-resident investors that act together, I am of the view that the impact would be minimal. This view is supported by Treasury.

37. The reason for that is that the business model of PPPs involves borrowing high levels of debt, often above 80% of assets, from third party lenders (mainly banks). The proposal to exclude only shareholder debt (not external debt) from the worldwide group comparator means that PPPs would have no denial of interest on external debt, and would be able to have another 10% of shareholder debt before there is a potential for interest denial.

38. To the extent that PPPs have shareholder debt in excess of 10% of the external debt, they would face interest denial on this excess. Treasury's view, however, is that this interest denial would be sufficiently minor to have no material impact on the PPP programme.

Technical issues

39. A number of other proposals featured in the officials' issues paper, which are largely technical in nature. Submitters provided comments in respect of these proposals and officials are currently working through the issues raised. Officials will be reporting back to the Minister of Finance and me in the next couple of months.

40. The additional proposals that featured in the issues paper are to:

- extend the thin capitalisation regime so that it applies to resident trustees of complying trusts if 50% or more of the settlements made on the trust have been made by a non-resident, a group of non-residents acting together, or an entity that is subject to the thin capitalisation rules;
- no longer exclude excess debt outbound companies from the New Zealand group of an individual or trustee;
- disallow capitalised interest to be included in asset values for thin capitalisation purposes, at least for some purposes; and

- generally disregard asset value increases that arise from internal group restructuring.

41. These are technical points that aim to ensure that the changes I have recommended in this paper are effective and cannot be easily avoided. Given their technical nature, I recommend that you delegate authority to the Minister of Finance and me, as the Minister of Revenue, to make decisions in respect of these four outstanding proposals, the technical definition of 'acting together' as well as other technical design issues that may arising during the drafting process.

Consultation

42. The Treasury and Ministry of Business, Innovation and Employment have been consulted on the proposals in this paper.

43. Inland Revenue received 15 external submissions on the issues paper. Submitters broadly supported officials' views that certain aspects of the thin capitalisation rules are in need of reform, in order to ensure that the rules operate effectively. However, many were concerned that the proposals could create too much uncertainty and could constitute "overreach".

44. Officials are continuing to work through these concerns with interested parties to ensure that any changes made to the thin capitalisation rules have the intended effect and will be reporting back to the Minister of Finance and me in the next couple of months.

Financial implications

45. These proposals are expected to raise $10m of revenue a year. Assuming they take effect from the beginning of the 2015/16 income year, they would raise $1m in 2014/15 fiscal year, $9m in the 2015/16 fiscal year and $10m per annum in later years.

	$m - increase/(decrease)				
Vote Revenue Minister of Revenue	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17 & Outyears**
Crown Revenue and Receipts: Tax Revenue	-	-	1	9	10
Total Change in Revenue	-	-	1	9	10

46. This revenue could be included as part of the Budget 2013 revenue package.

Human rights

47. The proposal is not inconsistent with the Human Rights Act 1993 or the New Zealand Bill of Rights Act 1990.

Legislative implications

48. A number of legislative changes to the Income Tax Act 2007 would be required. These would be included as part of the Taxation Bill that is currently scheduled for introduction in August 2013.

Regulatory impact analysis

49. The Work Programme Manager, Policy Advice has reviewed the regulatory impact statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Publicity

50. Publicity for these proposals will be decided as part of the overall revenue package for Budget.

Recommendations

51. I recommend that you

1. **Agree** to extend the application of the thin capitalisation rules to any group of non-residents if they are acting together and have a combined ownership of a New Zealand investment of greater than 50%.

2. **Agree** to tighten the inbound thin capitalisation rules so that the amount of debt allocated to the New Zealand group is limited to 110% of the external debt-to-asset ratio of the worldwide group, such that debt linked to shareholders is excluded.

3. **Agree** that recommendations 1 and 2 and any related changes to the thin capitalisation rules apply from the start of the 2015/16 income year.

4. **Note** that recommendations 1-3 are expected to raise revenue of $1m in the 2014/15 fiscal year, $9m in the 2015/16 fiscal year, and $10m per annum in later years.

5. **Note** that officials are continuing to consult on outstanding technical issues raised by submitters and that they will be reporting to the Ministers of Finance and Revenue with their findings in the next couple of months.

6. **Delegate** to the Ministers of Finance and Revenue, the authority to make decisions on design issues relating to recommendations 1 and 2, as well as to other technical amendments to ensure that the thin capitalisation rules are effective.

7. **Agree** to include the amendments in recommendations 1-3 and subsequent decisions made as a result of recommendation 5 in the tax bill scheduled for introduction in August 2013.

8. **Invite** the Minister of Revenue to instruct Inland Revenue to draft legislation so as to give effect to the proposals contained in this paper and subsequent technical decisions that arise as a result of recommendation 5.

Hon Peter Dunne
Minister of Revenue

____ / ____/ ____
Date