NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

Submission of the New Zealand Council of Trade Unions Te Kauae Kaimahi

to the

Inland Revenue Department

on the

Review of the thin capitalisation rules

P O Box 6645
Wellington
February 2013

Contents

1. Introduction 2
2. Summary 3
3. Scope 4
4. "Acting together" 4
5. The 110 percent safe harbour 6
6. Other issues 8
7. Conclusion 8

1. Introduction

1.1. This submission is made on behalf of the 36 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With 340,000 members, the CTU is the one of the largest democratic organisations in New Zealand.

1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.

1.3. We welcome the work being done to reduce tax avoidance by overseas investors in New Zealand in order to move a little in the direction of restoring fairness to the New Zealand tax system and preventing the erosion of the tax base, and welcome this opportunity to make a submission on the particular issue of thin capitalisation as described in the officials' issues paper (the Paper).

1.4. Please note that paragraph and page numbers referred to below are references to the Paper unless otherwise stated.

2. Summary

2.1. The scope of this Paper is limited to only part of a complex tax-avoidance landscape. Within that limited scope the ideas seem generally sensible, but the proposals tend to err on the side of excessive caution, deference to taxpaying corporate interests, and (without intending to demean the ability of IRD staff) confidence in the ability and resources of IRD to investigate complex arrangements given the resources, skills and determination those corporate interests can and will devote to tax avoidance.

2.2. In particular,

2.2.1. the burden of proof as to whether overseas investors are "acting together" is placed in the IRD rather than on the investors, which immediately means limited effectiveness due to public-sector resourcing constraints and the opportunities for legal manoeuvring and obstruction; and

2.2.2. faced with a choice between simply prohibiting the 110 percent safe-harbour provision when less than 50 percent of the worldwide group's assets are outside New Zealand, or entering into difficult administrative discretionary decision-making subject to all the usual lobbying and avoidance behaviour, the Paper opts for the second on very unclear grounds.

2.3. This creates new opportunities for tax accountants and lawyers to design new methods of avoidance.

2.4. Regarding "acting together", we therefore support the inclusion of all relevant companies with 50 percent or more ownership by non-residents.

2.5. Regarding safe harbours, we support a rule that would prohibit the use of the 110 percent worldwide group test if less than 50 percent of the worldwide group's assets were outside New Zealand or the New Zealand group was not controlled by a single non-resident.

2.6. We also suggest that the 110 percent rule apply only in the case of “large multinational groups with considerable holdings outside New Zealand and ultimately public shareholdings” described as the “only suitable” target in paragraph 4.34.

2.7. Consideration should also be given to further lowering of the 60 percent threshold.

2.8. The issue of asset revaluation is addressed, and sensible suggestions are made to outlaw some of the more outrageous practices that are currently allowed under New Zealand’s generally accepted accounting principles (GAAP). This raises serious issues in the GAAP which need to be addressed in other fora.

3. Scope

3.1. Three key issues with non-resident tax liability are identified in paragraph 2.6: thin capitalisation, transfer pricing, and non-resident withholding tax. Only the first is the subject of this Paper. **We hope that there will be forthcoming sets of proposals on transfer pricing and withholding tax and ask for confirmation that these will occur.**

3.2. The banks are entirely excluded from the discussion, as they are subject to their own regulatory arrangements. The IRD-Treasury team that prepared this Paper does not seem to envisage any extension of its analysis to the banks, notwithstanding that several of the issues raised about related-party debt funding would seem to be at least as important vis-à-vis the banks as they are for other activities. **Is there to be a matching analysis of the rules for banks?**

4. “Acting together”

4.1. The Paper shows that there is a huge loophole in the existing rules that allows non-resident individual investors to act jointly and thereby avoid the existing thin-capitalisation rules, which apply only if the New Zealand company is controlled by a *single* non-resident (paragraph 4.8). The issue is clearly a real one. The need is for a formula that extends the rules to such a group of cooperating investors, and the choice is a stark one between a simple rule that *any* company with 50 percent or more overseas ownership is subject to the rules (paragraph 4.20), or a provision that the rules be extended only to

> "companies in which non-residents who are not necessarily associated persons according to the tax definition, but who act together, hold an interest of 50 percent or more." (paragraph 4.13).

4.2. The Paper identifies some behaviours that would amount to "acting together" (paragraph 4.16), but anticipates that "what it means to 'act together' would not be defined exhaustively in legislation" (paragraph 4.15), which seems to imply that an administrative decision would have to be made in each case to determine whether "acting together" was in fact taking place. This presents the same obvious difficulties as arise in competition law with tacit collusion amongst companies where statutory provisions banning the making of explicit deals to, for example, fix prices, fail to catch companies that simply use their public body language to coordinate behaviour.

4.3. Any weakly-defined legislative provision enabling IRD to determine whether or not a group of investors is "acting together", while leaving the precise definition of that behaviour unclear, is wide open to regulatory capture, litigation and evasion.

4.4. Administrative simplicity is therefore an imperative. It avoids the discretionary swamp of an "acting together" test. The reason advanced in paragraph 4.20 for adopting the more complex and less clearcut option does not seem compelling. It is that "to widen the rules to cover all companies in which non-residents hold an interest of 50 percent or more … could bring in shareholders that are very unlikely to be able to influence the level of debt held by the company". With publicly listed companies and their numerous anonymous small shareholders explicitly excluded, it is not explained why this objection provides any compelling reason against the simple and straightforward option.

4.5. **We therefore support the inclusion of all companies with 50 percent or more ownership by non-residents.**

5. The 110 percent safe harbour

5.1. There are two safe harbours in the thin capitalisation rules. As set out in the Appendix (p.16),

> No [interest] deductions are denied if
>
> - the New Zealand group's debt-to-asset ratio is 110 percent or less of the worldwide group's ratio; or
> - the New Zealand group's debt-to-asset ratio is 60 percent or less.

5.2. The 60 percent safe harbour is straightforward and is left untouched in the Paper. It basically says that thin capitalisation arises only if the ratio goes above 60 percent, which is sensible, though a lower threshold could be considered, especially given the observation in paragraph 4.36 that even 60 percent is "unusually high for normal multinational businesses".

5.3. As the Paper notes, the 110 percent safe harbour is problematic when the worldwide group comprises mainly the New Zealand activity, because it then opens the way to virtually unlimited gearing in excess of the 60 percent benchmark. The legislative intention was to benchmark the New Zealand group against a much larger worldwide multinational group, within which the New Zealand activity would be just a small part of the action, but the 110 percent safe harbour opens a loophole for allowing interest deductions on excessive leverage when the worldwide group is just the New Zealand group, or is nearly so.

5.4. The proposal (paragraph 4.25) is that "when determining the worldwide ratio in the inbound rules, debt will not be counted if it is linked to shareholders of group entities". This is an attempt to rule out roundabout company structures with SPVs in the Cayman Islands which exist simply to create a fictional "worldwide group" and thereby render the 110 percent safe harbour meaningless. As paragraphs 4.27 to 4.34 make clear, the proposal would require considerable investigative effort and interpretation of company accounts to deal with the problem that arises from providing the safe harbour to all companies when in fact it is "suitable only for large multinational groups with considerable holdings outside New Zealand and ultimately public shareholdings".

5.5. If the sort of operations for which the 110 percent safe harbour is "suitable" can be so simply identified, it is unclear why one would not simply limit the safe harbour to those entities, instead of leaving it open for all and then embarking on complex and difficult case-by-case administrative decision-making that must invite evasion behaviour and litigation.

5.6. As paragraph 4.35 acknowledges, it would be simple to "prohibit the use of the 110 percent worldwide group test if less than 50 percent of the worldwide group's assets were outside New Zealand or the New Zealand group was not controlled by a single non-resident". The reason for rejecting this simple option is that "it would have arbitrarily denied interest deductions in rare cases of genuinely high levels of external gearing".

5.7. It appears that the likely economic costs, from the New Zealand economy's point of view, of those rare cases have not been evaluated and compared with the administrative resources require to implement the preferred alternative. Intuitively the case for the simple rule seems strong.

5.8. It is odd that the Paper's "questions we would like you to consider" (p.11) do not include whether the simple rule might be preferable.

5.9. **We support a rule that would prohibit the use of the 110 percent worldwide group test if less than 50 percent of the worldwide group's assets were outside New Zealand or the New Zealand group was not controlled by a single non-resident.**

5.10. **We also suggest that the 110 percent rule apply only in the case of "large multinational groups with considerable holdings outside New Zealand and ultimately public shareholdings" described as the "only suitable" target in paragraph 4.34.**

5.11. **Consideration should also be given to further lowering of the 60 percent threshold.**

6. Other issues

6.1. The discussion of trusts and capitalised interest on pages 12 to 14 appear to make sensible proposals.

6.2. **The section on "asset uplift" on pages 15-16 deserves strong support.** The practice of using artificial sale and purchase of assets within a company as a device to take revaluations to book without applying any genuine market test of fair value is clearly a breach of ethical business practice and should be outlawed completely, as proposed in paragraphs 4.62 and 4.63.

6.3. **The issue of asset uplift when a New Zealand operation is sold to an unrelated overseas third party for a price in excess of book value raises serious issues in GAAP which need to be addressed in other fora. The argument for an exception in such cases, proposed in paragraph 4.64, looks weak and open to potential abuse, given the acknowledged difficulty in "writing a sensible rule".**

7. Conclusion

7.1. Tightening up the tax code to reduce opportunities for tax to be evaded or avoided by accounting manipulation is good idea, and the Paper usefully identifies several areas of such evasion or avoidance and suggests remedies. In two areas ("acting together" and the 110 percent safe harbour) the proposed remedies seem less simple, effective, and clear-cut than rejected alternatives which should be revisited and seriously considered. In two other areas (trusts and asset uplift) the Paper deserves support, though there is considerably more still to do on the asset revaluation issue.