The Treasury

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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Thin capitalisation review

Date:	25 October 2012	**Priority:**	**Medium**
Security Level:		**Report No:**	T2012/2166 PAD2012/230

Action sought

	Action Sought	Deadline
Minister of Finance	**Agree** to recommendations	9 November 2012
Minister of Revenue	**Agree** to recommendations	9 November 2012

Contact for telephone discussion (if required)

Name	Position	Telephone	
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25 October 2012

Minister of Finance
Minister of Revenue

Thin capitalisation review

Executive summary

Inland Revenue and Treasury are reviewing the thin capitalisation rules this year.

These rules limit tax deductions for interest when foreign-owned companies use excessive amounts of debt. This is to ensure that a fair amount of tax is paid in New Zealand on income generated here.

The review followed reports that the rules are not working properly. Deficiencies have been highlighted by highly structured arrangements which get around the thin capitalisation rules. We give an example in this report of an arrangement which skirts the thin capitalisation rules even though debt is more than 90% of total funding.

We plan to consider two aspects of the rules in particular.

The first is the ‘single non-resident controller rule’. The thin capitalisation rules apply only when a New Zealand company is controlled by a single non-resident. We are seeing cases in which small groups of investors are co-operating or being co-ordinated by intermediaries to achieve the same control over debt levels as a single controlling shareholder would have. That is, such investors are not legally associated persons, but they behave as if they are because they have common goals and there is a degree of co-ordination. It might be appropriate to widen the rules to cover such cases.

The second aspect of the rules we plan to look at is the ‘110% worldwide group safe harbour’. The thin capitalisation rules do not deny a tax deduction for interest expenses unless the New Zealand company is more indebted – in a relative sense – than the worldwide group of which it is a part. This allows for the possibility that some industries have naturally high debt levels. However, if the worldwide group has no significant operations outside New Zealand, the New Zealand company can never be more indebted than the worldwide group. We are seeing investments that are structured to take advantage of this aspect of the rules, and it might be appropriate to modify the safe harbour in such circumstances.

We are also likely to consider a number of more minor matters.

We are at an early stage in the review. Reform is this area is important, because the current rules may allow foreign-owned companies to pay less tax than is intended. However, there may be difficult issues to work through and we will face some constraints in our review. An important constraint is the "arm's-length" requirement in the OECD's commentary on double tax agreements, which means that if the debt of a highly indebted company is consistent with what an unrelated third party would advance then it should be accepted as fair for tax purposes. The OECD Commentary has some legal force in New Zealand and could make any domestic law change less effective when a tax treaty applies.

Changes to the thin capitalisation rules, on their own, might not be sufficient to ensure a fair share of tax is paid on New Zealand income. Some of the weaknesses identified in the thin capitalisation rules are also present in transfer pricing and non-resident withholding tax legislation, and these weaknesses might be exploited more as the thin capitalisation rules are tightened. This would make the thin capitalisation changes less effective. To keep the thin capitalisation review manageable, we do not plan to consider these other matters as part of the review, but they should be given consideration when the tax policy work programme is next updated. Transfer pricing issues, in particular, might need to be given a high priority to ensure that thin capitalisation changes are not unwound.

Subject to approval by you and Cabinet, we plan to release an issues paper or discussion document at the end of 2012, to allow for public consultation about these issues. We would report to you again to recommend referral to Cabinet, once we had completed the issues paper.

Officials are developing a balanced revenue package for your consideration for Budget 2013 and we propose to include this item in the package. You will receive a report about the package shortly.

Recommended action

We recommend that you:

a) **Agree** that officials should do further work to develop an issues paper, which will propose changes to the thin capitalisation rules.

Agreed / Not agreed

Agreed / Not agreed

Andrea Black
Principal Advisor
Treasury

Tony Booth
Senior Policy Advisor
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Purpose

1. Inland Revenue and Treasury will review the thin capitalisation rules this year. This is part of the Government's Tax Policy Work Programme for 2012-13. This report briefs you about some of the issues that will be considered as part of the review and the process that we intend to follow. We will be reporting to you again before any public announcement of policy proposals.

Background

2. When a New Zealand company is controlled by a non-resident, the non-resident can freely capitalise the company with debt or equity. There is a strong incentive in many cases to artificially inflate the amount of debt and reduce the amount of equity, because subsequent interest payments are tax-deductible in New Zealand, which minimises New Zealand tax payments.

Example (ignoring foreign taxes):

Australian investor A puts $1,000 of capital into a New Zealand company as equity. Company earns $100 from sales and pays $28 tax. Company pays a net dividend (not tax deductible) of $72. Total New Zealand tax is $28.

Australian investor B puts $1,000 of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $100 from sales but has to pay $100 of tax-deductible interest, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on the foreigner (non-resident withholding tax). Total New Zealand tax is $10.

3. The thin capitalisation rules were put in place to prevent the excessive use of debt, to ensure a fair share of the company's income is taxed in New Zealand. In general, tax deductions for interest expenses are denied once the company's debt exceeds 60% of its total assets.

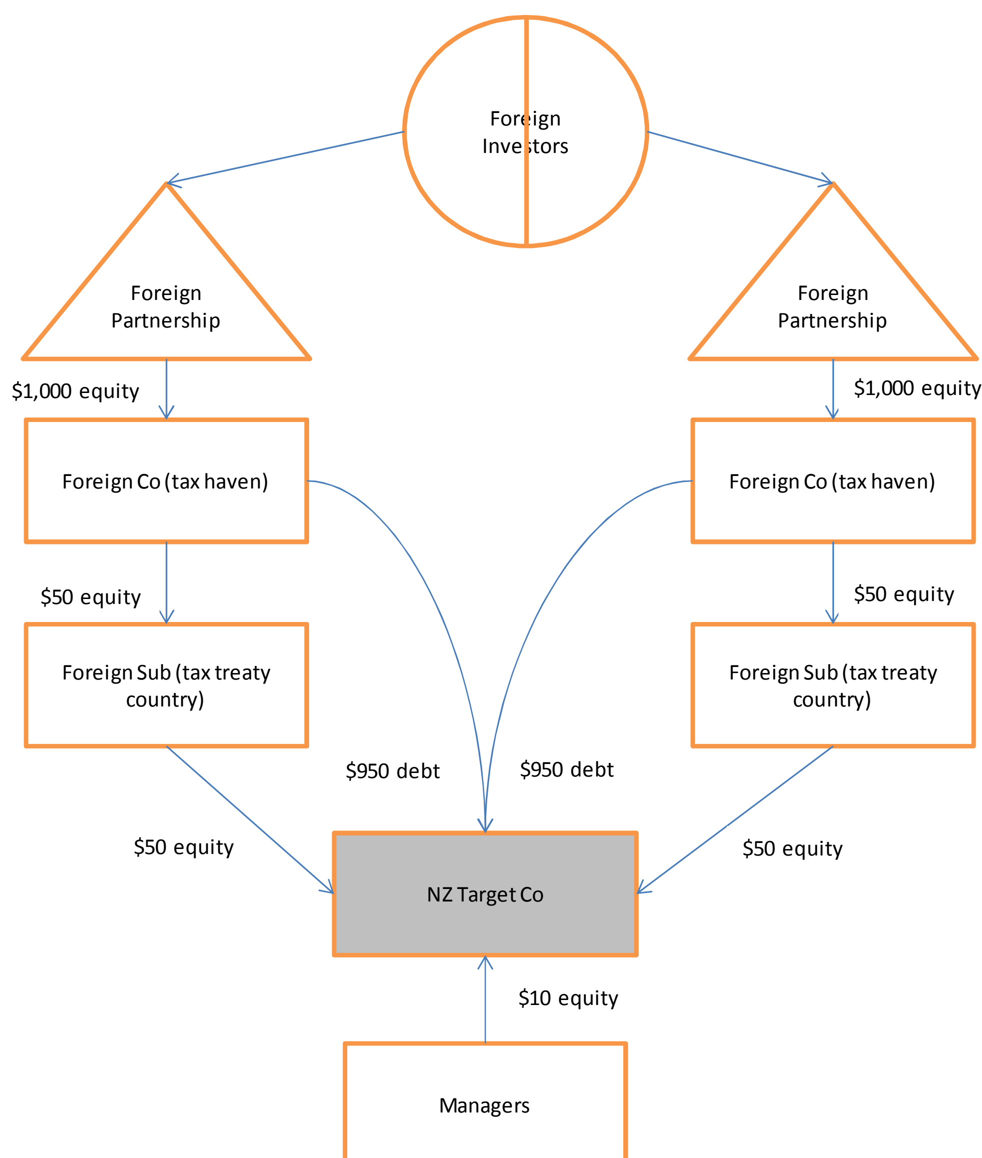
What we are seeing

4. Inland Revenue's investigators, through their normal audit work, have come across some situations where the thin capitalisation rules are not applying in the way that might have been intended.

5. For instance, a recently identified "private equity" transaction (leveraged buy-out) involved debt of more than 90% of total assets. The thin capitalisation rules do not apply in

this case, even though some of the debt comes from shareholders and the resulting interest expense will significantly reduce taxable profits.

Idealised version of transaction:



A group of investors is organised by a private equity manager into two partnerships, each of which owns $1,000 of shares in a foreign company incorporated in a tax haven.

Each foreign company puts $950 of debt into the New Zealand target company. Each foreign company also has a subsidiary in a tax treaty country and each subsidiary holds $50 of shares in the New Zealand target company (any dividend taxation will be reduced by the tax treaty).

Some residual equity ($10) is held by management of the New Zealand target.

Total debt of the company is approximately 95% of assets. However, there is no single resident controller under current law and so the thin capitalisation rules do not apply.

6. The transaction seems to escape the application of the thin capitalisation rules because of the specific structure employed. Similar structures have been used in the past by private equity investors and there is a risk that this sort of structure will be used more widely in future, significantly reducing company tax revenue.[1]

7. Because of this transaction, and others like it, it may be desirable to legislatively clarify the application thin capitalisation rules.

8. It is important to note that changes to the thin capitalisation rules, on their own, might not be sufficient to ensure a fair share of tax is paid in New Zealand in all cases, particularly in the case of a highly structured arrangement such as the one depicted above.

9. Later in this report we discuss some of the limitations we might face in changing the thin capitalisation rules.

10. We also discuss the relationship of the thin capitalisation rules to other tax rules which could be used to increase the New Zealand tax paid by non-residents if that was thought to be appropriate; in particular, rules reclassifying some debt as equity, the transfer pricing rules, and the non-resident withholding tax rules. We are not proposing to change these other rules as part of the thin capitalisation review. However, the thin capitalisation changes could ultimately be made ineffective if problems with some of these other rules are not remedied reasonably soon. We think these problems should be considered when the next tax policy work programme is being put together. We think, in particular, that changes to the transfer pricing rules might need to be given a high priority at that time.

Matters to be reviewed

11. The issues that have been raised by structures like the one illustrated above are:

12. *The single foreign controller rule*. The thin capitalisation rules apply only when the New Zealand company is controlled by a single non-resident. We are seeing cases in which two or more shareholders are not subject to the rule but have the same ability to manipulate debt levels as a single controlling shareholder. The scope of the rule should therefore be reviewed. (An alternative option would be to widen the scope of existing rules which completely reclassify debt as equity – see *Relationship to other tax rules* below).

13. *The worldwide group "110%" safe harbour*. Interest deductions are not denied unless the New Zealand operations of the foreign shareholder are more indebted than its worldwide operations. This is an exception to the general rule. For example, a multinational manufacturer going through a slow patch might have a 70% worldwide debt-to-asset ratio because it has had to temporarily borrow more to stay afloat. In such a case, a New Zealand ratio of 77% (110% of 70%) would be allowed before denying any interest deductions. We

[1] This report expresses no view about whether or not the general anti-avoidance rule would apply to the transaction. If it did, the risk would be reduced in that specific case, though not necessarily in others.

are seeing situations where the New Zealand group is the same as the worldwide group; that is, there are no operations outside this country. The New Zealand and worldwide indebtedness are always equal in this case and no interest deductions could ever be denied. The scope of the 110% safe harbour should therefore be reviewed.

14. *Inflation of asset values*. The thin capitalisation rules generally apply when the amount of debt exceeds 60% of the total asset value of the company. We have seen cases in which assets are effectively sold to a related party and then repurchased at a higher price, to increase the reported value of assets and escape the application of the thin capitalisation rules. This is a greater concern if the assets involved are intangible assets such as intellectual property, which can be hard to value reliably. Asset values are also increased by the capitalisation of financing costs in some cases (this is an accounting requirement under International Financial Reporting Standards). These issues should be considered as part of the review.

15. *Finance companies*. Companies, such as finance companies, that borrow money to lend it to others can ignore their borrowing for thin capitalisation purposes. This makes the thin capitalisation rules ineffective for finance companies. Special thin capitalisation rules were introduced for registered banks for this reason, but they rely heavily on prudential requirements administered by the Reserve Bank. At the time the bank rules were introduced, there were no such requirements for finance companies, but this has recently changed. It might now be appropriate to widen or adapt the bank thin capitalisation regime to include finance companies. However, we do not intend to address this concern as part of the current review, other than to signal it is an area of further work. This is to keep the size of the current review manageable.

16. *Insurance companies*. An insurance company has a naturally high level of non-debt liabilities, reflecting its liability to pay out claims to policyholders. With such a high level of non-debt liabilities, it is very unlikely that the insurer could have a level of debt that exceeds 60% of assets. The thin capitalisation rules are therefore unlikely to ever apply to insurers. This is possibly not appropriate, and special rules might be justifiable for insurance companies. Like finance companies, newly introduced prudential requirements might serve as a basis for special rules, but we do not intend to address this issue at this stage, other than to mention it as an area for further work.

17. Some more technical corrections to the rules are also likely to be suggested as part of the review.

Anticipated constraints on the review

18. We are at an early stage in the review. Reform is this area is important, because the current rules may allow foreign-owned companies to pay less tax than is intended. However, there will be difficult issues to work through and we will face some constraints.

Arm's-length principle

19. A constraint on the review is the "arm's-length principle". That is, there should be no denial of interest deductions when the level of debt is the same as a third party at arm's-length, such as a bank, would be willing to provide.

20. We are obligated to observe this principle in our double tax agreements. This is because New Zealand, along with many other countries, adheres to the "OECD Commentary", a document which guides interpretation of tax treaties. For instance, the Commentary says (Commentary on Article 9, at paragraph 3):

> [Article 9] does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;
>
> […but…]
>
> the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties

21. We do not have an explicit reference to the arm's-length principle in the Income Tax Act, but we do not deny any interest deductions until debt exceeds 60% of total assets, which for most businesses would exceed the amount an arm's-length party would be willing to lend. In addition, we do not deny deductions until the debt-to-asset ratio of the New Zealand operations is higher than the debt-to-asset ratio of the worldwide group (the worldwide group 110% safe harbour). For these reasons, we have not been challenged about our domestic law by taxpayers relying on the arm's-length principle in a tax treaty.

22. However, were we to widen the application of the thin capitalisation rules it would increase the possibility that we would deny deductions in some cases of arm's-length debt.

23. If the rules are broadened we are particularly likely to be criticised for violating the arm's-length principle in cases of private equity investment. Private equity investments, worldwide, are often highly geared and a significant proportion of that debt comes from banks and other financial institutions.

24. It will be argued that the high level of third-party debt in overseas private equity investments is normal industry practice, and this will be used to justify a very high level of arm's-length debt here. Ultimately the Courts might be asked to decide on what an arm's-length level of debt is, for a particular arrangement. The Courts in New Zealand have not often been required to interpret tax treaties and it is difficult to know how they would approach the matter.

25. It will also be argued that denying interest deductions when there are such high levels of debt – whether or not arm's-length – will make private equity investments, new or existing, uneconomic, at the cost of investment and employment.

26. Determining whether or not the amount of debt is an arm's-length amount is more difficult when some shareholders, but not others, lend money to the company. This difficulty

would be more pronounced if the thin capitalisation rules were widened to cover more cases of joint ownership.

Applying rules to entities controlled by multiple foreigners

27. As noted, one of the areas we plan to look at is the single non-resident controller limitation – the rules apply only if a single foreigner controls the New Zealand company.

28. With a single controller, we look at the level of debt of the New Zealand company and any other entities in New Zealand controlled by the non-resident (the "New Zealand group"). If this exceeds 60% of the assets of the New Zealand group, we look at the level of debt in the worldwide group of which the New Zealand operations are a part. The members of the worldwide group are entities, inside and outside New Zealand, who are associated with the non-resident controller in some way. If the debt-to-asset ratio of the New Zealand group is less than 110% of the worldwide group's ratio, we do not deny any interest deductions. Otherwise we do deny some deductions.

29. With multiple controllers, it would be difficult to decide who to include in the New Zealand and worldwide groups, and whether to include them in whole or in part. The technical difficulty of resolving this issue could complicate the review.

Relationship to other tax rules

[6]

[6]

Transfer pricing and non-resident withholding tax

36. The thin capitalisation rules reduce tax deductions for interest by a fixed proportion which is determined by the debt-to-asset ratio of the taxpayer. However, they do not affect the interest rate on the debt or the rate of withholding tax charged on any interest payments, both of which might be used to reduce the amount of New Zealand tax payable. Restrictions on interest rates are instead imposed by the transfer pricing rules and the rate of withholding tax (if any) is determined in the non-resident withholding tax rules.

37. We do not plan to look at transfer pricing and withholding taxes as part of the thin capitalisation review. However, the thin capitalisation changes could ultimately be made ineffective if problems with some of these other rules are not remedied reasonably soon. We think these problems should be considered when the next tax policy work programme is being put together. We think, in particular, that changes to the transfer pricing rules might need to be given a high priority at that time.

Process for review

38. We intend to release an officials' issues paper or a discussion document for public consultation in December 2012, subject to approval from you and Cabinet. We would report to you again to recommend referral to Cabinet, once an issues paper had been developed.

39. Officials are developing a balanced revenue package for your consideration for Budget 2013. We propose to include this item in the package (you will receive a report about the package shortly). The intention would be that, following consultation on the issues paper, final decisions about thin capitalisation changes could be announced in the Budget, with legislation to follow in the next available tax bill. However, a final decision to include thin capitalisation as part of the Budget package could be contingent on public reaction to the issues paper.

[6]