The Treasury

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POLICY ADVICE DIVISION

Tax policy report: Thin capitalisation – submissions and recommendations

Date:	7 March 2013	**Priority:**	High
Security Level:		**Report No:**	PAD2013/36 T2013/506

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Agree** to the recommendations	Tuesday 12 March 2013
Minister of Revenue	**Agree** to the recommendations	Tuesday 12 March 2013

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
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7 March 2013

Minister of Finance
Minister of Revenue

Thin capitalisation – submissions and recommendations

Executive summary

New Zealand has thin capitalisation rules which deny interest deductions on foreign investment that has been excessively debt funded. These rules are aimed at ensuring non-residents pay a fair share of New Zealand tax on their investments.

These rules currently apply only to New Zealand companies that are controlled by a single non-resident investor. An issues paper, however, was released in January with the key proposal to extend the rules to situations where non-residents invest in a coordinated manner either by express agreement or through a person such as a private equity manager.

In addition, it was proposed that the thin capitalisation rules be tightened to ensure that the level of debt allocated to the New Zealand group does not exceed 110% of the external debt to asset ratio of the non-resident's world-wide group.[1] While this would have no effect in practice on multinational groups that are currently caught by the thin capitalisation rules, it would apply to investments in New Zealand by a single non-resident that in turn is owned by multiple parties. Currently the thin capitalisation rules apply to such groups but they have no effect as the worldwide debt ratio is the same as the New Zealand group.

Additional proposals were included in the issues paper to make the rules more effective overall. This included the proposal to make resident trustees subject to the thin capitalisation rules in situations where trusts can currently be used to avoid the application of the rules.

We have received submissions on the proposed reforms. The submissions raised concerns about the design of the new rules – particularly in relation to the boundaries of the reform. These concerns will be taken into account in the final design of the rules but do not present obstacles to the Government deciding to proceed with the reform.

[1] By external debt we mean debt from third parties, not debt advanced by shareholders or associated persons.

Submissions also raised concerns regarding the impact on public private partnerships ("PPP"s). However, our expectation is that impact of the new rules on existing or future PPPs will be minimal. This is because the new rules will accommodate investment that is highly geared provided that gearing is supported by external debt funding. Preliminary consultation with some stakeholders confirms this view. We propose to continue discussions with interested parties to resolve any concerns or issues.

The new rules could apply for the first income year after the bill receives Royal Assent (likely to be the 2015/16 income year). Our preference is that they apply from the 2015/16 income year to ensure consistent application to taxpayers. We do not propose any specific transitional rules to delay the application of the new rules to existing investment. However, this is an issue that is likely to continue to be raised by interested parties.

The key proposals 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.

We recommend that you agree in principle to extend the application of the rules to non-resident investors who coordinate their investment by acting together and to limit the amount of debt allocated to New Zealand to 110% of the external debt to asset ratio of the worldwide group.

Recommended action

We recommend that you:

(a) **Agree** to extend the application of the thin capitalisation rules to non-resident investors who coordinate their investment by acting together.

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** to tighten the inbound thin capitalisation rules so that the amount of debt allocated to New Zealand is limited to 110% the **external** debt to asset ratio of the worldwide group.

Agreed/Not agreed Agreed/Not agreed

(c) **Agree** that, subject to Cabinet approval, recommendations (a) and (b) and any related changes to the thin capitalisation rules be introduced in a tax bill later this year and apply from the 2015/16 income year.

Agreed/Not agreed Agreed/Not agreed

(d) **Note** that the recommendations in (a) and (b) 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. This revenue could be included in the 2013 Budget revenue package.

Noted Noted

(e) **Agree** that a Cabinet paper be prepared for the Minister of Revenue to take to Cabinet later this month to seek approval for these decisions.

Agreed/Not agreed Agreed/Not agreed

(f) **Note** that we are continuing to work through submissions on some related reforms to the thin capitalisation rules and will report to you to seek decisions on the related reforms before a Bill is introduced.

Noted Noted

(g) **Note** that based on consultation with Treasury and other stakeholders our expectation is that impact of the proposed reforms on existing or future Public Private Partnerships (PPPs) will be minimal.

Noted Noted

Andrea Black
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

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

2. 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. 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% safe harbour). The thin capitalisation rules are one mechanism by which we ensure that a fair share of New Zealand tax is paid on foreign direct investment in New Zealand.

3. 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.

4. 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.

5. On 14 January 2013, an officials' issues paper on the review of the thin capitalisation rules was released [CAB Min (12) 44/34]. Submissions closed on 15 February 2013. A list of submitters is attached as Annex 1 to this report.

6. This report provides you with an overview of the issues raised by submissions in relation to the key policy proposals. It seeks your agreement to proceed with the broad framework and direction of the thin capitalisation reform.

7. We will report separately on technical details concerning the application of the proposed framework, as well as other issues arising out of the submission process later this year.

Key proposals in officials' issues paper

8. The officials' issues paper proposed to make a number of changes to the thin capitalisation rules for inbound investment. These changes would make the thin capitalisation rules operate more effectively.

9. The most significant proposal is to extend the application of the thin capitalisation rules to a New Zealand investment, where non-residents hold an interest of 50% or more, and they act together. This is to bring private equity investments held by non-residents into the ambit of the thin capitalisation rules. Where there is no single non-resident controller it can be difficult or impossible to determine what the worldwide group is, so for the purposes of the 110% safe harbour test, the worldwide group would be the New Zealand group.

10. The second proposal targets what is to be included in the calculation of the worldwide group's level of debt when calculating the 110% safe harbour ratio. When determining the worldwide group's debt to asset ratio, debt linked to shareholders of group entities (related party debt) would be excluded. Under the current rules, there is no exclusion for related party debt although in the case of a single non-resident controller, related party debt is likely to be consolidated out at the worldwide level.

11. Therefore this proposal will, in practice, only apply to unrelated non-resident investors who invest through a holding company and have high levels of shareholder debt. It will also mean that investors who are 'acting together' will only have interest deductions denied to the extent that the total debt of the New Zealand group exceeds 110% of the external debt to asset ratio of the New Zealand group.

12. One potential fiscal risk with the first proposal is that foreign investors would be able to get around the thin capitalisation rules through the use of trusts, as the rules currently only apply to trusts under very limited circumstances. To eliminate this risk, the issues paper proposed to make a resident trustee subject to the thin capitalisation rules if 50% or more of the settlements on the trust were made by a non-resident, a group of non-residents acting together, or an entity that is subject to the inbound thin capitalisation rules. As detailed below in paragraphs 25–30, we recognise that there are a number of concerns with this in respect of securitisation vehicles. As a result, we are not seeking a decision on this particular proposal in this report.

Issues raised in submissions on key proposals

13. We received 15 external submissions on the officials' issues paper, primarily from professional advisory firms and professional bodies. However, one submission was received from a private equity investment and another from a firm that specialises in public private partnership investment.

14. Submitters were largely supportive of officials' views that certain aspects of the thin capitalisation rules are in need of reform. In particular, many agreed that private equity structures, which mimic the levels of control seen with single non-resident controllers, should be subject to the thin capitalisation rules.

15. One submitter was of the view that the proposed changes did not go far enough in bringing foreign investment into the scope of the thin capitalisation rules. It is important to note that this view was unique to this particular submitter.

16. While many of the submissions supported the broad proposals contained in the issues paper, disagreement was expressed with finer technical aspects of the proposals. The main concerns were that there would be too much ‘overreach’ and uncertainty, as well as that the proposed changes have the potential to lead to increased compliance costs.

17. The major issues raised by submitters relate to the technical design of the policy, the impact on PPPs, and the application date.

Key design issues

“Acting together”

18. The majority of submitters agreed in principle that the thin capitalisation rules should apply to situations where shareholders “act together” to determine the debt levels of a New Zealand company, but they did not agree with how officials proposed to treat “acting together” in legislation. The issues paper proposed that “acting together” would not be exhaustively defined in legislation, but would include situations where shareholders explicitly cooperate through a shareholder agreement and where shareholders are effectively coordinated by a person or group of people.

19. This definition, it was argued, would create significant uncertainty for taxpayers as it would not be clear for a number of investors whether they would need to account for the thin capitalisation rules when deciding to invest in New Zealand. This uncertainty would lead to increased compliance costs, lower rates of return, and the corresponding risk that New Zealand would no longer be an attractive destination for foreign investment. Submitters were also concerned that different policy and operational interpretations of “acting together” across Inland Revenue would lead to further uncertainty.

20. A number of submitters provided practical suggestions as to how “acting together” could be defined in legislation. We are taking these comments into consideration and undertaking further work in order to formulate an adequate definition that achieves the desired policy outcome without creating excessive uncertainty for taxpayers.

Debt linked to shareholders of group entities

21. The second proposal to exclude debt linked to shareholders of group entities from the worldwide ratio was addressed by a number of submitters, with the overall view being that the proposal is too broad and constitutes overreach. The intention of the proposal is that the worldwide group test will only be used when it is meaningful, that is funding is genuinely external. Submitters were of the view that such a proposal assumes that all debt linked to shareholders is not genuine, which is incorrect.

22. Some submitters argued that shareholder debt is the norm for certain industries, as it guarantees a flow of income back to the shareholder, and for this reason it should not be

excluded from the calculation of worldwide debt. We do not agree. Shareholder debt is readily substitutable for equity and restricting this substitution is a key aspect of the proposals. Where taxpayers are required to use their New Zealand group to proxy the worldwide group ratio, allowing shareholder debt to be included in the proposal would mean that there could never be any difference between the actual debt levels and the worldwide/New Zealand group levels, thus making this test ineffective.

23. In the issues paper, we sought feedback in relation to extending this exclusion to debt where the security for the debt or a guarantee of repayment comes from outside the worldwide group. Submitters were largely opposed to this proposal and considered it inappropriate to distinguish debts based on how they are secured or guaranteed. It was argued that the proposal overstates the value of such a guarantee, and in the experience of some submitters a shareholder guarantee is used to simply reduce the cost of external debt funding.

24. We are still working through these concerns and will report back to you regarding a practical solution regarding what debt should be excluded from worldwide debt within the next couple of months.

Securitisation vehicles

25. A number of concerns were raised as to how the changes to thin capitalisation rules would affect the securitisation industry in New Zealand, although in general submitters were not opposed to broadening the application to trusts. The main concern is that there are often legitimate non-tax reasons to introduce a trust into a corporate structure and any proposed changes to the thin capitalisation regime should not discourage this.

26. Special Purpose Vehicles (SPVs) are commonly used in securitisation structures to facilitate lower-cost third party funding. To be commercially viable, they also need to be tax neutral and bankruptcy remote.

27. Bringing SPVs into the scope of the thin capitalisation rules has the potential to negate this tax neutrality which would have the effect of increasing the cost of funding for New Zealand taxpayers.

28. A number of submitters noted that while the on-lending concession would theoretically be available, the concession does not always work perfectly for securitisation vehicles. This is because the on-lending concession requires that the entity "provides funds", which does not actually occur when a securitisation structure consists of hedging and derivative arrangements.

29. Submitters referred to exemptions for and mechanisms to deal with securitisation structures in thin capitalisation rules in other countries, such as Australia.

30. We are continuing to explore options to address the concerns raised regarding securitisation vehicles and do not seek agreement in this report on the proposal to broaden the types of trusts that are covered by the thin capitalisation rules. However, we do still support

the proposal in general. This is because it ensures that taxpayers do not simply use a trust to circumvent the "acting together" rule proposed.

Public private partnerships (PPPs)

31. The main proposed change would make the thin capitalisation rules apply to investments which are controlled by a group of non-residents that act together. This would include some existing and potential investors in public private partnerships (PPPs).

32. A number of submissions expressed concern that the application of the thin capitalisation rules to PPPs would create uncertainty and make investment in New Zealand PPPs unattractive. They argued that this would reduce the pool of potential investors and push up the cost of PPPs for the Government. The reason for this is that PPPs have high levels of debt often above the 60% safe harbour, which may result in some interest denial.

33. To address these concerns some submitters proposed a specific carve-out for PPPs from the thin capitalisation rules. Alternatively it was suggested that any proposed changes should not apply to existing PPP arrangements (a grandparenting provision).

34. When evaluating these concerns, it is important to note that just because the thin capitalisation rules apply, it does not necessarily follow that the thin capitalisation rules will have any significant impact on the viability, cost, or funding arrangements of PPPs.

35. The information that we have received from submitters and the Treasury PPP team suggests that the impact of the new rules on existing or future PPPs would be minimal. This is because the actual and potential PPPs that we are aware of have high levels of external debt and relatively low levels of shareholder debt.

36. Under the proposed changes, PPPs without a single non-resident controller would be able to use the external debt of their New Zealand group as a proxy to calculate 110% worldwide ratio. The result of this is that these PPPs would continue to be allowed deductions for any external debt, such as bank loans. There would also be some allowance for shareholder debt to be deductible, effectively where shareholder debt is less than 10% of the external debt.

37. Even if the PPP has more than 10% shareholder debt, interest deductions should only be denied to the extent that its shareholder debt exceeds this 10% limit. It is appropriate to deny deductions where there is a high level of shareholder debt otherwise shareholder debt could be used in place of equity to unduly reduce the effective New Zealand tax rate on the investment.

38. We note some existing PPPs are currently above these limits, but even if they find themselves unable to replace shareholder debt with external debt, the interest denial should not be material.

39. One submission raised the issue that a PPP with a single non-resident controller may be, in certain circumstances, disadvantaged relative to a PPP with a consortium of non-resident investors acting together. This could occur if the worldwide group of the single non-resident

controller PPP has a lower debt to asset ratio than the New Zealand group[2], because a PPP with investors acting together would have no real worldwide group and so would rely on the proxy worldwide group test detailed above.

40. However, this potential disadvantage already exists under the current rules, as a PPP with a consortium of non-resident investors is not subject to the thin capitalisation rules at all. The treatment of single non-resident controller PPPs is largely unchanged. As a result, the proposed new rules are an improvement on the status quo as the difference in treatment would be reduced, albeit not fully removed.

41. When designing the proposals, the New Zealand group external debt test available to investors acting together was chosen as a relatively simple way to proxy the correct level of debt for the worldwide group given that these investors do not have a worldwide group. The alternative was to either rely simply on the 60% test or force a worldwide group test of the individual investors. Neither seemed ideal. We accept that the external debt ratio will not be an exact replica of the worldwide group test. However we will continue to assess whether this causes any significant issues.

42. We do not consider the proposed new thin capitalisation rules to be an obstacle for future PPPs. The Treasury PPP team expects that PPPs will continue to be mainly funded through external bank debt in the short to medium term as this is the cheapest form of finance available to a consortium.

Application date

43. A number of submitters commented that any changes to the thin capitalisation rules should be prospective rather than retrospective; the issues paper proposed an application date of the beginning of the income year following the date of enactment of the legislation.

44. While the proposed application is prospective, a number of submitters were concerned that it would not provide taxpayers with enough time to adequately review their financing structure and restructure them where necessary. Some submitters suggested that the application should be the second income year following the enactment of legislation. Other submissions suggested that a grandparenting provision should be considered whereby the new rules would not apply to existing investments (or alternatively would have a delayed application date for existing structures).

45. We note that the proposed application date is likely to be the beginning of the 2015/16 income year. This represents a relatively long lead-in time given the proposals were first announced in January 2013.

46. For the consistency of treatment between taxpayers we recommend that the application date be explicitly from the 2015/16 income year.

47. We also note that new rules would continue to allow deductions for genuinely external debt, which is the type of debt that is most difficult to restructure. We consider that this largely eliminates the case for a delayed application date or grandparenting provisions.

[2] This situation arises where multinational companies are involved in activities other than PPP investment at the worldwide level.

48. Compared to delayed application, grandparenting would involve some further drawbacks as it would favour existing investments over new investments and could create boundary issues in distinguishing whether some funding was the continuation of an existing investment or a new investment.

49. Finally, any decision to delay application or include grandparenting provisions would reduce or delay the $10m per annum of revenue which the proposals are expected to raise.

Other proposals in officials' issues paper

50. The issues paper also contained several discrete items which are more technical and minor in nature. These proposals are:

- The New Zealand group of an individual or trustee under section FE 3(2)(1) of the Income Tax Act 2007 should no longer exclude excess debt outbound companies or those included in a New Zealand group of an excess debt entity (Proposal 4 in the issues paper);
- Where a New Zealand tax deduction has been allowed for interest that is capitalised for accounting purposes, it should not be included in the New Zealand group assets (Proposal 5);
- The increase in the total asset value of a New Zealand or worldwide group resulting from the sale of assets between associated persons should be ignored for thin capitalisation purposes (Proposal 6).

51. These three proposals have not been addressed in this report, and as such we do not seek decisions on them. A number of technical concerns were raised in the submission process regarding the complexity of the capitalised interest proposal and whether the proposal regarding asset uplift is necessary in the context of general accounting rules.

52. As per the other issues raised in this report, we are continuing to work through these concerns.

Recommendations

53. As discussed above, the main objections to the proposals contained in the issues paper were with respect to the technical points, rather than the overall proposals themselves. For this reason, we recommend proceeding with the broad direction of the changes to the thin capitalisation rules as proposed in the officials' issues paper.

54. We will continue our discussions with submitters on the points that they raised in their submissions with respect to definitional issues and other technical points. These discussions will not alter the general direction of the policy, but will enable us to finalise technical aspects

of the changes without creating uncertainty as to the application of the thin capitalisation rules, or unnecessarily increasing compliance costs.

55. As such, the detailed design of the package of changes will follow.

Fiscal implications

56. This report seeks your agreement on two key proposals:

a) That the thin capitalisation rules be extended to situations where non-residents invest in a coordinated manner either by express agreement or through a person such as a private equity manager.

b) That the thin capitalisation rules be tightened to ensure that the level of debt allocated to the New Zealand entity does not exceed 110% of the external debt to asset ratio of the non-resident's worldwide group.

57. These key 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	-	-	1.000	9.000	10.000
Total Change in Revenue	-	-	1.000	9.000	10.000

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

Next steps

59. If you agree to the recommendations contained in this report, we will prepare a Cabinet paper for the Minister of Revenue to take to Cabinet Economic Growth and Infrastructure Committee on 27 March 2013.

60. We will report to you on the technical details concerning the proposals later this year, following further discussions with submitters and other interested parties to resolve the definitional and other technical issues raised in submissions.

61. We will also report to you on the remaining proposals contained in the issues paper, but for which we have not sought decisions in this report.

Annex 1: List of submitters

Professional services firms

Bank of New Zealand
Ernst & Young Ltd
KPMG
Pricewaterhouse Coopers
Russell McVeagh
Staples Rodway Ltd
WHK (NZ) Ltd

Other professional bodies

Corporate Taxpayers Group
New Zealand Bankers Association
New Zealand Council of Trade Unions
New Zealand Law Society
New Zealand Institute of Chartered Accountants

Affected parties

John Laing
SKYCITY Entertainment Group Limited
Veda Advantage Limited