NEW ZEALAND
BANKERS ASSOCIATION

Submission

to the

Inland Revenue Department

on

BEPS – Strengthening our interest limitation rules: A Government Discussion Document

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28 April 2017

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fifteen registered banks in New Zealand are members of NZBA:

   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - Bank of Tokyo-Mitsubishi, UFJ
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited.

Background

3. NZBA welcomes the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on "BEPS – Strengthening our interest limitation rules: A Government Discussion Document" (**Discussion Document**).

4. NZBA appreciates the opportunity to have discussed the Discussion Document with IRD Officials to date and welcomes the opportunity to discuss any of our feedback directly with IRD Officials. As outlined in our feedback, we recommend ongoing discussions with IRD Officials on this topic as the proposals develop. In this regard, please contact:

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Chair of NZBA Tax Working Group
GM, Tax – ANZ
04 436 6493 / 021 280 4717

General Comments

5. As a general comment, NZBA supports the ongoing work of the OECD and IRD to address valid concerns over base erosion and profit shifting (**BEPS**), including shifting taxable income out of New Zealand through aggressively priced related party debt. However, addressing valid concerns should be targeted at the minority that engage in aggressive tax practices and not be applied across the board to all related party debt, the majority of whom represent legitimate commercial behaviour, which will impose an unwarranted cost on the New Zealand economy. This is particularly pertinent for the New Zealand banking industry as the primary financial intermediary for New Zealand individuals and businesses. The New Zealand banking industry is subject to significant prudential regulation in respect of the manner and source of its funding in order to ensure stability of the New Zealand financial system. The regulation already imposed on the New Zealand banking industry means the concerns stated in paragraphs 3.3 to 3.14 of the Discussion Document do not arise in the case on the New Zealand banking industry.

6. This submission centres upon the interest limitation proposals in chapter 3 of the Discussion Document.

Submissions

7. NZBA outlines below key submission points in respect of the potential outcomes from the interest limitation proposals on bank funding and also bank regulatory capital.

   a. NZBA submits that New Zealand banking groups should be excluded from the interest limitation proposals.

      i. New Zealand banking groups obtain the majority of their funding from various non-related party sources. The Reserve Bank of New Zealand (**RBNZ**) requires diversity in the funding utilised by New Zealand registered banks to ensure liquidity of inwards and outwards funding flows (often referred to as the minimum core funding ratio).[1] The calculation of the core funding ratio provides a preference for deposit funding compared to wholesale funding (which includes related party funding in the core funding ratio calculation). As such, New Zealand registered banks are unable to obtain a significant portion of funding from related parties.

      ii. New Zealand registered banks are subject to the RBNZ's conditions of registration which require New Zealand registered banks to act independently and in their own best interests. It follows that aggressively priced related party funding would not be permissible. For regulatory, commercial and tax reasons, related party debt must bear arm's length terms and interest. Hence, in light of paragraph 3.11 of the Discussion Document, it is not correct that New Zealand banking groups are indifferent to or accept "unnecessary or uncommercial terms".

      iii. Further, the Australian owned New Zealand banks face limits on exposures their parent can have to New Zealand banks by the Australian Prudential regulator (APRA). APRA restricts the exposure of an Australian Deposit Taking Institution (**ADI**) in their New Zealand subsidiaries to 50% of the

[1] Refer RBNZ Document BS13 (Liquidity Policy)

amount of Level 1 Capital of the ADI[2]. Therefore, existing prudential regulation precludes the exact type of behaviour the IRD are seeking to address through the proposals. New Zealand banking groups are not the target of the interest limitation proposals such that their exclusion is justified.

iv. The proposals seek to apply an offshore parent's senior unsecured debt interest rate as an approximation for the worldwide group's cost of funding and any interest paid to offshore related parties at a rate above this (plus a margin) will be disallowed as a deduction. Economically, this axiomatically assumes that a majority of the New Zealand foreign owned subsidiary's debt is sourced from their offshore parent and that the New Zealand subsidiary would only seek, in a commercial sense, senior unsecured debt from the market. However, this is not the case in the New Zealand banking industry. As above, the New Zealand banking industry primarily sources funding from unrelated parties. Further, New Zealand banks are required to hold, at least, 10.5% regulatory capital over risk weighted exposures, of which 7.0% must comprise Common Equity Tier 1 Capital (ordinary shares and retained earnings; not debt). The balance of regulatory capital, over and above Common Equity Tier 1, takes the form of Additional Tier 1 (**AT1**) or Tier 2 (**T2**) capital. RBNZ (in applying the Basel III framework) requires AT1 and T2 to include specific features, including subordination, permanence (with a minimum 5 year term), flexibility of payment (e.g. AT1 must include terms whereby interest is payable at the option of the issuer and be non-cumulative) and loss absorbency measures. These features are mandatory and, as a consequence of these features, regulatory capital is priced well above senior unsecured debt.

v. While it is necessary that New Zealand banks have diversity of funding sources and can be restricted as to the level of funding available from their parent, it is logical for New Zealand banks to apply such restriction primarily to source regulatory capital from their offshore parent. This is because:

- the New Zealand market is not sufficiently liquid to fund all the New Zealand bank's regulatory capital needs (particularly given the idiosyncratic complexity and cost of issuing such capital);
- of the regulatory benefits of a parent raising such capital (i.e. a parent bank may not be able to recognise 100% value of regulatory capital externally issued by its New Zealand subsidiary bank);
- it reduces the complexities of multiple prudential regulatory rules applying to the same capital issuance (which is the case when the New Zealand bank issues regulatory capital externally);
- the commercial undesirability for a New Zealand bank to issue regulatory capital into its parents' home market; and
- generally, the offshore parent bank can raise regulatory capital more cheaply than the New Zealand bank (particularly in international markets).

[2] Refer APRA's Prudent Standard APS 222 (Associations with related Entities). The ADI parents of the 4 major New Zealand banks are subject to additional tighter related party exposures which require that, by 1 January 2021, no more than 5% of the Australian ADI's Level 1 Tier 1 Capital comprise non-equity exposures to its New Zealand operations, including New Zealand holding companies (excluding regulatory capital instruments).

vi. Consequently, a significant source of funding of New Zealand banks' regulatory capital is from their offshore parent. This is due to commercial and regulatory reasons and is not driven by tax considerations. As such, applying an offshore parent bank's senior unsecured rate to such funding is inappropriate as it does not reflect the predominant type of debt sourced from offshore parents in terms of both the legal and economic substance of such debt. As above, such debt is obtained from offshore parent banks for commercial and regulatory reasons.

vii. NZBA considers the above position is not altered if the New Zealand registered bank is owned by an offshore parent bank via a New Zealand holding company (which is not a registered bank). It is possible that a foreign parent provides regulatory capital to its New Zealand subsidiary bank by providing non-regulatory debt funding to the New Zealand holding company which, in turn, provides the regulatory capital funding to the New Zealand registered bank. While the debt funding to the New Zealand holding company cannot be regulatory capital, such debt does need to closely mirror the terms, and therefore pricing, of the regulatory capital issued to the New Zealand registered bank. This mirroring is important for commercial reasons to ensure the New Zealand holding company can "pass through" the risk of the regulatory capital instrument to the debt it has issued to ensure, amongst other things, the solvency of the New Zealand holding company. For example, the New Zealand holding company faces a risk of non-payment of interest on the regulatory capital funding to the New Zealand bank. If this risk is not passed on, it could become insolvent. Further, the use of a New Zealand holding company results in a similar position, economically and tax wise, as if the offshore parent bank provided regulatory capital direct into the New Zealand bank (and not through the New Zealand holding company).

viii. If New Zealand banking groups are not excluded from the proposals, foreign owned New Zealand banking groups would suffer adverse funding and inconsistent tax outcomes compared to other industries. Foreign owned New Zealand banking groups must hold regulatory capital and do not have the flexibility that many other industries have of restructuring related party debt. As such, foreign owned New Zealand banking groups will be required to pay interest, at commercial rates (as required under the RBNZ conditions of registration as well as for tax transfer pricing purposes), on bank regulatory capital to their parent but be denied a full interest deduction for doing so.

ix. The proposals, if they did apply to New Zealand banking groups, may drive a perverse economic position in that New Zealand banking groups may be forced to directly issue regulatory capital in international markets at a higher pre-tax cost (than if the regulatory capital was sourced from its parent) to obtain a lower post tax outcome (than if the regulatory capital was sourced from its parent). Such a position appears contrary to good tax policy.

x. NZBA considers that excluding New Zealand banking groups from the interest limitation proposals may not be contrary to OECD recommendations. The OECD public discussion document on Action 4[3]

[3] OECD, BEPS Action Item 4: Approaches to address BEPS involving interest in the banking and insurance sectors

highlighted the difficulty on applying interest limitation rules in the banking industry, in particular noting that *"…excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low …"*. In this regard we also refer to the submissions from the Australian Banker's Association (**ABA**) and the International Banking Federation (**IB Fed**) on the OECD's Action 4[4].

b. If our submission that New Zealand registered banks should be excluded from the interest limitation proposals is not accepted, NZBA submits that bank regulatory capital should be excluded from the proposals, for the same reasons outlined above. NZBA considers that the combination of the existing prudential regulation and the New Zealand transfer pricing rules provides sufficient comfort and power to the IRD to ensure arm's length pricing is applied. This is particularly the case in light of the proposed enhanced powers for the IRD in respect of transfer pricing as outlined in the *"BEPS – Transfer pricing and permanent establishment avoidance: Government Discussion Document"*.

c. If our submissions above are not accepted, NZBA submits that the interest limitation proposals should apply as a safe harbour only and not over ride application of the transfer pricing rules or prevent use of a true commercial arm's length arrangement. NZBA considers that such an approach would minimise the compliance burden for both taxpayers and the IRD by allowing taxpayers to fall within the interest limitation rule and, therefore, not be required to apply transfer pricing rules. It would also provide flexibility for taxpayers to apply the arm's length principle in respect of instruments where the interest limitation proposal would not reflect arm's length commercial terms and price (such as bank regulatory capital).

   Further, NZBA is concerned that as a domestic anti-avoidance measure, the interest limitation proposals would unilaterally apply outside New Zealand's Tax treaty network. As it is necessary for New Zealand banking groups to pay arm's length interest rates to related parties (refer 7a ii above), the interest limitation proposals would result in a unilateral tax impost (i.e. the double tax outcome referred to above) that could not be corrected via Tax Treaty competent authority procedures.

d. If none of the above submissions are accepted, NZBA submits that the interest limitation rules should not apply to existing related party debt instruments, or at least not to existing related-party bank regulatory capital issuances. Contrary to the statement in the Discussion Document that the proposed implementation timeframe of the proposals will provide sufficient time to companies to rearrange their affairs, New Zealand banks will not have this option. It is not possible to restructure bank regulatory capital with a different instrument predominantly due to the inability to call such instruments. Further, if the New Zealand banks were forced to call and re-issue such instruments, significant liquidity pressures would arise which may result in very highly priced capital being raised in international markets and place a significant strain on the security of the New Zealand banking system.

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[4] Refer to pages 36-48 (for the ABA submission) and pages 179-182 (IB Fed) of the "Comments received on Public Discussion Draft BEPS Action 4 – available at http://www.oecd.org/ctp/aggressive/public-comments-received-on-the-discussion-draft-on-approaches-to-address-beps-involving-interest-in-the-banking-and-insurance-sectors-under-action-4.htm

e. NZBA understands from discussions with Officials that the proposed "related-party" debt definition at paragraph 3.43 of the Discussion Document should not extend to capture debt raised by offshore branches of subsidiaries in the New Zealand banking group for the purposes of funding the New Zealand banking group. NZBA supports this approach as such funding is raised by the New Zealand banking group, for the New Zealand banking group.

f. NZBA recommends extensive consultation occurs on any further development of the interest limitation proposals, importantly before legislation is drafted, and that any draft legislation/exposure draft is made available to interested parties for comment prior to introduction to Parliament as a Bill. We would be very happy to set up working group meetings with appropriate representatives from members of the NZBA in this regard.