Regulatory Impact Statement

Thin-capitalisation amendment to address insurance delays relating to the Canterbury earthquakes

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question is whether amendments to the thin capitalisation rules are needed in order to address a tax issue created by the fact that earthquake damage must be recognised immediately for tax and accounting purposes, whilst the related insurance proceeds can only be recognised at a later date.

The question is limited to assets damaged by the Canterbury earthquakes since there are likely to be larger impairments and longer delays in securing insurance proceeds after the Canterbury earthquakes than in other cases.

This issue was one of a number of earthquake-related issues outlined by Inland Revenue in a presentation and accompanying paper to the 2011 New Zealand Institute of Chartered Accountants Conference. That paper was published online and asked any affected taxpayers to contact Inland Revenue.

So far, only one taxpayer appears to be seriously affected by this problem and we have consulted in detail with this taxpayer. However, given the damage caused by the Canterbury earthquakes, it is likely that other taxpayers are affected, but may not realise that they have a problem. Inland Revenue will consult on the draft legislation with affected parties and other key stakeholders.

There are no other significant gaps, constraints, caveats or uncertainties concerning the regulatory analysis undertaken.

The recommended approach does not impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

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PROBLEM DEFINITION AND STATUS QUO

1. The thin-capitalisation ("thin-cap") rules apply to multinational groups with operations in New Zealand. They help to protect the tax base by limiting the extent to which these groups can place debt in New Zealand in order to generate deductions to reduce their New Zealand income. The rules achieve this by denying further interest deductions in those cases where the New Zealand operations have an excessive ratio of debt to assets (compared to commercially-sensible levels and the multinational's worldwide operations).

2. Some multinational groups have had buildings and other major assets destroyed by the Canterbury earthquakes. There can be significant time delays between this damage being recognised, and the recognition of the related insurance proceeds. As a result of these delays, the thin-cap rules can create additional tax liabilities for multinational groups that would otherwise be regarded to have a reasonable level of debt relative to their New Zealand operations.

3. The status quo leads to inconsistent tax outcomes for a small number of taxpayers. For example, a company with the same debt-to-asset ratio before the earthquake, and after their insurance is received, could suffer an artificial spike in their ratio because the damage is recognised in advance of the insurance proceeds. Such a spike could lead to some interest deductions being denied by the thin-cap rules. Outcomes will also vary between similar taxpayers with different income years. Multinational groups that end their income year before their insurance proceeds are recognised, could be disadvantaged relative to groups that are able to recognise the damage and insurance in the same income year.

4. In the absence of an amendment, the Government would receive a small windfall revenue gain from the Canterbury earthquakes in respect of some multinational companies whose assets have been damaged. Due to lack of information it is not possible to quantify this amount, or to confirm exactly how many taxpayers are affected.

Example of problem

A company's only New Zealand asset is a building which is valued at $6m and is insured for the same amount. The company has $3m of debt. Prior to the earthquake, the company would have been able to claim a tax deduction for the interest payments on its debt. This is because their debt-to-asset ratio is 50%, which is comfortably under the 60% safe-harbour in the thin-cap rules (within which interest deductions are not denied).

As a result of damage caused by the February 2011 earthquake the building must be demolished.

The company's 2010-11 income year ends on 30 March 2011.

In June 2011, the company's insurance claim is confirmed by their insurer and they receive a $6m insurance pay-out.

From February 2011, the company is no longer able to recognise a $6m building asset. The company cannot recognise the $6m of insurance proceeds until June 2011. As a result, the company has no assets at the end of the 2010-11 income year and their debt-to-asset ratio goes above 60% for that year. The thin-cap rules prevent the company from deducting some of their interest payments, which results in an additional tax liability in the 2010-11 income year.

In the 2011-12 income year, the insurance proceeds can be recognised as an asset so that the debt-to-asset ratio returns to 50% and the company's interest payments become deductible again.

In this example, the company does not have an excessive amount of debt relative to the size of their New Zealand operations. This is reflected by the fact that there would have been no interest denial if the insurance proceeds could have been recognised in the same income year as the earthquake damage.

5. The question is whether amendments to the thin capitalisation rules are needed in order to address a tax issue created by the fact that earthquake damage must be recognised immediately for tax and accounting purposes, whilst the related insurance proceeds can only be recognised at a later date.

OBJECTIVES

6. The main objective is to ensure that tax outcomes produced by the thin-cap rules are broadly in line with outcomes arising before the Canterbury earthquakes and those that occur after the insurance proceeds have been recognised.

7. A second objective is that any amendment should not undermine the overall intention of the thin-cap rules, which is to deny interest deductions in cases where a multinational has placed an excessive level of debt in New Zealand relative to the size of their New Zealand operations.

8. Finally, any relief should be limited to assets damaged as a result of the Canterbury earthquakes. The severity and widespread impact of the Canterbury earthquakes means there are likely to be larger impairments and longer delays in securing insurance proceeds than in other cases. Taxpayers may be able to deal with smaller impairments or delays by measuring their assets using a daily or quarterly average (these measurement options are available under the existing thin-cap rules). The Canterbury earthquakes appear to be the first time this problem has arisen since the thin-cap rules were introduced in 1995.

9. A secondary consideration for limiting relief to the Canterbury earthquakes is that it allows for options that are simpler to apply due to the events occurring in the

past. For example, it allows taxpayers to use the value of insurance proceeds as opposed to attempting to estimate them in advance.

REGULATORY IMPACT ANALYSIS

10. Three main options were considered. Consistent with the above objective they are all focused on the Canterbury earthquakes.

Option 1: Temporary exemption from thin cap rules

11. The simplest legislative solution would be to provide a temporary exemption from the thin-cap rules for the affected companies. This would remove the compliance costs associated with performing a thin-cap calculation.

12. However, it would fail the objective of ensuring that multinational groups cannot allocate an excessive level of debt in New Zealand relative to the size of their New Zealand operations. For example a company which had an excessive debt-to-asset ratio prior to the earthquakes would have no interest denial during the exemption period.

13. We have therefore considered how the affected taxpayers should value their assets in the interim period between the asset being written down and the insurance proceeds being recognised for financial reporting purposes. Two main measurement options were considered.

Option 2: Allow pre-earthquake asset values to be used

14. We considered allowing taxpayers to continue to use the pre-earthquake value of any assets that had been damaged by the earthquakes. This approach would make sense if the objective was to keep taxpayers in the same position as if the earthquakes had not occurred. It would provide affected taxpayers with more time to adjust to any reduction in assets.

15. However, the problem is not that asset values have declined per se, rather it is that the insurance proceeds are recognised at a later date than the earthquake damage. Allowing historical asset values to be used would be poorly-targeted approach to this timing problem. This is because it would provide relief in respect of assets that no longer exist and that will not be replaced by insurance proceeds. In such cases there is a true reduction in assets and ignoring this reduction would be inconsistent with the fact that the thin-cap rules usually take into account reductions in asset values.

16. Another issue with using the pre-earthquake values is that it could potentially provide relief in cases where an asset had been sold or disposed of, or that had declined in value for reasons not directly related to earthquake damage, such as the general economic downturn. This risk could be reduced by limiting any relief to the amount of earthquake damage. Under this option there would be some additional compliance costs associated with calculating the amount of earthquake damage.

Option 3 (preferred option): Allow the insurance proceeds to be carried-back to the date that the damage occurred

17. A better-targeted approach would be to use the value of the insurance proceeds. Under this approach, the affected taxpayers would be able to go back and recognise these amounts as assets, for the purposes of the thin-cap rules, at the time that the earthquake damage was recognised.

18. One complication is that the future insurance proceeds could be greater than the amount of the earthquake damage. This could be seen to undermine the intention of the thin-cap rules as it could provide relief in cases where the taxpayer had an excessive debt-to-asset ratio prior to the earthquakes.

19. This problem could be mitigated by limiting the relief to the lesser of the insurance proceeds or the amount of earthquake damage. This would ensure that relief would only be available in cases where a taxpayer had a reasonable ratio of debt-to-assets prior to the earthquakes, and a reasonable ratio after their insurance proceeds had been received. This would help to protect the tax base and ensure consistency of tax outcomes.

20. Although this option is well-targeted at the timing problem, as with any tax change, there is a small risk of unintended outcomes. This risk will be reduced by having the amendment apply for a limited period and to those taxpayers affected by the timing problem. In addition we will require taxpayers to notify Inland Revenue if they use the amendment. If unintended outcomes arise remedial amendments could be considered to ensure appropriate results.

21. This option increases compliance costs for those taxpayers that are able to use it as it requires them to make adjustments for insurance proceeds. However, in most cases an adjustment should only be required for a single tax year. We intend to limit these compliance costs by making the provision optional.

CONSULTATION

22. This issue was one of a number of earthquake-related issues outlined by Inland Revenue in a presentation and accompanying paper to the 2011 New Zealand Institute of Chartered Accountants Conference. That paper was published online and asked any affected taxpayers to contact Inland Revenue.

23. So far, only one taxpayer appears to be seriously affected by this problem. That taxpayer has confirmed that they are unable to resolve the issue by taking a quarterly or daily measurement of assets (these measurement options are available under existing thin-cap rules). The preferred option would address the problem for this taxpayer.

24. Given the damage caused by the Canterbury earthquakes, it is likely that other taxpayers are affected, but may not realise that they have a problem. Inland Revenue

will consult on the draft legislation with the affected taxpayer and other key stakeholders. We will take this consultation into account when designing the final form of the amendment.

25. The Treasury has been consulted on this Regulatory Impact Statement and agrees with the preferred option.

CONCLUSIONS AND RECOMMENDATIONS

26. The preferred option is to allow affected taxpayers to count future insurance proceeds at the time that the damage occurred.

27. Compared to the other options, this approach is the most targeted at the timing problem. This helps to protect the tax base and should ensure that the resulting tax outcomes are consistent with those that arose prior to the earthquakes, and those that occur after the insurance proceeds are received.

28. The preferred option would make no taxpayers worse off relative to the existing rules.

IMPLEMENTATION

29. Amendments to the Income Tax Act would be needed to give effect to the proposed solution. Because the amendment affects past events and is taxpayer favourable it is proposed that it be included in the next available Tax Bill.

30. Any new rules would be administered by Inland Revenue through existing channels. The amendment would involve some implementation and on-going costs for communication, education and monitoring. These costs would be covered through Inland Revenue's baseline funding.

MONITORING, EVALUATION AND REVIEW

31. The preferred option is well-targeted at a technical timing problem. Therefore the potential impact should be relatively small, especially considering the amendment would be optional and apply only in limited circumstances and for a limited time period.

32. The preferred option would require taxpayers to notify Inland Revenue if they choose to use the amendment. This will allow Inland Revenue to monitor the resulting outcomes and ask for further information if required.

33. Inland Revenue officials will make themselves available for discussion with affected taxpayers should any further difficulties arise.