

The Treasury

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Taxation issues paper: review of the thin capitalisation rules

Proposal

1. We propose the release of an officials' issues paper containing options to tighten the thin capitalisation rules. These rules are supposed to ensure that New Zealand can impose a reasonable level of tax on foreign investors, but currently are not fully effective.

Executive summary

2. This Cabinet paper seeks approve to release an officials' issues paper (see attachment).

3. The issues paper proposes a tightening of tax rules applying to foreign investors, particularly groups of foreign investors who act together and fund their businesses with shareholder debt.

4. The proposed changes will mostly affect groups of foreign investors who act in a co-ordinated fashion and use high levels of shareholder debt instead of equity. This includes private equity investors.

5. The proposed changes will not affect most foreign direct investors. They are already complying with the rules in the way that is intended and have moderate levels of debt.

6. The proposed changes have been designed to have minimal effects on foreign investors who have genuinely external borrowing, as opposed to shareholder debt.

7. If approved, the issues paper would be released (by agreement between Ministers' offices) in January 2013 and would be the first step in a consultation process which could culminate in legislative change.

8. If the proposals in the issues paper were implemented there would be an increase in government revenue. The amount of revenue would depend on the final design of the policy but would be likely to exceed \$10 million per year.

Background

9. New Zealand taxes foreign investors on their New Zealand income.

10. Foreign-owned New Zealand companies pay the same headline rate of tax as domestically-owned New Zealand companies (28%). But they can reduce their effective tax rate to a reasonably low level by investing using shareholder debt, which is tax-deductible, instead of equity. Because we still want some tax, we have rules – the thin capitalisation rules – to limit the amount of tax-deductible shareholder debt to a reasonable level, typically 60% of a firm's assets.

11. The rules are not working as well as they could. It is currently possible for some foreign investors to get tax deductions for much more shareholder debt than is intended.

12. Officials have drafted an issues paper, which is attached. It explains the problems with the rules and proposes some options for resolving them. Subject to your approval, we plan to release the issues paper before Christmas. This would be the first step in consultation about possible law changes.

Comment

Proposed changes

13. The issues paper proposes making the thin capitalisation rules apply to more foreign investors.

14. The rules currently apply only if the New Zealand investment is controlled by a single non-resident. To give an example of a very common case, the rules apply to a wholly-owned New Zealand subsidiary of a foreign company. This is a case in which it would be very easy to substitute related party debt for equity.

15. However, it has become increasingly common for groups of non-resident investors, in co-ordination, to act in the same way as a single non-resident controller. The issues paper proposes extending the rules to investments made by a group of non-residents acting together.

16. The issues paper also proposes restricting an exception to the rules.

17. The thin capitalisation rules do not currently apply unless the New Zealand operations of a multinational are more highly geared than its worldwide operations. For instance, if a multinational company had taken on an unusually high level of external debt during a recession, it could justify putting a similarly high level of debt in New Zealand.

18. This exception from the rules does not work very well if the multinational has most of its operations in New Zealand and the debt is provided by ultimate investors in the worldwide group. The issues paper proposes that debt provided by ultimate investors will be disregarded when determining the gearing of the worldwide group.

19. The issues paper proposes a number of other technical changes to make the rules apply as intended.

Affected parties

20. The intention is that most multinational enterprises operating in New Zealand will not be affected by the proposed changes in any significant way. They are already complying with the thin capitalisation rules and have relatively low debt levels (less than 60% of total assets).

21. The proposed changes are likely to have their greatest effect on a small number of co-ordinated groups of investors who use high levels of debt to invest directly in New Zealand businesses.

22. In particular, private equity investors are likely to lose some of their tax deductions. They commonly use very high levels of debt, including shareholder debt, to invest and are not currently subject to the thin capitalisation rules.

23. Efforts have been made to prevent the proposed changes from affecting investors with high levels of *external* debt (as opposed to shareholder debt). These investors are less likely to be able to reduce the level of debt they use, and would not end up paying a higher effective New Zealand tax rate even if they did.

24. Private equity investors might react negatively to the proposed changes, but this is consistent with current tax policy which is to impose a moderate level of tax on all non-resident investors even though this might deter some investment. Past reviews have concluded this is in the national interest.

25. It is possible that other parties will be affected in ways we have not anticipated. One of the purposes of the issues paper is to identify such parties and to refine options for change to avoid overly broad application.

Consultation

26. Inland Revenue and Treasury have prepared the issues paper. The Ministry of Business, Employment and Innovation has been informed. There has been no consultation with the private sector about the content of the issues paper, because the purpose of the paper is to begin such consultation.

Financial implications

27. There are no financial implications of releasing the issues paper.

28. If, following consultation, decisions were made to proceed with proposals in the issues paper (further Cabinet approval would be sought) there would be an increase in Crown revenue. The amount of the increase would depend on the final form of any policy, but it is expected it would exceed \$10 million per year.

Human rights

29. The proposal in this paper is consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative implications

30. There are no legislative implications of releasing the issues paper.

31. If, following consultation, decisions were made to proceed with proposals in the issues paper primary legislation would be required.

Regulatory impact analysis

32. A regulatory impact statement is not required.

33. If, following consultation, decisions were made to proceed with proposals in the issues paper, a regulatory impact statement would be prepared.

Publicity

34. The issues paper will be publicly released by Ministers with an accompanying press statement.

Recommendations

35. We recommend that you:

1. Note that the thin capitalisation rules are tax rules which are designed to ensure New Zealand imposes a reasonable amount of tax on foreign investors (a policy which has been endorsed by previous reviews of New Zealand's tax system).
2. Note that the thin capitalisation rules are currently deficient in some respects, so that non-resident investors reduce tax in ways that are unintended.
3. Approve the release of an officials' issues paper (attached to this Cabinet paper) proposing options to improve the thin capitalisation rules.
4. Authorise the Minister of Revenue to approve editorial and other minor changes to the attached issues paper before release.
5. Note that if approved, the issues paper will be released (by agreement between Ministers' offices) in January 2013.
6. Note that the issues paper is likely to provoke a negative reaction from some parts of the private sector, particularly private equity investors who are highly geared and use shareholder (rather than genuinely external) debt.

Hon Bill English
Minister of Finance

____ / ____ / ____
Date

Hon Peter Dunne
Minister of Revenue

____ / ____ / ____
Date