NEW ZEALAND
BANKERS ASSOCIATION

Submission

to the

Finance and Expenditure Select Committee

on the

Taxation (Neutralising Base Erosion and Profit Shifting) Bill

8 February 2018

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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 seventeen 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
   - China Construction Bank (New Zealand) Limited
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - Industrial and Commercial Bank of China (New Zealand) 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 submit on the Taxation (Neutralising Base Erosion and Profit Shifting) Bill (**the Bill**). NZBA's submission primarily focuses on the interest limitation proposals in the Bill as well as the hybrid and certain tax administration proposals.

4. NZBA would appreciate the opportunity to make an oral submission to the Finance and Expenditure Select Committee (**Committee**) on this Bill. Please contact Miles Erwin, Associate Director – Government Relations at NZBA on 021 569 715 regarding times for appearing before the Committee.

5. If the Committee or Officials have any questions about this submission, or would like to discuss any aspect of the submission further, please contact:

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General Comments

6. We outline below our general comments on the Bill.

    a. NZBA supports the work of the Government and the Inland Revenue (**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, any measures to address such concerns should be multi-lateral to ensure consistent and certain application of tax rules across tax jurisdictions. NZBA considers the interest limitation proposals are a unilateral approach to transfer pricing cross border related party debt that may result in double taxation. This is particularly the case with Australia, a significant source of capital for New Zealand's economy. In respect of Australian Authorised Deposit-taking Institutions (**ADIs**), Australia has adopted the OECD's arm's length principle for transfer pricing cross border debt. The interest limitation proposals take a different approach by prescribing what credit rating can be used by New Zealand borrowers and also specifically listing features of loans that must be disregarded or adjusted. This difference in approach may lead to the Australian tax rules imposing a different price to New Zealand's tax rules on the same cross border debt.

    b. NZBA also considers the interest limitation proposals inappropriately treat the financial services industry differently from other taxpayers by limiting the ability for this industry to apply certain of the exceptions within the proposals. NZBA considers this in inappropriate in light of the significant New Zealand and foreign prudential regulation already imposed on registered banks which places limits upon the level of parental funding into New Zealand registered banks. This most notably occurs where alternative credit ratings from those of the worldwide group are unable to be applied (not all members have the same credit rating as those of their parents) as well as not allowing certain features of debt to be respected when pricing cross border related party debt (with the exception of bank capital).

    c. Bank capital instruments are idiosyncratic to the banking sector which require mandatorily imposed features as prescribed by the Reserve Bank of New Zealand (**RBNZ**) and, in certain circumstances, overseas prudential regulators. Broadly, such mandatorily imposed features are designed to help mitigate the need for Governments to bail out banks in time of financial stress. The ability to issue bank capital as efficiently as possible is critical for the New Zealand banking sector to ensure stability of the New Zealand banking system. While NZBA considers some amendments are required to the interest limitation proposals to clarify how the proposals apply to bank capital, we appreciate the ability to have openly consulted with the IRD Officials to confirm that the ability to issue bank capital is not unduly impeded by the proposals.

    d. The proposals within the Bill are inherently complex and will take both taxpayers and the IRD significant time to determine their application in practice. The rules impose new obligations and methodologies for taxpayers to apply around which there is currently a lack of certainty – noting in particular certain inconsistencies between the Bill and the Commentary to the Bill. NZBA recommends that the effective date for the proposals (most of which are from income years beginning on or after 1 July 2018) should be delayed for 12 months. This would, for example, give time for detailed guidance on the Bill to be issued allowing for greater consistency and certainty on application of the Bill.

Submissions

7. NZBA outlines below key submission points on the Bill.

Interest Limitation

a. Section GC 17 should allow the same ability for alternate credit ratings to be used by the New Zealand borrower (being a insuring or lending person) as is available to taxpayers who fall under section GC 16 (entities that are not insuring or lending persons). Not all members of the NZBA have the same credit rating as their offshore parents. Restricting the ability for such banks to use, for example, their own credit rating would be unfair compared to other taxpayers who can use their own credit rating and does not reflect the market position prevailing for such banks (where they borrow from the market at rates reflecting a different credit rating than that of their parent).

b. In addition to our submission above, section GC 17 should be amended to reflect that it should be the highest credit rating for "long term" senior unsecured debt of a member of the borrower's worldwide group that is applied to the New Zealand borrower. As presently drafted, section GC 17 merely refers to the highest credit rating for senior unsecured debt. Applying the credit rating for long term senior unsecured debt would make section GC 17 consistent with the wording of section GC 16 and NZBA sees no reason for any difference to occur.

c. NZBA notes that even where a New Zealand borrower bank has the same credit rating as its parent, it does not issue debt to the market (i.e. to unrelated parties) at the same price as it parent can to the market for the same type of debt. While the transfer pricing rules, including all of the proposed amendments from the Bill, provide for such an outcome when transfer pricing cross border related party debt, the Commentary to the Bill implies otherwise. In particular, the Commentary to the Bill states (at page 7) that the interest limitation rules:

> *"… will generally result in the interest rate on the related-party debt being in line with that facing the foreign parent."*

The above wording appears inconsistent to the Bill. To mitigate this inconsistency and, consequent uncertainty, for both taxpayers and the IRD, NZBA recommends detailed guidance on the Bill is issued by the IRD which explains how the interest limitations rules are intended to be applied (which should reflect comparable prices for New Zealand banks which are unlikely to be the same prices for their parents).

d. NZBA understands that section GC 18(9)(a) is intended to allow certain features of bank capital to not be disregarded when transfer pricing such bank capital (and, through section GC 18(9)(b), back to back loans into bank capital). As currently drafted, section GC 18(9)a) applies where the features of the bank capital are imposed as a *"condition of registration under the Reserve Bank of New Zealand Act 1989"*. NZBA submits that section GC 18(9)(a) be amended to reflect that the features of bank capital are imposed under regulations set by the Reserve Bank of New Zealand and not as a condition of registration under the Reserve Bank of New Zealand Act 1989.

e. Broadly, section GC 18(9)(b)(i) allows certain features of cross border related party debt (referred to in the Bill as a funding arrangement) to be priced into that debt where it is entered into for the purpose of providing funds for another *"financial arrangement"* which meets the requirements of bank capital. Broadly, this section allows the features of cross border related party debt to be priced into that debt where it is used to fund bank capital. This is important for the banking industry to preserve flexibility in ways bank capital is issued, particularly in light of the RBNZ's current review of what should qualify as bank capital, which is likely to result in more bank capital being issued internally within wholly owned groups.

   However, bank capital can take wider forms than merely financial arrangements (effectively debt). For example, Additional Tier 1 and Tier 2 bank capital can currently take the form of preference shares. Further, the RBNZ's review of what should qualify as bank capital has, to date, expressed a clear option for preference shares to be available to qualify as Tier 1 capital. Consequently, preference share bank capital may become more prevalent once the RBNZ has completed its review. Limiting the interest limitation rules to apply to only one particular type of bank capital (i.e. debt), as section GC 18(9)(b) is currently worded, risks diminishing the options available to New Zealand banks for raising bank capital.

   NZBA submits that section GC 18(9)(b)(i) be amended to also provide for the scenario where the cross border related party debt is entered into for the purpose of providing funds in Additional Tier 1 or Tier 2 bank capital which includes an excepted financial arrangement (such as preference shares).

f. Further in respect of section 18(9)(b), this section allows features of a "funding arrangement" to be priced into that arrangement where those features "reflect" features of a "funded arrangement" which itself has features required to be bank capital. NZBA recommends the IRD provide clarification on what is required to satisfy the term "reflect" in section GC 18(9)(b). NZBA submits that a perfect matching would be too high a threshold as it would result in the funding arrangement being exactly the same as bank capital (i.e. the funded arrangement). Such a threshold would be too high because it requires a duplication of complex instruments that are imposed in order to meet the RBNZ requirements even though the funding arrangement would itself not qualify as bank capital (as it is unlikely to be issued by a registered bank). NZBA recommends the IRD provide guidance in this regard for which we would be happy to work with the IRD to ensure appropriate outcomes.

g. Where the term of a loan is greater than 5 years, the interest limitation rules will adjust the term of a loan to be 5 years, subject to certain exceptions (section GC 18). NZBA notes that some cross border related party debt can have terms greater than 5 years (e.g. to provide certainty over the tenor of funding to match long term investments), but have interest rates that are re-set more regularly than every 5 years. Such regular interest rate re-sets are to ensure market pricing regularly applies for the full term of the loan. How the proposed interest limitation rules would apply to such a scenario is uncertain. NZBA therefore submits that specific amendments are made to the Bill to cater for such scenarios so that the regular interest rate re-sets are given due regard when pricing cross border related party debt or that detailed guidance is provided which confirms such a position.

h. Broadly, section GC 18 is designed to disregard or adjust certain features of cross border related party debt, subject to exceptions listed in section GC 18(8). However, "insuring or lending persons" are specifically carved out from being able to apply the exceptions listed in section GC 18(8). While section GC 18(9) provides exceptions for issuances of bank capital, it is impossible for banks to apply the exceptions in GC 18(8) for non-bank capital instruments. NZBA sees no reason why banks should be treated differently from other corporate organisations for non-bank capital. NZBA considers New Zealand banks are a low risk of BEPS given the prudential regulation already imposed on New Zealand registered banks. Such regulations include core funding ratio obligations (to ensure liquidity of inwards and outwards funding flows)[1] set by the RBNZ and, for certain of our members, the Australian Prudential Regulations Authority impose lending restrictions on Australian Deposit-taking Institutions (**ADIs**) into their subsidiaries[2]. Certain New Zealand banks (like other corporate organisations) may also rely on their offshore parent for debt funding. NZBA submits that a specific exception to GC 18 should be available to banks (in addition to the exception available for bank capital). Such an exception will need to cater for the banking industry which is presently not the case for any of the exceptions contained within section GC 18(8).

i. NZBA recommends that implementation of the interest limitation proposals are delayed by 12 months to income years beginning on or after 1 July 2019. The Bill proposes that the interest limitation changes will apply for income years beginning on or after 1 July 2018. For some of our members, this will result in the implications of the Bill having to be implemented by 1 July 2018. Given the significant shift these proposals have on existing transfer pricing rules, the current uncertainty with how the rules will be applied in practice and the potential risk of double taxation, NZBA considers this is insufficient time for taxpayers to ensure compliance with the new proposals. An extension of 12 months should provide taxpayers and the IRD a more appropriate timeframe within which to implement the changes to ensure certainty is available to all parties.

Hybrids

j. The hybrid financial instrument rule contained in proposed section FH 3 will apply in a scenario where a payment is deductible in New Zealand as interest but is treated by Australian tax rules as non-share equity, and therefore has Australian franking credits attached (up to a maximum of 30%). The recipients of the payments may, however, be on a higher tax rate than 30% and hence still have further income tax payable on these receipts. The application of the formula in proposed section FH 3(5) to this franking scenario, which determines the amount of the deduction to be disallowed, is unclear.

The formula is intended to disallow the deduction unless it is taxed as income in the recipient's country. Example 3 of the Commentary to the Bill (refer page 67) suggests that a partial deduction is available where the recipient's country taxes part of the income. Australia will generally impose income tax on all of the

[1] Refer RBNZ Document BS13 (Liquidity Policy)

[2] Refer APRA's Prudent Standard APS 222 (Associations with related Entities) which limits exposure of ADIs in their New Zealand subsidiaries to 50% of the amount of Level 1 capital of the ADI. 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).

receipt, and then allow a franking credit, which will be up to 30% in the above scenario. However, after the franking credits are taken into account, further income tax will be payable by Australian recipients who may have a marginal tax rate of above 30% (e.g. at the Australian 45% marginal tax rate). It is unclear, in applying the definition of payee tax in formula in proposed section FH 3(5), whether the rate of tax imposed by Australia on that income is 45%, 15% (i.e. 45% less 30% franking credits), or some other figure. This figure will drive the level of any disallowance of interest deduction.

Given that significant tax will be paid in Australia by many recipients on this income, it would be reasonable that some part of the deduction should be preserved, as is suggested by Example 3. Further, where a payment is only partially franked (i.e. franked at a rate below 30%), there would be even more reason to allow a portion of the payment to be deductible. NZBA recommends this matter be clarified in the Bill.

k. The Bill proposes certain changes to the thin capitalisation rules to ensure that where deductions are permanently denied under the hybrid mismatch rules, they are not also treated as giving rise to assessable income for thin capitalisation purposes, as this would effectively be an additional denial of deduction. To support this outcome, the Bill treats the underlying debt in relation to which the interest arose as not being treated as debt for thin capitalisation purposes.

However these changes are only proposed in respect of the general thin capitalisation rules and not in relation to the banking thin capitalisation rules. As a result, banks would still face the possibility of having a double denial of deductions. NZBA submits that the banking thin capitalisation rules should also be amended to ensure that banks are treated consistently with other corporates to negate the risk of a double denial of a deduction. Specifically, section FE 21 should be amended to allow the underlying debt to be treated as equity for thin capitalisation purposes and section FE 7 should be amended to remove the disallowed interest deduction from the definition of interest expenditure.

Tax Administration Proposals

l. Proposed section HD 30 of the of the Bill seeks to treat a wholly owned New Zealand subsidiary of a wholly-owned large multinational group as agent for any other group entity in respect of its tax obligations, if that other group entity fails to meet its New Zealand tax obligations.

NZBA considers such a proposal to be an inappropriate lifting of the corporate veil and for which there is little evidence provided in the Commentary to the Bill, or elsewhere, that a significant problem with collecting unpaid New Zealand tax liabilities of large multinationals exists.

Such a proposal could, potentially, impose substantial obligations on a New Zealand entity resulting in a significant adverse financial impact for that entity. In a banking context, it could conceivably lead to unintended consequences such as a breach of regulatory requirements for the New Zealand entity. New Zealand banks face regulations and significant responsibilities to act independent. Proposed section HD 30, however, has the potential to make New Zealand entities a guarantor of overseas group entities. This outcome would place banks at risk of not satisfying the prudential regulations set upon it. For these reasons, NZBA submits that this proposal should not proceed.

m. If our submission above is not accepted, NZBA submits that the reference to “tax obligations” is too broad and should be limited purely to “unpaid taxes”. The Commentary to the Bill suggests that the purpose of the proposed change is to collect unpaid tax liabilities. Yet the Bill applies more broadly to “tax obligations”.

n. Proposed section 17(1CB) of the Tax Administration Act 1994 requires that a company resident or operating in New Zealand becomes responsible for providing to the IRD information requested by the IRD where that information is held anywhere globally by a member of the same large multinational group as the company resident of operating in New Zealand. NZBA considers this proposal is a significant overreach and should not proceed. Offshore jurisdictions often have privacy and secrecy rules which prevent disclosure of certain information (including, for example, information held about bank customers in the relevant jurisdiction). New Zealand, itself, has such privacy law requirements. The proposals in section 17(1CB) risks placing the large multinational group in the untenable position of either breaching such offshore jurisdiction privacy or secrecy laws or breaching proposed section 17(1CB). Given the IRD already has powers to gather information through the exchange of information process with foreign revenue authorities (which provide a conventional method for managing competing jurisdictions privacy and secrecy laws), NZBA considers there is no need for the extension of powers prescribed by proposed section 17 (1CB) to be implemented.

o. If our submission above is not accepted, NZBA submits that non-provision of the information requested by proposed section 17(1CB) should not result in a criminal penalty and is more appropriately addressed by way of a civil penalty. NZBA considers it is inappropriate to impose a criminal penalty in a scenario, as outlined above, where the information requested places the large multinational group in a position of having to breach one jurisdiction’s laws.