Debt and equity finance and interest allocation rules

Background paper for Session 4
of the
Victoria University of Wellington Tax Working Group

October 2009

Prepared by the Policy Advice Division of the Inland Revenue Department
and by the New Zealand Treasury

Summary

This paper addresses the question of whether New Zealand's inbound interest allocation (thin capitalisation) rules are set at the right level. It highlights that reducing the current 75% "safe harbour" to 60% could raise up to $177 million. This could also partly counteract any bias towards debt, rather than equity, investment.

Against this there is a question of whether tighter thin capitalisation rules would increase the cost of capital and so deter otherwise marginally viable investment.

The Group may wish to apply its usual tests to consider whether the revenue gain associated with tighter thin capitalisation rules can contribute overall to a well performing tax system and possibly reduce any bias towards foreign acquisition of New Zealand companies due to the ability to thinly capitalise.

New Zealand's taxation of inbound debt investment

Some recent reports have suggested that the way in which most countries tax company income – in particular, allowing deductions for interest but not dividends paid by the company – has created a bias in favour of investing through debt over equity. Some reports posit that this bias may have contributed to the over-leveraging that has contributed to the credit crunch.[1] However, the difference in tax treatment between debt and equity has been a longstanding feature of tax systems worldwide, so it seems unlikely that taxation alone could explain recent over-leveraging.

The New Zealand tax system is broadly neutral in terms of the incentives to finance a company by debt or equity from residents. Together, the deductible/assessable nature of interest and the imputation system provide that returns on equity and debt are ultimately taxed once, at the investor's tax rate.

In terms of finance from non-residents, the situation is not as clear. The New Zealand tax system interacts with the tax system in the investor's country of residence to affect the overall return to the investor. In some cases – for example, when the investment is made from or through a low-tax jurisdiction – there may be a bias in favour of investing by debt.

How much should we care about this? Putting aside questions about over-leveraging and financial stability, if a non-resident investor can arbitrage the New Zealand tax system with the tax system of another country to get a better after-tax return, that would reduce the cost of capital for debt investments made in New Zealand. This should increase overall investment by debt in New Zealand. On the other hand, if the investor is simply substituting debt investment for investment that would otherwise have been made by equity, New Zealand is forgoing tax revenue it would otherwise have earned.

[1] For example, International Monetary Fund, *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy*, June 12, 2009.

Many countries are aware of the revenue risk from allowing their companies to be over-leveraged and have "thin capitalisation" rules to address this risk.

Interest allocation rules in practice

Interest allocation rules fall into two broad categories:

- Inbound (thin cap) rules. These apply to foreign-controlled entities in New Zealand. They limit the scope for debt to be loaded against New Zealand operations to reduce tax paid here. There are special rules for foreign-controlled banks.

- Outbound (fat cap) rules. These will apply to New Zealand residents with income interests in controlled foreign companies (CFCs). They limit the scope for people to load debt against their domestic income while investing the capital to earn CFC income. (In future this will be mostly exempt.)

The discussion here focuses on the inbound (thin cap) rules. It assumes no change to either the new outbound rules or the special rules for banks. More generally, it assumes no change to the underlying structure of New Zealand's company tax system that would affect the relative attractiveness of investing by way of debt rather than equity.[2]

The general approach of the thin cap rules is to ensure that a multinational group does not over-allocate debt to New Zealand. The key rule is that some interest deductions may be disallowed if the debt percentage (essentially, the debt-equity ratio) of the New Zealand group exceeds 110 percent of the worldwide group's debt percentage. However, if the New Zealand debt percentage does not exceed 75 percent, then the worldwide comparison is not needed and all of the interest may be deducted. This 75 percent safe harbour helps to reduce compliance costs.

The question for consideration is whether the 75 percent safe harbour is too generous and is encouraging multinationals to over-allocate debt to New Zealand. A key judgement will be on how sensitive (elastic) foreign investment is to the New Zealand tax impost. If the foreign investment is inelastic, lowering this threshold will increase tax revenue without having much effect on the total foreign investment in New Zealand. This would make New Zealand better off. If foreign investment is highly elastic, New Zealand could become worse off by losing national income from discouraging foreign investment that might otherwise occur. But a concern about the potential elasticity of foreign investment is not incompatible with tighter thin capitalisation rules: it is perhaps, more correctly, an argument for a lower corporate tax rate across the board.

[2] Under the ACE system, interest allocation rules would be irrelevant as deductions would be allowed for both equity and debt finance.

The 75 percent safe harbour

The 75 percent safe harbour is arbitrary. It is based on judgement and compromise rather than any particular tax/economic theory. Commercial levels of debt vary between companies and sectors. Having a safe harbour with a reasonable amount of headroom recognises this: a tighter threshold increases compliance costs and may ultimately lead to denial of some interest deductions as the general test must then be applied. On the other hand, a high threshold increases the exposure of the domestic tax base, with associated fiscal cost. Any reasonable threshold will give rise to difficult cases at the margins.

Approaches in other countries vary, making direct comparisons tricky. Australia has a 75 percent safe harbour. The United States adopts a 60 percent safe harbour under its anti-stripping rules. Germany lowered its safe harbour from 75 percent to 60 percent in 2001 (although it still has a 75 percent safe harbour for holding companies).

The 110 percent threshold

The worldwide debt percentage of 110 percent caters for multinationals that are highly geared generally, in which case a high level of debt in New Zealand would be consistent with the overall capital structure of the business, suggesting that debt had not been loaded against New Zealand profits to reduce taxable profits here. The 10 percent uplift provides some additional flexibility but again is essentially arbitrary.

The use of a worldwide debt percentage makes some sense if the business carried on in New Zealand is similar to that carried on by the rest of the worldwide group. It has less validity for multinationals operating across a range of industries or if the business carried on in New Zealand is materially different from the wider business of the worldwide group. This could result in either an over-allocation or an under-allocation of interest deductions.

"Natural" levels of debt

The discussion document published in February 1995,[3] prior to the introduction of the thin capitalisation rules, stated that the average debt-equity ratio of the top 40 NZSX companies in November 1994 was about 1:1 (November 1994 figures).

The discussion document published in December 2006,[4] prior to the introduction of outbound rules, noted that commercial debt contracts tend to impose on New Zealand borrowers a maximum 60 percent debt-to-tangible asset ratio. (No data was provided on how average debt-equity ratios had changed since 1994.) The discussion document proposed lowering the safe harbour, although the idea was subsequently dropped in the face of significant opposition.

[3] *International Tax – A Discussion Document*, Policy Advice Division, Inland Revenue.
[4] http://www.taxpolicy.ird.govt.nz/publications/files/internationaldd.doc

It is unclear whether debt-equity ratios have changed markedly in recent years. Banks would likely demand lower ratios now, suggesting they may have fallen. On the other hand, distress borrowing may have increased debt ratios for some businesses.

Efficiency

Tightening thin cap rules on inbound investment could potentially increase both tax revenue and national income through the replacement of debt with equity. At the same time it could discourage investments which would otherwise be economic. There are trade-offs that need to be thought through.

To see these as simply as possible, initially consider a case where tighter thin cap rules could lead to an increase in tax revenue and national income with no discouragement to investment. Suppose that $1,000 could be invested into New Zealand and that this generates revenue of $100 per annum. The capital can be advanced as debt or equity by a foreign direct owner of the New Zealand firm which is exempt in its home country on dividends from its New Zealand subsidiary. Also suppose that the foreign owner is resident in a country which, like New Zealand, has a 30 percent company tax rate. Suppose that the owner requires a 10 percent pre-tax return or 7 percent post-tax return on its funds. For simplicity, we ignore any withholding taxes.

This investment would be a break-even or marginal investment whether the parent finances it with debt or equity. Cash flows in the two cases are outlined below.

Debt financed		Equity financed	
NZ Company Level			
Revenue	100	Revenue	100
Tax	0	Tax	30
Interest Payment	100	Dividend	70
Net benefit to NZ	0	Net benefit to NZ	30
Foreign company			
Interest income	100	Dividend income	70
Tax	30	Tax	0
After-tax cash flow	70	After-tax cash flow	70

If the investment were fully debt financed, New Zealand would receive no net benefit from the investment. If, on the other hand, the investment were fully equity financed, New Zealand would receive a net benefit of $30. Both New Zealand's tax revenue and its national income would be $30 higher in the case where the investment was equity financed.

Suppose that while the foreign company is indifferent between debt and equity, it would just so happen that the investment would be debt financed up to the safe harbour threshold. Reducing the safe harbour from 75 percent to 60 percent could boost New Zealand's tax revenues and its national income by $4.50 compared to the status quo (depending on the debt percentage of the worldwide group).

It is worth emphasising the attractiveness of this as a potential tax base from a NZ inc. perspective. Normally raising taxes imposes deadweight losses. The cost to New Zealanders of tax increases will be more than the amount of revenue raised. If raising a dollar of revenue costs the private sector $1.20, we say that the dollar of tax imposes a deadweight loss of 20 percent. In the example above, however, raising an extra $4.50 of revenue through reducing the thin cap safe harbour to 60 percent came at no cost to New Zealanders so this has a deadweight loss of -100 percent, that is, an efficiency gain. The change raises revenue and national income simultaneously.

In practice, of course, it will often be the case that a non-resident parent company has a preference for debt financing its New Zealand subsidiary. Consider a case where there is once more an exemption system abroad but this time assume that there is a 20 percent company tax rate in foreign parent's home jurisdiction. The parent company demands a 10 percent pre-tax rate of return or an 8 percent post-tax rate of return. In this case, a debt financed investment into New Zealand of $1,000 would once more be marginal if it was earning revenue of $100 per annum. But now an equity financed investment would need to earn revenue of $114.3 to be marginal. Marginal investments are outlined below.

Debt financed		Equity financed	
NZ Company Level			
Revenue	100	Revenue	114.3
Tax	0	Tax	34.3
Interest Payment	100	Dividend	80
Foreign company			
Interest income	100	Dividend income	80
Tax	20	Tax	0
After-tax cash flow	80	After-tax cash flow	80

Now consider the impact of cutting the thin cap safe harbour from 75 percent to 60 percent. With a 75 percent debt-to-asset ratio, the pre-tax revenue on a marginal investment would be approximately $103.60. If the debt-to-asset ratio fell to 60 percent, the marginal investment revenue required would rise to approximately $105.70. This means that investments debt financed up to the safe harbour and earning between 10.36 percent and 10.57 percent would cease to be economic and would no longer be undertaken. This is a cost to New Zealand of the proposed change. It drives up New Zealand's cost of capital.

75 percent safe harbour		60 percent safe harbour	
NZ Company Level			
Revenue	103.6	Revenue	105.7
Interest payment	75	Interest payment	60
Tax	8.6	Tax	13.7
Dividend	20	Dividend	32
Foreign company			
Interest income	75	Interest income	60
Dividend income	20	Dividend income	32
Tax	15	Tax	12
After-tax cash flow	80	After-tax cash flow	80

The "optimal" thin cap provision will involve trade-offs between concerns about discouraging investment and the benefits to New Zealand of replacing debt with equity. Lowering the safe-harbour will increase national income if the increased tax revenue from encouraging a switch from debt to equity finance[5] exceeds the national income forgone from discouraging some marginal investment from taking place. This, in turn, depends on how sensitive (elastic) foreign investment is to the New Zealand tax cost.

Equity and integrity

If the safe harbour for inbound investment is significantly higher than "natural" levels of external debt, then there is an opportunity for foreign-owned firms to reduce their effective rate of New Zealand tax. The 2001 McLeod Review noted that, with a natural debt level of 50 percent, non-resident direct investors could basically "help themselves" to an effective New Zealand tax rate of around 20 percent.[6]

Anecdotal evidence suggests that some foreign-owned firms do gear up to exploit this. Note that this issue does not arise only for multinationals with scope to shift profits to low-tax jurisdictions. The largest source of inbound direct investment into New Zealand is Australia, where the imputation system provides a significant incentive to profit-shift back across the Tasman.

Related to this, having a relatively generous safe harbour may provide an incentive for non-resident direct investors to acquire controlling interests in New Zealand companies. This is because a single foreign direct investor is able to gear up to exploit the threshold in a way that is impractical when a company is owned by portfolio investors.

[5] Or alternatively the direct revenue gain from some interest deductions being disallowed.
[6] With an external debt-equity ratio of 50:50, the non-resident can capitalise the company with 50 percent external debt, 25 percent related party debt and 25 percent equity. Ignoring yields, the weighted average effective tax rate on the non-resident's investment is (.5 x 10%) + (.5 x 30%) = 20%. The effective rate cited in the McLeod Review was actually 21.5%, based on a 33% company tax rate.

It is legitimate to ask whether, as a matter of policy, we should be concerned that foreign direct investors can benefit from an effective rate of New Zealand tax below the statutory rate of 30 percent. The 2001 McLeod Review recommended reducing the rate of tax on foreign direct investment as a means of encouraging inbound investment. This idea was not pursued for a number of reasons, including concern at the time of losing revenue by reducing tax on foreign direct investment that may be relatively insensitive to tax.[7]

Note also that there are circumstances in which taxing non-residents yields revenue at low (or even no) economic cost to New Zealand, namely when the non-resident is earning economic rents here or is able to claim a credit for New Zealand tax in their home jurisdiction. Some foreign jurisdictions, including the United States and Japan, provide foreign tax credits, and much direct investment into New Zealand is likely to be rent seeking.

Administration and compliance

The Taxation (International Tax, Life Insurance, and Remedial Matters) Act 2009 has extended the interest allocation rules to outbound investors, namely New Zealand residents with income interests in CFCs. This is because, in future, much income earned through CFCs will be exempt, creating an incentive for New Zealand-owned groups to concentrate debt in New Zealand and equity finance their offshore operations (to the extent that foreign taxes are lower than those in New Zealand).

The outbound rules will be integrated with the existing inbound thin cap rules. Specifically, both sets of rules share the 75 percent and 110 percent thresholds and the same statutory framework. Lowering the safe harbour for the inbound rules while keeping the existing 75 percent threshold for outbound investors would require some unpicking of these rules, with trade-offs in terms of legislative complexity and compliance costs for business.

A lower safe harbour would also increase compliance costs for foreign direct investors that were not already geared up to around the level of the existing safe harbour. For these firms, the reduced amount of head room would increase the need to monitor, and perhaps adjust, debt levels throughout the year.

Revenue implications

The annual fiscal gain from a reduction in the thin cap safe harbour to 60 percent is estimated at $177 million. The fiscal gain from reducing the safe harbour to 67 percent is estimated at $92 million. These estimates should be treated with caution. They are probably at the upper end of the likely fiscal saving.

[7] As discussed in the main paper, there is a prima facie case that at least some FDI into New Zealand is arising to capture location specific economic rents.

The estimates are based on there being 5,377 non-bank companies controlled or owned by non-residents (based on IR10 data). Of those, we only have information on asset values for 2,161 companies. To account for those companies without asset data, taxable income has been used as proxy for company assets, based on an interest rate of 5.5%. (It should be noted that there is not, in fact, a close correlation between taxable income and assets.)

Information on worldwide group debt-to-asset ratios is not available. The estimates therefore assume interest denial based solely on the safe harbour. The estimates take no account of the on-lending concession in the thin cap rules.