Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Budget 2010: Thin capitalisation rules

Date:	16 February 2010	**Priority:**	High
Security Level:		**Report No:**	PAD2010/21 T2010/202

Action sought

	Action Sought	Deadline
Minister of Finance	Agree to recommendations	25 February 2010
Minister of Revenue	Agree to recommendations	25 February 2010

Contact for telephone discussion (if required)

Name	Position	Telephone	
John Marney	Senior Policy Advisor, PAD	[deleted – privacy]	[deleted – privacy]
Steve Mack	Principal Advisor, Treasury	[deleted – privacy]	[deleted – privacy]

16 February 2010

Minister of Finance
Minister of Revenue

Budget 2010: Thin capitalisation rules

Executive summary

Because interest payments are deductible expenditure for tax purposes, high levels of debt in New Zealand reduce taxable profits here. Therefore, in common with many other countries, we have interest allocation rules (also known as "thin capitalisation" rules) to ensure that debt is not over-allocated to New Zealand.

There are two elements to our interest allocation rules. Inbound rules apply to foreign multinationals with New Zealand subsidiaries. Outbound rules apply to New Zealand residents with offshore interests. Currently, the same thresholds are used for the purposes of both the inbound and the outbound rules. Interest deductions are disallowed to the extent that the debt-percentage (essentially, the debt-to-asset ratio) of the New Zealand group exceeds a 75% "safe harbour" and also exceeds 110% of the worldwide group's debt percentage.

There is some evidence that the typical debt-percentage of New Zealand companies is considerably lower than 75%, and there are anecdotal reports of foreign multinationals gearing up to exploit the safe harbour. In their recent reports, the Capital Markets Development Taskforce ("the CMDT") and the Victoria University Tax Working Group ("the TWG") both recommended that the Government consider lowering the safe harbour in the inbound rules from 75% to 60%.

There are trade-offs to consider. Lowering the safe harbour will mean that some marginal investments cease to be economic and are no longer undertaken. However, we can also expect some existing debt investment to be replaced with equity, increasing revenue. This is likely to be the case, in particular, when the foreign investor is earning economic rents or is able to claim credits at home for tax paid in New Zealand; in these circumstances, there is unlikely to be any economic loss to New Zealand from lowering the safe harbour.

On balance, officials recommend lowering the safe harbour in the inbound interest allocation rules from 75% to 60% as part of an overall tax reform package in Budget 2010. This is a revenue-positive proposal that would further restrict the amount of debt that could be allocated to New Zealand by foreign multinationals. The maximum expected annual revenue gain from the change is estimated at $210 million. The relevant legislation could be enacted on Budget night under urgency, in line with the preferred approach for implementing the overall package (the 29 January 2009 report, *Implementation of Tax Reform Package* (T2010/73, PAD2010/8) refers). We recommend that the change apply for the 2011-12 and subsequent income years: this will give affected firms some time to adjust their capital structures.

A bigger reduction in the inbound safe harbour would increase the revenue raised. The maximum expected annual fiscal gain from reducing the safe harbour to 50% is estimated at $373 million, although this figure needs to be treated with considerable caution; the actual fiscal gain is likely to be significantly less in practice. A change of this magnitude is not recommended because of the risk that the negative impacts would outweigh the benefits.

Neither the CMDT nor the TWG suggested changing the safe harbour used in the outbound rules. The arguments for moving this threshold, in either direction, are not clear cut. Officials do not recommend adjusting that threshold as part of Budget 2010.

Recommended action

It is recommended that you:

(a) **Note** that the CMDT and the TWG both recommended that the Government consider lowering the safe harbour in the inbound interest allocation rules from 75% to 60%.

Noted Noted

(b) **Note** that the maximum expected annual fiscal gain from reducing the safe harbour in the inbound rules from 75% to 60% is estimated at $210 million.

Noted Noted

(c) **Agree** that that the safe harbour in the inbound interest allocation rules should be reduced from 75% to 60% and that the necessary legislation be enacted on Budget night under urgency, with the change applying for the 2011-12 and subsequent income years.

Agreed / Not agreed Agreed / Not agreed

(d) **Agree** that the safe harbour in the outbound interest allocation rules should not be changed as part of Budget 2010.

Agreed / Not agreed

Agreed / Not agreed

Steve Mack
for Secretary to the Treasury

John Marney
Senior Policy Advisor
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. Interest payments are deductible for tax purposes. Debt is therefore commonly used as a tax planning tool by corporate groups operating in more than one jurisdiction. If high levels of debt are allocated within such a group to companies in New Zealand, that can reduce taxable profits here. Outbound interest payments are subject to non-resident withholding tax, but at a lower rate than the standard company tax rate. Accordingly, like many other countries with developed tax systems, New Zealand has rules to limit the scope for excessive amounts of debt to be loaded against the domestic tax base.

2. These interest allocation rules (also known as "thin capitalisation" rules) have two elements:

- Inbound rules. These apply to foreign-controlled entities in New Zealand. They limit the scope for foreign multinationals to load debt against New Zealand operations to reduce tax paid here. (There are separate interest allocation rules for foreign-controlled banks. These special banking thin capitalisation rules are outside the scope of this report.)

- Outbound rules. These apply to New Zealand residents with income interests in controlled foreign companies (CFCs). They limit the scope for people to load debt against their domestic income while investing the capital to earn CFC income (which is now mostly exempt).

3. Currently, the same thresholds are used for the purposes of both the inbound and the outbound rules. Interest deductions are disallowed to the extent that the debt-percentage (essentially, the debt-to-asset ratio) of the New Zealand group exceeds a 75% "safe harbour" and also exceeds 110% of the worldwide group's debt percentage.

4. The 75% safe harbour is arbitrary. It is based on judgement, compromise and relativity with close trading partners, rather than any particular tax/economic theory. Commercial levels of debt vary between companies and sectors. Having a safe harbour with a reasonable amount of headroom recognises this. A tighter threshold increases compliance costs and may ultimately lead to denial of some interest deductions and the general test must then be applied. On the other hand, a high threshold increases the exposure of the domestic tax base, with associated fiscal cost. Any reasonable threshold will give rise to difficult cases at the margins. Accordingly, there is no universally "right" threshold.

5. The 110% threshold caters for multinationals that are highly geared generally, in which case a high level of debt in New Zealand would be consistent with the overall capital structure of the business, suggesting that debt has not been loaded against New Zealand profits to reduce tax here. The 10% uplift provides some additional flexibility but is again essentially arbitrary. Referring to the worldwide debt percentage makes some sense if the business carried on in New Zealand is similar to that carried on by the rest of the worldwide group. It may have less validity for multinationals operating across a range of industries or if the business carried on in New Zealand is materially different to the wider business of the worldwide group.

Changing the safe harbour in the inbound rules

6. Because debt can be used to reduce New Zealand tax, foreign multinationals may prefer to finance New Zealand operations using debt rather than equity. Note that this issue does not arise only for multinationals with scope to shift profits to low-tax jurisdictions. The largest source of inbound direct investment into New Zealand is Australia, which has an imputation system that provides a significant incentive to profit-shift back across the Tasman.

7. Both the CMDT and the TWG recommended in their recent reports that the Government consider the possibility of lowering the 75% safe harbour in the inbound interest allocation rules. Essentially, the question posed by both groups is whether this safe harbour is currently too generous and is encouraging foreign multinationals to over-allocate debt to New Zealand.

8. If an investor is simply substituting debt investment for investment that would otherwise have been made by equity, a lower safe harbour will increase revenue without distorting investment levels. It is worth emphasising the attractiveness of this as a potential tax base. To the extent that a lower safe-harbour encourages a straightforward shift from debt investment to equity investment, extra revenue is raised at no cost to New Zealanders: an efficiency gain. (Normally, raising taxes imposes deadweight losses: the cost to New Zealanders of the tax increase is more than the amount of revenue raised.)

9. However, a lower safe harbour could mean that some marginal investments cease to be economic and will no longer be undertaken. This is the cost to New Zealand of such a change. It will increase the cost of capital.

10. So, there are some clear trade-offs to consider. Lowering the safe-harbour will increase national income overall if the increased tax revenue from encouraging a switch from debt to equity finance exceeds the national income forgone from discouraging some marginal investment from taking place. Annex A provides an example illustrating this point. More generally, reducing the safe harbour is a revenue-positive measure, increasing the scope for lower taxes elsewhere in the system.

Natural debt levels and effective tax rates

11. If the safe harbour for inbound investment is significantly higher than "natural" levels of external debt, then there is an opportunity for foreign-owned firms to gear up in order to reduce their effective rate of New Zealand tax. The 2001 McLeod Review noted that, with a natural debt level of 50%, non-resident direct investors could basically "help themselves" to an effective New Zealand tax rate of around 20%. Anecdotal evidence suggests that some foreign-owned firms do gear up to exploit this.

12. There is some evidence that the typical debt percentage of New Zealand companies is considerably lower than 75%. A discussion document published in February 1995, prior to the introduction of the thin capitalisation rules, stated that the average debt-equity ratio of the top 40 NZSX companies in November 1994 was about 1:1, implying a debt percentage of around 50%. A discussion document published in December 2006, prior to the introduction of the outbound interest allocation rules, noted that commercial debt contracts tend to impose on New Zealand borrowers a maximum 60% debt-to-tangible asset ratio.

13. It is unclear whether debt-to-asset ratios have changed markedly in recent years. Banks would likely demand lower ratios now, suggesting they may have fallen. On the other hand, distress borrowing may have increased debt ratios for some businesses.

Elasticity of foreign investment

14. A key judgement is how sensitive (elastic) foreign investment is to the New Zealand tax impost. If the foreign investment is inelastic, lowering the safe harbour will increase tax revenue without having much effect on the total foreign investment in New Zealand. This would make New Zealand better off. If foreign investment is highly elastic, New Zealand could become worse off by losing national income from discouraging foreign investment that might otherwise occur.

15. Looked at another way, it is legitimate to ask whether, as a matter of policy, we should be concerned that foreign direct investors can benefit from an effective rate of New Zealand tax below the statutory rate of 30 percent. The 2001 McLeod Review recommended reducing the rate of tax on foreign direct investment as a means of encouraging inbound investment. However, this idea was not pursued for a number of reasons, including concerns about losing revenue on investment that may be relatively insensitive to tax.

16. A foreign investor is likely to be insensitive to New Zealand tax if they are earning economic rents here or are able to claim a credit for New Zealand tax in their home jurisdiction. In these circumstances, taxing non-residents yields revenue at low (or even no) economic cost to New Zealand.

Preference for direct investment over portfolio investment

17. Having a relatively generous safe harbour may provide an incentive for non-resident direct investors to acquire controlling interests in New Zealand companies. This is because a single foreign direct investor is able to gear up to exploit the threshold in a way that is likely to be impractical for a company owned by portfolio investors, when commercial constraints may cap the amount of debt. Current settings may therefore create a preference for foreign direct investment over foreign portfolio investment. The CMDT was concerned that this might favour the development of some capital markets over others.

Administration and compliance

18. Reducing the safe harbour would mainly affect corporate taxpayers rather than the Inland Revenue Department (although there would be some minimal administrative costs). The main impacts are likely to be as follows:

- A modest increase in legislative complexity. The change would mean that, in future, the safe harbour used in the inbound rules (applying to foreign-controlled entities in New Zealand) would be different to that used in the outbound rules (applying to New Zealand-owned entities with offshore subsidiaries).

- Increased tax liabilities for some highly geared firms. Foreign-owned New Zealand companies with a New Zealand debt percentage that exceeds both the safe-harbour and 110% of the worldwide group's debt percentage would face partial denial of their interest deductions. Cleary, this effect will increase the further the safe harbour is reduced.

- Increased compliance costs for foreign-owned companies with significant levels of debt. A lower safe-harbour would increase the need for such firms to monitor, and perhaps adjust, debt levels throughout the year, even if they do not eventually breach the threshold. The number of firms that are unable to rely on the safe harbour and are therefore required to calculate their worldwide debt percentage would also increase. Again, these impacts will increase the further the safe harbour is reduced.

19. Foreign-owned New Zealand companies with significant levels of debt may wish to revise their capital structure before the safe-harbour is lowered, reducing debt to avoid denial of interest. It may take some time and involve some cost for firms to unwind existing financing arrangements.

International comparisons

20. Direct comparisons with other countries are difficult because the structure of interest allocation rules differs between countries. Whereas the New Zealand safe harbour applies by reference to total debt, typically countries with lower safe harbours (Canada at 67%, France at 60%) measure related-party debt only. An exception is the United States, which has a 60% safe harbour based on total debt, although restrictions under its thin capitalisation rules still focus on deductions for related-party debt.

21. Overall, New Zealand's current 75% safe harbour is probably not out of line with comparable thresholds in other countries (annex B provides a summary of similar rules in ten key jurisdictions). However, there are two reasons in particular why New Zealand may nevertheless be justified in moving to a lower threshold.

- First, a lower safe-harbour may be justified in New Zealand because a high proportion of foreign direct investment comes from counties where tax settings may encourage parent companies to heavily debt-finance their New Zealand subsidiaries. Fifty five percent of foreign direct investment comes from Australia, where imputation encourages profitshifting out of New Zealand (because Australian investors can benefit from franking credits for tax paid in Australia, whereas they typically cannot use New Zealand imputation credits).

- Second, even if the safe harbour is reduced below 75%, interest deductions will only be restricted under New Zealand's rules if the debt percentage of the New Zealand group is more than 110% of the worldwide group's debt percentage. In other words, restrictions will only apply under our rules if the leveraging of New Zealand operations is significantly higher than that of the worldwide group as a whole.

22. Australia has a 75% safe harbour. There is no equivalent to our 110% threshold in Australia's inbound rules, but they do have an additional rule whereby deductions are not restricted unless the level of debt exceeds that which might reasonably have been provided on an arm's length basis (although we would not recommend adopting a similar, subjective test here). *[information deleted to avoid prejudice to the entrusting of confidential information by a foreign government or international organisation]*

Fiscal impact

23. The maximum expected annual fiscal gain from reducing the safe harbour threshold in the inbound rules from 75% to 60% is estimated at $210 million.

24. The maximum expected annual fiscal gain from reducing the safe harbour to 50% is estimated at $373 million. However, this estimate should be treated with considerable caution. The actual fiscal gain is likely to be significantly less in practice. Even if the safe harbour is breached, full interest deductions are allowed under the rules if the debt percentage of the New Zealand group does not exceed 110% of the worldwide group's debt percentage. We do not hold data on worldwide group debt percentages, so this is not factored into the estimated fiscal impacts. However, as the safe harbour is reduced, the 110% threshold will come into play more often, limiting additional revenue raised. It is reasonable to assume that this dampening effect would be significant if the safe harbour were set as low as 50%.

25. Note that these estimates are based on the existing company tax rate of 30%. If the company tax rate were reduced, the annual fiscal gain from lowering the safe harbour would be less.

The outbound rules

26. Just as foreign multinationals may prefer to finance New Zealand operations using debt rather than equity, so a New Zealand taxpayer may prefer to borrow in New Zealand in order to equity finance offshore operations. Under the new rules for CFCs enacted last year, profits from such operations will generally be exempt from New Zealand tax. This provides an incentive for New Zealand taxpayers with CFCs to keep debt at home in order to utilise the

interest deductions. Accordingly, when the CFC rules were reformed, new outbound interest allocation rules were introduced for New Zealand residents with CFC interests.

27. There is not the same consensus for lowering the 75% safe harbour in the outbound rules: neither the CMDT nor the TWG recommended such a change.

28. There are a number of reasons why you may prefer not to reduce the safe harbour in the outbound rules below its current level of 75%, at least for the time being:

- The outbound rules have only recently been introduced (with a 75% safe harbour), as part of an overall package of international tax reform. This package was developed through a process of extensive consultation with stakeholders.

- For New Zealand-owned companies, the imputation system provides some level of protection against excessive gearing of New Zealand operations. In principle, if debt is used to shelter profits at company level, the tax should be clawed back from shareholders when those profits are subsequently distributed as unimputed dividends.

- Businesses may face commercial or regulatory restrictions on borrowing offshore. In particular, when businesses start up in foreign jurisdictions, the initial funding may be in the form of equity from the New Zealand parent – either because the host jurisdiction has minimum equity requirements or because the subsidiary cannot obtain funds from banks in the host jurisdiction. This may mean that more restrictive interest allocation rules could inhibit offshore expansion by New Zealand firms. A number of submissions to this effect were made at the time the outbound rules were introduced.

29. There is a body of opinion which holds that the safe harbour in the outbound rules should, in fact, be increased above its current level of 75%. We received a number of submissions to this effect at the time the outbound rules were introduced. However, there are good reasons for not increasing the safe harbour at this stage:

- The underlying principle behind the outbound interest allocation rules is that interest incurred to earn offshore active income, which is now exempt in New Zealand, should not be deductible against domestic income. Any safe harbour represents a compromise on that principle. As noted earlier, a debt percentage of 75% is higher than typical debt-asset ratios of New Zealand companies. To the extent that firms are able to gear up to exploit the safe harbour, they can benefit from an effective subsidy for moving activities offshore. This may impact adversely on the productive sector within New Zealand.

- More straightforwardly, excessive gearing in New Zealand would undermine the domestic tax base, at fiscal cost. The imputation system provides some protection against this, through the incentive it provides for New Zealand-owned companies to earn profits (and pay tax) here rather than offshore. However, firms may still defer tax by delaying the distribution of unimputed dividends. Or they may avoid tax altogether if gains are realised through the sale of shares to non-residents. Australia has outbound interest allocation rules (with a 75% safe harbour) despite also having an imputation system.

Possible Budget announcement

30. There seems a reasonable case for reducing the safe harbour threshold in the inbound interest allocation rules from 75% to 60%, in line with the recommendation of the CMDT and the TWG. This could be announced as part of the Budget 2010 tax reform package as a revenue-positive measure. The relevant legislation could be enacted on Budget night under urgency in line with the preferred approach for the overall implementation of the Budget tax reform package (our 29 January 2009 report, *Implementation of Tax Reform Package* (T2010/73, PAD2010/8) refers). We would recommend that the change apply for the 2011-12 and subsequent income years: this will give affected firms some time to adjust their capital structures.

31. Going beyond the recommendations of CMDT and TWG and lowering the safe harbour in the inbound rules further (say, to 50%) is not recommended at this stage. This is because of the risk that the negative impacts of such a reduction, in terms of discouraging inbound investment and increasing compliance costs for firms, would outweigh the benefits of increased tax revenue, potentially making the change detrimental to New Zealand overall. A safe harbour of 50% would be too low to accommodate many legitimate financing arrangements (as noted earlier, the average debt percentage of New Zealand companies is probably within the range of 50-60%). Firms would instead have to rely on the 110% threshold: applying that threshold would increase compliance costs for business at the same time as dampening the fiscal gain for government. Such a significant reduction in the safe harbour would be unexpected and controversial amongst stakeholders.

32. We do not recommend making changes to the safe harbour threshold in the outbound interest allocation rules at this stage.

Fit with overall objectives

33. The Government's overall objectives for tax reform were set out in Cabinet Minute (10) 3/2 and in the Prime Minister's statement to Parliament of 9 February 2010 – namely to reduce the impact of tax on efficiency and growth; support New Zealand's global competitiveness in a sustainable way; and improve the fairness, coherence and integrity of the tax system.

34. Reducing the safe harbour in the inbound interest allocation rules will contribute towards fairness, coherence and integrity by limiting the ability of foreign multinationals to reduce the effective rate of tax on their New Zealand profits.

35. The change will not directly encourage inbound investment or improve the competitiveness of the tax system. Indeed, the opposite may be true because of the negative impact on some marginal inbound investment that is sensitive to tax and only economic when highly leveraged. However, we can also expect some existing debt investment to be replaced with equity investment and, to the extent this happens, revenue will be increased at no economic cost. This is likely to be the case, in particular, when the foreign investor is earning

economic rents or is able to claim credits at home for tax paid in New Zealand. The change is, therefore, not incompatible with the Government's overall objectives when considered as part of a broader, balanced reform package.

ANNEX A: EFFECTS OF CHANGING THE SAFE HARBOUR

A foreigner invests $1,000 in a New Zealand company. The New Zealand tax rate is 30 percent and the foreign tax rate is 20 percent. The investor requires a net return of $80. Assuming the investment is debt financed up the maximum level allowed, with a safe harbour of 75 percent, there must be pre-tax New Zealand earnings of $103.60 to generate the final $80 return (see column 1 below). Reducing the safe harbour to 60 percent increases the required pre-tax return to $105.70 (see column 2).

75% safe harbour		**60% safe harbour**	
New Zealand company			
Revenue	103.60	Revenue	105.70
Interest payment	75.00	Interest payment	60.00
Tax	8.60	Tax	13.70
Dividend	20.00	Dividend	32.00
Foreign company			
Interest income	75.00	Interest income	60.00
Dividend income	20.00	Dividend income	32.00
Tax	15.00	Tax	12.00
After-tax cash flow	80.00	After-tax cash flow	80.00

If the investment is earning economic rents, the gross earnings may already be higher than the required gross return of $105.70. In that case, the investment will continue despite the reduced threshold and New Zealand tax revenue will increase. However, if the investment is achieving gross earnings below $105.70, it will no longer be economic when the threshold is lowered and will cease, to New Zealand's detriment.

ANNEX B: INTEREST ALLOCATION RULES IN SELECTED COUNTRIES

	Debt-equity threshold	Debt in column (1) refers to	Restrictions apply to	other safe harbours
Australia	3:1 (75%)	total debt	total debt	arm's length
Canada	2:1 (67%)	related party debt	related party debt	no
Denmark[(a)]	4:1 (80%)	total debt	related party debt	arm's length
France[(b)]	1.5:1 (60%j)	related party debt	related party debt	see note (b)
Germany[(c)]	group average	total debt	total debt	30% EBITDA[1]
Italy[(d)]	no	-	-	30% EBITDA
Japan[(e)]	3:1 (75%)	total debt	related party debt	industry norm
Netherlands	3:1 (75%)	total debt	related party debt	group average
New Zealand	3:1 (75%)	total debt	total debt	110% group average
United Kingdom[(f)]	no	-	related party debt	arm's length
United States[(g)]	1.5:1 (60%)	total debt	related party debt	50% EBITDA

(a) Denmark: The 4:1 debt-equity ratio does not limit deductions if it can be shown that a similar loan could have been obtained from an independent third party without related party backing. Note that the 4:1 debt-equity ratio is not a safe harbour as such. Under Danish law, three separate limits apply to interest deductions. The other limits are based on net interest expenses (excess of interest expense over interest income), which are restricted if they exceed either 80% of EBITDA or a cap determined by multiplying the taxable value of the company's assets by a prescribed interest rate (7% in 2008).

(b) France: Only related-party debt is restricted, and only to the extent that all three of the following thresholds are breached: (i) a 1.5:1 debt-equity ratio; (ii) 25% of adjusted current profits; and (iii) the amount of interest income received from related parties (if funds on-lent to affiliates).

(c) Germany: Net interest expenses are limited to 30% of EBITDA. The rules apply to both related and unrelated party debt. The "group average" safe harbour only applies if less then 10% of net interest expense is paid to related parties.

(d) Italy: Net interest expenses are limited to 30% of EBITDA. The rules apply to both related and unrelated party debt.

(e) Japan: Deductions for related party interest may be restricted to the extent that the ratio of related party debt to related party equity is greater than 3:1. However, there is no restriction if the ratio of total debt to total equity does not exceed 3:1 (or the ratio for a comparable company, if that gives a better result for the taxpayer).

(f) United Kingdom: Related party interest is not deductible to the extent that amounts borrowed from, or with the backing of, group companies exceed the amount the company would have been able to borrow from an independent lender. HMRC maintains that there are no safe harbours, although some of the literature cites administrative tolerances based on a debt-equity ratio of 1:1 and an income cover ratio of 3:1 (equivalent to net financing expenses being around 33% of EBITDA).

(g) United States: If the 1.5:1 safe harbour is breached, the lesser of the following is denied: (i) the exempt related person interest expense (broadly, related party interest subject to full or partial exemption under a tax treaty); and (ii) the excess interest expense, being the amount by which net interest expenses exceed 50% of EBITDA.

[1] Earnings before interest, tax, depreciation and amortization.