Regulatory Impact Statement

Thin capitalisation – low-asset companies

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to make thin capitalisation rules fairer for a small group of resident companies with offshore investments. The thin capitalisation rules are designed to deny tax deductions for interest if interest expenses of a multinational group are unreasonably concentrated in New Zealand. The specific problem addressed by this statement is that some companies that have a high debt-to-asset ratio because their assets are not recognised for accounting purposes. As a result, the thin capitalisation rules may deny tax deductions for interest. This may be the case even though interest expenses are reasonably allocated between countries.

A general limitation of our analysis is the time constraint in considering options. Speed was of the essence since, unless a legislative change is made promptly, there will be uncertainty and the potential for taxpayers to suffer significant unwarranted costs as provisional and terminal tax liabilities fall due.

A key gap in the analysis is that it is not possible to quantify the economic benefits of fairer treatment. Quantification would require knowledge about the sensitivity of business-location choices to tax, which is not directly observable.

Although the broad parameters of the preferred policy have now been established, further work may lead to changes to the detailed design before implementation.

As part of this analysis, we have consulted with the small number of taxpayers who have been identified as being adversely affected by the thin capitalisation rules. The effect of the consultation was to clarify that there is a problem with the existing rules and to confirm that the status quo is not the right option for these taxpayers. We have also consulted with Treasury, which agrees with our analysis. We did not undertake wider consultation because, having sought information from tax practitioners about other affected taxpayers, the issue seems to affect only a small group.

The options considered in this statement do not:

- impose additional costs on businesses
- impair private property rights, restrict market competition, or reduce the incentives on businesses to innovate and invest, or
- override fundamental common law principles.

The options are likely to impose some minor additional compliance costs on taxpayers, but are expected to reduce tax liabilities by a greater amount. The options would also be expected to increase incentives to innovate and invest.

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STATUS QUO AND PROBLEM DEFINITION

1. This statement considers how to ensure fair application of the thin capitalisation rules for resident companies that are not controlled by foreigners.

2. The thin capitalisation rules deny interest deductions for tax purposes when an excessive amount of interest is allocated to the New Zealand operations of a multinational enterprise. The rules were widened in 2009 to include all resident companies with controlling interests in foreign companies. The rules previously applied only to non-residents and residents controlled by non-residents.

3. The rules apply to deny a portion of interest deductions if New Zealand operations are highly indebted. Operations are considered highly indebted if the ratio of New Zealand debt to New Zealand assets is greater than 75%. Such high debt levels may indicate that debt is being concentrated in New Zealand and not being reasonably allocated to the offshore CFCs.

4. There is an exception to the rules when the high level of debt is not confined to New Zealand. The exception applies if the New Zealand debt-to-asset ratio is less than 110% of the equivalent ratio for worldwide debt and assets. In such a circumstance, it may be argued that debt, while high, is being reasonably allocated across countries and not loaded into New Zealand operations.

5. Debt of the New Zealand group is not counted if the debt is "on-lent" to members of the worldwide group that do not operate in New Zealand.

6. The rules may not work well for residents who have built up substantial businesses in New Zealand and then expanded offshore by way of a debt-financed acquisition of a foreign company. This is because some of the assets of a long-established business in New Zealand are likely to be internally-generated intangibles, such as brand value, that are not recognisable on the balance sheet. If they are not recognisable on the balance sheet, they cannot be included in the measure of assets in the debt-to-assets ratio. This makes it more likely that the ratio will exceed 75%.

7. In contrast, the assets of the acquired foreign company are likely to be recognisable on a consolidated balance sheet because they have been purchased by the New Zealand resident rather than internally developed. This pushes down the worldwide ratio and makes it more likely that the New Zealand ratio will exceed 110% of the worldwide ratio.

8. A numeric example that clearly sets out the problem is provided in the Appendix to this document.

9. It is important to note that on-lending to CFCs – passing on debt to the newly acquired foreign companies – can alleviate the problem that has been identified. However, on-lending is not always convenient for the business. For example, other countries may impose their own thin capitalisation restrictions that prevent on-lending, if there is already a high level of debt in the CFC.

OBJECTIVES

10. The objective of the policy is to ensure fair treatment of certain companies that are subject to the thin capitalisation rules as a result of the legislative changes in 2009.

11. 'Fair treatment', in the context of thin capitalisation, broadly implies denial of interest deductions only to the extent that interest deductions are not spread across jurisdictions on some reasonable basis (discussed further below).

12. There is a particular focus on New Zealand-based multi-national enterprises that have expanded abroad by debt-financed acquisition of existing foreign businesses. The existing rules are more likely to work without remedy when they apply to non-residents or non-resident-controlled resident entities, because the situation above is reversed: recognised assets will be in a resident group that has been acquired, making it easier to pass the 75% and 110% tests. For this reason, consideration of a solution to the policy problem is confined to the case of outbound investment, where the entity operating in New Zealand is neither non-resident nor controlled by a non-resident.

13. The changes introduced in 2009 are already applying to New Zealand businesses and it is highly desirable that further changes, to solve the problem that has been identified, be made quickly. Businesses are already facing provisional tax obligations that are affected by the amount of interest denial. Even if further changes are made retrospective, so that there is ultimately less interest denial, there is temporary uncertainty about the amount of tax liability until the law is changed.

REGULATORY IMPACT ANALYSIS

Policy background

14. The problem for residents with interests in CFCs is an acknowledged feature of thin capitalisation rules such as New Zealand's. Internationally, there are (broadly) two approaches to thin capitalisation: one imposes a maximum debt-to-asset ratio (New Zealand takes this approach) and the other imposes a maximum interest-to-cash-flow ratio.

15. The debt-to-asset approach works well for companies with volatile earnings, because it is a relatively stable ratio even in the presence of unpredictable cash flows. However, it does not work well when the company has unrecognised high-value assets such as internally generated goodwill (these assets are recorded at minimal cost or not recorded at all).

16. In contrast, the interest-to-cash-flow approach works well for companies with high-value assets, even if the assets cannot be recognised for accounting purposes, because high-value assets are likely to generate cash flows (though not always immediately). Third parties lend on the basis of these cash flows.

Proposed solutions

Detailed consideration of two solutions

17. Two solutions, other than the status quo, have received detailed consideration:

- **Option 1 (our preferred option)** – allow the use of an interest coverage ratio (interest-to-cash-flow) rather than a debt-to-asset ratio in some circumstances, and deny interest only when the interest coverage ratio exceeds some benchmark; or

- **Option 2** – impute an asset value from cash flows and a prescribed deemed rate of return, and use this in the standard leverage ratio (debt-to-assets).

18. The two proposed solutions are equivalent, for a particular combination of actual interest rate on debt, deemed rate of return and benchmark interest-to-cash-flow ratio (such as 50%). Both would reduce the extent of the existing problem for businesses with assets that are not on the balance sheet but are generating net cash inflows.

19. However, if the benchmark ratio is not fixed, such as if it is based on the interest-to-profits ratio of the worldwide group, the two proposed solutions are not equivalent unless the ratio happens to equal a presumed fixed ratio. Similarly, if the actual interest rate is higher than the rate assumed when the deemed rate of return is calibrated, the two proposed solutions are not equivalent.

20. Option 2 (an imputed asset value) has the advantage that it fits cleanly within the current rules, which reduces the risk of unforeseen side effects.

21. However, option 2 has the disadvantage that assumptions must be made about the actual interest rate and the benchmark ratio. If the assumptions are incorrect, the imputed asset value risks being too generous or not generous enough.

22. Put another way, if the actual rate of interest can be manipulated upwards, such as by pushing up the interest rate in a related-party transaction, more "headroom" can be created. This problem is inherent in the use of a leverage ratio – we already observe some multi-nationals putting their higher-cost debt in New Zealand – but the problem is made more obvious by the use of a notional measure of assets.

23. The risks inherent in the second solution are reduced in the first solution (an interest coverage ratio) if the interest coverage test is appropriately designed. The interest coverage test cannot be easily manipulated by changing the actual interest rate, and the benchmark ratio may be made variable.

Economic, fiscal and compliance costs and benefits of the two primary options

24. The net economic benefit in the case of either option 1 or option 2 has several components:

- a benefit from the removal of impediments to expansion of resident businesses from a New Zealand base (reducing incentives for emigration of companies and accompanying loss of revenue);

- a benefit to the owners of a resident business in the form of lower New Zealand taxation; and

- a cost in the form of the loss of some New Zealand tax revenue.

25. The first (and main) component of net economic benefit is unquantifiable, since it depends on unobservable factors such as the willingness of business owners to relocate their head offices in response to tax treatment. However, qualitative information we have received in discussions with one tax agent indicates that significant denial of interest deductions would be a material incentive to consider emigration. Emigration of companies results in the loss of

not only business revenue and taxes on business income, but also loss of employee income, PAYE and GST.

26. The second and third components are (at least approximately) offsetting, for both option 1 and option 2. Either may be estimated using the fiscal cost of the option. The projected fiscal cost of option 1 is $15 million per annum. This cost depends on some aspects of detailed design that are discussed later in this statement (the costing assumes the preferred detailed design options that are indicated there). It also depends on the accuracy of data supplied to Inland Revenue and keyed into its computer systems, and on assumptions made about some variables for which there is no data. Because of the equivalence of options 1 and 2 noted above, the cost of option 2 would probably be similar to the cost of option 1. However, as has been discussed the equivalence is imperfect and incentives to put higher-cost debt in New Zealand under option 2 mean the cost of option 2 could be higher.

Social, environmental and cultural costs and benefits of the two primary options

27. None identified.

Other options

28. A number of other solutions have been explored, but have undesirable features and so were not examined in great depth:

- Allow recognition of assets for the purpose of calculating the debt-to-asset ratio, even where assets would not be recognisable under generally accepted accounting practice – Australia allows this in limited circumstances, but valuation of intangible assets such as goodwill is recognised as extremely difficult unless the cost in a market transaction can be observed (this is why accounting standards do not permit it).

- Provide an exception to the thin capitalisation rules for "arm's-length" debt – Australia and the United Kingdom have such an exception but it has proved difficult to establish the meaning of the term "arm's length". In the typical case the "110% of worldwide ratio" safe harbour in the existing New Zealand rules serves a similar function without uncertainty about the scope of the exemption.

- Allow market capitalisation as a proxy for assets – this would require complex rules for allocating the market capitalisation between jurisdictions, and is likely to inefficiently favour listed over unlisted companies.

Preferred solution and broad design

29. Our preferred solution is option 1 which allows the use of an interest coverage ratio instead of a leverage ratio. Interest coverage is to be measured as the ratio of interest to earnings before interest, tax, depreciation and amortisation (EBITDA), or some variant of that ratio – there is discussion about the choice of this measure below. The use of the new ratio would be optional, so taxpayers could continue to use the existing debt-to-asset ratio if they wished.

30. Some of the key detailed design choices are discussed further in the following sections.

Limitations on use of the option

31. The option to use the additional ratio is intended to address a specific and limited problem within the current rules. For this reason, and to limit any risk of unexpected side effects or fiscal cost, use of the option would be allowed only when:

- the worldwide group of the New Zealand taxpayer is highly indebted; and
- the debt is provided mostly by unrelated parties; and
- both the New Zealand and worldwide groups have a positive EBITDA (no losses) and net interest expense.

32. The policy problem that has been identified could conceivably occur when a worldwide group is not highly indebted. For instance, a resident company with very few recognisable assets but a valuable internally developed brand could raise debt to purchase a largely debt-free foreign company in the same industry. If for some reason the resident company were unable to pass on a reasonable portion of the debt to the acquired company, New Zealand interest deductions may be denied.

33. On the basis of current knowledge such a scenario is thought to be unlikely. Cases where debt is unable to be passed on, such as when thin capitalisation rules apply in other countries, will usually involve high global levels of debt. In the very small number of actual cases where the problem is known to exist, worldwide indebtedness is relatively high.

34. The unrelated party requirement ensures that the worldwide group is genuinely indebted. In addition, in our judgment it is more likely to be possible to require related-party lenders to allocate debt reasonably between New Zealand and offshore operations, than it is to require third parties such as trading banks to do so.

35. The requirements relating to EBITDA are to ensure that the ratios used in the calculation are meaningful. In particular, they remove situations where the ratios could be negative. They effectively confine the use of the option to situations where operations are reasonably profitable (before provision for asset replacement).

36. An alternative to imposing restrictions would be to allow the use of the interest coverage ratio for all taxpayers (although restrictions relating to EBITDA would need to remain in order for calculations to be sensible). In the vast majority of cases, our judgment is that taxpayers would gain no benefit from the wider approach because they are not affected by the existing thin capitalisation rules – their New Zealand debt is less than 75% of their New Zealand assets. As noted above, allowing the option for all would also increase the potential cost of any unintended side effects.

37. It is possible that restrictions on the use of the option will need to be revisited after a period, in the light of the restrictions' observed effects.

Measure of cash flow in the interest coverage ratio

38. Other countries that use an interest coverage ratio in thin capitalisation or "earnings stripping" legislation use a cash flow measure which is comparable to EBITDA (for example, the United States).

39. EBITDA is a proxy for cash flows. It is a measure of income before any allocation to equity holders, debt holders and government, and before provision is made to maintain the productive capacity of assets. EBITDA is commonly used in financial markets as an indicator of relative value.

40. A possible alternative measure would be earnings before interest and tax (EBIT). EBIT gives an indication of *sustainable* cash flows to be allocated between equity holders, debt holders and government, because it allows for depreciation and therefore for the productive capacity of assets to be maintained.

41. EBITDA has the strength, as a cash flow proxy, that it is not affected by non-cash provisions for depreciation, which can vary between countries, over time or because of accounting choices. It is preferred over EBIT for that reason.

42. EBITDA could be measured under either accounting or tax concepts. The appropriate choice of measure depends on the choice of benchmark for the interest coverage ratio, which is discussed further below. A tax measure could be more appropriate if the New Zealand interest coverage ratio was compared to a fixed benchmark (such as 30%), since a New Zealand tax liability will usually be available. It is less likely to be appropriate if the New Zealand ratio was compared to a worldwide ratio, since it is probable that no New Zealand tax liability will have been calculated for offshore companies.

The benchmark for the interest coverage ratio

43. Other countries that use an interest coverage ratio impose a fixed benchmark. In the United States interest deductions are pared back if the interest-to-profits ratio is more than 50%. In some European countries, the ratio is 30%. This ratio is broadly consistent with common notions of acceptable interest coverage in financial markets.

44. A fixed ratio has the advantages that it easy to understand and that it is not necessary to separately calculate the benchmark. It has the disadvantage that in certain situations it may be too high to ensure a reasonable allocation of debt between countries, or too low to allow for commercially acceptable borrowing. In one of the actual cases we have looked at, it seems that a high fixed ratio would be required to ensure a fair outcome. In another, it seems that a lower fixed ratio would be appropriate. The high ratio would solve the problem in both cases, but at an unnecessarily high fiscal cost.

45. An alternative to a fixed ratio is a ratio based on the interest coverage ratio of the worldwide group. This is more likely than a fixed ratio to ensure a reasonable allocation of interest expenses between countries within the group. However, its use means that a tax-based measure of EBITDA becomes impractical. Accounting measures need to be used to provide comparability between New Zealand and worldwide ratios and to avoid high compliance costs. Accounting measures are imperfect proxies for income that would be taxable, and may allow more scope for manipulation of ratios.

46. A worldwide ratio or some variant is the preferred benchmark because it can produce a fair outcome for taxpayers in different circumstances, without unnecessary fiscal cost.

47. It is possible in some circumstances for interest coverage ratios to be very sensitive to small movements in cash flows, leading to wild changes in the amount of interest allowed or denied. This would lead to unpredictable fiscal costs and may increase incentives for tax planning. Sensitivity of the ratio to cash flows occurs, in particular, when cash flows are

small relative to net interest expense. For this reason, it is appropriate to impose a maximum on the variable benchmark, such as 50%.

CONSULTATION

48. We have consulted, through tax agents, with two taxpayers known to be affected by the problem identified in this statement. As a result of this consultation, we have decided that the status quo is not a suitable option. We have advised these two taxpayers of our preferred solution and the reasons for it. In respect of detailed design, this consultation is ongoing. At this stage, we have received an informal indication that the general structure of the preferred option is likely to be helpful. However, we understand the two taxpayers have not yet completed their analysis. Any concerns raised in future will be dealt with as they arise.

49. We also sought information about other affected taxpayers from an accounting firm which made a submission about the thin capitalisation rules. We were advised that there are two further cases where taxpayers may be affected by the identified problem in future. Those two taxpayers have chosen not to be involved in consultation at this stage.

50. We have also consulted with The Treasury, which agrees with our findings.

CONCLUSIONS AND RECOMMENDATIONS

51. Option 1 is our preferred option. It addresses the specific problem that has been identified. It does so at a moderate fiscal cost, and is practical to implement.

IMPLEMENTATION

52. Officials propose that the solution be included in an international taxation bill later this year, and that the solution be retrospective to remedy any unfairness that has arisen since the beginning of the new rules (no taxpayer will be worse off as a result of being able to use the new option).

53. Publicity will be provided through the normal process (a Tax Information Bulletin, following enactment of legislation).

54. Little further action is likely to be necessary to implement the option.

55. We have not identified any implementation risks.

MONITORING, EVALUATION AND REVIEW

56. It is possible that the solution will be available to more taxpayers than was anticipated, which would have an additional impact on fiscal cost. We will seek to provide additional reporting requirements to ensure that Inland Revenue is aware of uptake of the solution and can respond in a timely manner if this occurs.

57. It is also possible that there may be other taxpayers affected by the thin capitalisation rules in unintended ways, and that these taxpayers will not have their problems addressed by the preferred solution. These cases are expected to be exceptional, but if they occur Inland Revenue officials will continue to be available to discuss them with taxpayers.

APPENDIX

57. The following is an example of how the existing rules could apply to a resident company that has debt-financed the acquisition of a controlled foreign company (CFC) to expand its business.

58. Following the acquisition, the company has $100m of debt and notionally $200m of assets, excluding the value of its investment in the foreign company. However, $100m of those assets are not recognised on the balance sheet because they are internally generated goodwill.

	$million
Assets of New Zealand company (excluding CFC investment)	200
of which	
- recognisable under accounting standards	100
- not recognisable under accounting standards	100
Liabilities of New Zealand company (debt)	100

59. The company's debt-to-asset ratio, using the assets recognised on the balance sheet, is 100%. Since this exceeds 75%, some interest deductions will be denied unless the ratio is less than 110% of the equivalent ratio for the worldwide group.

60. The worldwide group has notionally $400 million of assets, including $200 of offshore assets. The $200m represents the amount paid to acquire the CFC. Accounting standards allow this entire amount, including any goodwill, to be recognised on the balance sheet. Adding the $100m of recognised assets of the resident company, the worldwide group has total recognised assets of $300m. There is total debt of $200m.

Total assets of consolidated worldwide group	400
of which	
- recognisable under accounting standards	300
- not recognisable under accounting standards	100
Total liabilities of consolidated worldwide group	200

61. The worldwide debt-to-asset ratio, using the assets recognised on the balance sheet, is 67%. The resident company's ratio of 100% exceeds 110% of the worldwide ratio (110% of 67% is 73%) so there will be some denial of interest deductions. There is denial even though the New Zealand and worldwide ratios would be equal if all assets could be recognised.

NZ asset-to-liability ratio (total assets incl unrecognised)	50%
Worldwide asset-to-liability ratio (total assets incl unrecognised)	50%