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Our ref KPMGsubThinCap

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Dear David

Thin Capitalisation settings for infrastructure

KPMG is pleased to make a submission on the issues paper. We provide our responses to the specific questions below. Please note that we have attempted to answer most, but not all, of the questions asked.

General comments

As a general comment, KPMG welcomes and supports targeted reform of the thin capitalisation rules.

We agree that New Zealand needs to be an attractive place for non-residents to invest, particularly as this relates to helping to fill New Zealand's infrastructure deficit. There seems to be a number of key propositions, which are largely uncontroversial.

- New Zealand is a price taker internationally when looking to attract foreign direct investment (FDI) and capital more generally.
- Non-resident investors and lenders will not accept a lower rate of return, net of New Zealand taxes, than they would receive in any other location (the "world rate of return").
- New Zealand tax, to the extent it results in the after-tax rate of return to non-resident investors being less than the world rate, will either result in foreign capital not coming to NZ or the gross return being increased to cover any tax impost. This will result in a higher cost of capital in New Zealand.
- Current tax settings, such as the approved issuer levy (AIL) and supplementary dividend / foreign investor tax credit (FITC) rules reflect this economic reality, by seeking to lower the tax rate on foreign investors in certain circumstances.
- An argument can be made for (more) fully taxing non-resident investment in New Zealand, if pre-tax rates of return are sufficiently high that the after-tax rate of return would still be higher than the world rate (i.e. there are economic rents). However, it is not clear when this will be the case and it also assumes all other things are equal, which arguably they are not due to factors such as New Zealand's geographic isolation and the relative size of our economy. In

other words, there may be significant non-tax reasons why capital might be attracted to other locations.

In our view, New Zealand's implementation of measures to combat Base Erosion and Profit Shifting (BEPS) has gone beyond other countries. In particular, we note the application of the restricted transfer pricing rule, which imposes additional interest restrictions, to thin capitalisation and the arm's length principle under transfer pricing.

This suggests to us that there needs to be a careful balancing act, between tax base protection on the one hand, and ensuring that New Zealand's tax settings for inbound investment, including application of interest limitation rules, are not an undue deterrent to FDI and other foreign capital investments.

It is not clear to us that this balance is correct or would be materially improved under the proposals. This is because the focus of the issues paper is limited to relaxing the thin capitalisation settings to third-party debt funding.

In our experience, it is not clear that third-party lenders, either in New Zealand or offshore, will be willing to majority fund a NZ project, infrastructure or otherwise. Therefore, to the extent third-party debt funding is not available as a funding mechanism, the issue is to what extent the NZ tax rules should impact the debt/equity mix of the non-resident investor, as any related party debt funding would continue to be subject to interest limitation under the thin capitalisation rules.

Specific comments

We favour adopting a more general rule that applies to third-party debt (option 2) over a rule targeted at infrastructure projects (option 1). There are several reasons for this, as discussed throughout our submission.

The Government needs to take a holistic view of tax settings and potential policy changes and how these collectively may impact on the Government's objectives. This includes needing to be clear about the problem definition and how the proposals are intended (and reasonably expected) to achieve those objectives. For example, we expect there may be a significant overlap between taxpayers who may benefit from the recently enacted "investment boost" deduction as well as a targeted exemption from the thin capitalisation rules, given the nature of the assets in scope of both rules.

We agree that focussing on FDI is important given the insufficiency of domestic capital required to fund investment in infrastructure. The same is true of a broader class of assets than might traditionally be viewed as "infrastructure" but which remain important to broader public interest. For example, the need to increase the quantity (and quality) of New Zealand's residential housing stock.

Such capital is highly mobile. As discussed, we expect the investors New Zealand is seeking to attract will have a significant focus on their projected return on investment. To the extent they can derive a higher return from similar investments (with similar risk profiles) in other jurisdictions,

there is little reason to believe money will flow into New Zealand projects in a meaningful way. The tax impost is an important part of the analysis for investors. There are of course many non-tax settings that also influence such decisions.

Australia has recently enacted a third-party debt test, where, by election, an Australian entity is allowed all debt deductions attributable to genuine third-party debt (that meets the relevant third-party debt conditions). Where the regime is elected, any related party debt would be non-deductible. It is not unreasonable to expect that foreign investors looking to invest in infrastructure in the region may compare the settings in New Zealand and Australia (and elsewhere), and differences in the thin capitalisation settings could impact on decision making.

Additionally, where projects are able to secure limited-recourse debt from third-party lenders and those lenders are willing to lend at more than 60% of the asset value, the level of debt may not be considered excessive in commercial terms (as is noted in the Issues Paper). This suggests such projects may be "overtaxed" by increasing the effective tax rate due to denial of deductions for interest expenditure which has genuinely been incurred.

This issue is not unique to "infrastructure". The quotation marks are deliberate and intended to convey that definitional issues will of course arise where the rule seeks to target a specific asset class. The definitional problem is the subject of several questions from Officials in the Issues Paper.

In our view, provided a third-party (e.g. bank) is willing to lend in excess of 60% of the asset value on limited recourse terms (including no parental guarantees, etc.) then there is not sufficient justification to limit the exemption to "infrastructure" only.

Our responses to the specific questions included in the Issues Paper should be viewed through the lens of this preference. We acknowledge, however, that Officials have already expressed a preference for the targeted approach (option 1), and this is likely the basis on which funds allocated in Budget 2025 have been made. Accordingly, our comments on the design aspects for the targeted rule (in Chapter 5) have been provided on the basis this option may be more likely to be adopted.

Further information

Please do not hesitate to contact us if you would like to discuss our submission in greater detail.

Yours sincerely

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Responses to Selected Queries from Issues Paper

Chapter 3 - Problem definition

Issues for infrastructure

Q3.2 If the thin capitalisation settings do not restrict the debt level to 60%, what types of non- PPP infrastructure projects do you think are likely to be able to be commercially debt funded by third parties on limited recourse terms at more than 60% of the project/asset value?

In our experience, any investments which generate long term stable cashflows can be highly leveraged. Examples of these assets may include:

- Renewable energy projects, particularly where there is a power purchase agreement / offtake agreement
- Datacentres
- Electricity distribution boards
- Electricity and/or communication towers
- Fibre optic cabling
- Social housing (particularly where supported by concession agreements with central / local Government)
- University accommodation (particularly where it is subject to a concession agreement)

Q3.3 What role do you think tax settings play in whether an infrastructure project or investment is made in New Zealand?

In our experience, tax settings can play a role in determining the financial viability of infrastructure projects and investments. The level of taxation directly affects whether a project meets the required rate of return thresholds. Where tax burdens are high, projects may fall short of these thresholds, making them unattractive to investors.

Conversely, favourable tax treatment — such as accelerated depreciation (e.g. the Investment Boost) or exemptions (e.g. the PPP thin capitalisation exemption) — can enhance post-tax returns and improve the likelihood of investment proceeding.

Q3.4 To what extent do you think changing the thin capitalisation settings will lead to more infrastructure investment in New Zealand?

Changing the thin capitalisation settings may lead to more infrastructure investment – it is difficult to determine the extent to which the proposed reforms will impact infrastructure investment as this depends on how widely applicable the reforms are.

Chapter 5 - Rule targeted at infrastructure

Scope of eligible infrastructure – new infrastructure vs existing infrastructure

Q5.1 Do you think any new rule should be targeted at new infrastructure projects (such as a new wind farm)? Should it apply more broadly to existing infrastructure investment (such as an existing electricity lines company)? Why?

It is suggested the targeted rule would only apply to assets that are constructed after a set date (e.g. 1 April 2026). In addition to new assets ("greenfield" projects), the scope may also include projects intended to upgrade existing assets ("brownfield" projects), presumably where such upgrades are completed after the effective date. This approach is broadly similar to the rule adopted for "investment boost", where the intention in both cases is to encourage creating new capital assets rather than benefitting owners of existing assets (who made their investment decisions based on existing settings).

Whilst we appreciate increasing new capital assets is the primary goal, restricting the rule in this manner may adversely impact the ability for investors to exit existing investments and potentially recycle capital into the next project.

Where an existing asset can support a high level of debt (e.g. due to strong cashflows of the asset), foreign purchasers may be at a relative disadvantage compared to domestic purchasers who do not face thin cap limitations. We consider it would be desirable to allow foreign investors to acquire existing (mature) assets where a high level of third-party gearing can be supported to increase the attractiveness of these assets on the global marketplace. The original investors, who may be seeking their next project, could then free up capital to invest in a new infrastructure project (which would also potentially benefit from the exemption).

We note this rationale broadly aligns with our views on the "length of concession" question below (Q5.13).

We suggest the exemption should apply to new investors who acquire existing in-scope assets after the relevant date. This would ensure that existing investors who already exceed the 60% thin cap threshold do not benefit from the rule change (for existing assets), but subsequent purchasers of those assets may do so.

Q5.2 Do you agree that the potential targeted rule should be based on the PPP rule? Is there another approach that would be better?

The PPP rule is a good starting point, however there are several design features we consider ought to differ in this context. These are covered in our responses to other questions.

Q5.3 The description of the key requirements and features in paragraphs 5.2 and 5.4 are targeted at new infrastructure projects. How could they be applied/adapted to existing infrastructure investment if you think that a new rule should cover such investment?

As per above, we consider the rule should apply for investors who acquire (or are deemed to acquire) qualifying assets after the effective date, rather than only to assets constructed after the

effective date. Our views on the other requirements and features in paragraphs 5.2 and 5.4 are covered in the subsequent questions.

Scope of eligible infrastructure – defining infrastructure

Q5.4 What should constitute eligible infrastructure projects or investment? Please include all types of projects that you think should be part of the list of eligible infrastructure projects.
This should focus on projects that can be funded at debt levels of 60% or higher from the outset of the project.

If option 2 (a wider third-party debt rule) is not adopted, then defining “infrastructure” will be of paramount importance.

We are in favour of a broader definition than ‘traditional’ infrastructure. The Issues Paper uses the example of large-scale residential developments which are included on the list of eligible infrastructure under Ireland’s targeted exemption.

The approach adopted in New Zealand should cover a wide-range of asset classes which can generally be viewed as being in the public interest.

The scope of eligible projects should extend to cover assets which are not inherently “infrastructure-like” in isolation, but in the context of the overall project are closely related and may serve and ancillary or auxiliary functions. For example, where a hotel is constructed adjacent to a new hospital / medical precinct (in order to provide capacity for relatives of patients etc.), the hotel should be within the scope of the infrastructure project assets. The extent to which the hotel can serve other patrons should not be part of the test (i.e. there should be no explicit requirement tying the intended use to the hospital’s visitors, for example). Similarly, if a large-scale residential development is within scope, the whole project (inclusive of ancillary/auxiliary buildings, etc.) should be included rather than only the dwellings/roads/waterworks/etc.

Q5.5 Do you agree that a relatively traditional definition of infrastructure could be developed, or supplemented, by a list of eligible infrastructure projects?

If this approach is taken, any such list should be flexible and able to adapt easily to changing needs, novel projects, new technology, etc. For example, “decentralised” infrastructure such as solar panel networks should, in our view, qualify. The rules need to keep pace with developments.

The list should not require an Act of Parliament to update, but rather should, at a minimum, be able to be updated by Order in Council. Ideally the Commissioner of Inland Revenue would have delegated authority to update the list, with a process available to apply for Inland Revenue approval of projects that are not clearly within scope. It will be important for potential investors to be able to get certainty (with relative speed) to assess opportunities, prior to committing to projects.

Q5.6 Do you think New Zealand should adopt any features from similar rules in Ireland and the UK?

As between the two, our preference is more broadly with the Ireland approach. The UK approach require taxpayers to elect to be a qualifying infrastructure company (QIC), as well as for the assets to meet a "public benefit test". Consistent with New Zealand's general self-assessment approach, we favour allowing taxpayers to determine whether they are "in-scope" of the exemption without a formal election to be a QIC (or equivalent).

In our view the prescriptive Ireland approach also has downsides. In particular, their list approach is quite prescriptive as to the size and scale of projects (e.g. by reference to megawatts of energy generation). As suggested at para 5.22, the New Zealand approach need not be so formally prescriptive, which we would agree with.

Our preference would be for a more general "in principle" approach (e.g. having a general public benefit test), with a non-exhaustive list of examples only, which is flexible and could be updated/expanded as required. As noted above, we recommend implementing a process by which Inland Revenue could assess and approve projects where they may be doubt as to eligibility (however such sign-off should not be required), and such process should not require the formality of obtaining a private binding ruling.

Q5.7 Do you think there is another approach that would be better?

See above.

Third-party debt

Q5.8 Do you agree that any new rule for infrastructure projects should only apply to third-party debt?

As a starting point, we agree any new rule should align with the associated persons rules such that any debt provided by non-associated parties should qualify.

In addition, we consider the rule should be aligned with the existing PPP exemption, i.e., investor debt should be permitted when it is not proportional to (and to the extent it exceeds) the investor's equity interests in the project vehicle.

Q5.9 If you think that related-party (investor) debt should be permitted, please outline your reasons why, and in what circumstances it should be allowed.

It is noted at para 5.31 that, in Officials' view, related-party debt may be considered riskier from a tax base protection perspective. It is acknowledged, however, that related-party funding can sometimes be used in new infrastructure projects to allow some return to investors in early stages where the project has tax losses and dividends/profits are unlikely to be repatriated.

This suggests to us that even proportional investor debt should arguably be eligible for the exemption, where it is (arguably) a substitute for equity and investors are seeking a return/repatriation without dividend payments. We observe that in this scenario, interest payments are likely to be subject to similar levels of NRWT as with unimputed dividends, subject

to varying rates of treaty relief under applicable DTAs (in some instances interest may be subject to higher NRWT rates than dividends), and there may be no present cash-tax benefit to the interest deductions for the NZ entity (where it is in tax losses). We question to what extent this may present a genuine risk to the tax base. Moreover we question to what extent the trade-off may be "worth it" for the sake of getting critical infrastructure assets built in New Zealand that might not otherwise be built (noting such assets are of permanent benefit to the NZ public and may otherwise need to be funded by the Government in any event).

To the extent investor debt is not proportional and exceeds the investor's equity interests, we consider such debt should be viewed as third-party debt as this is more clearly not in substitute for equity. The rationale for this is aligned with that of the PPP exemption.

Limited recourse debt

Q5.10 Do you think that the debt eligible for full interest deduction under the potential targeted rule should include portfolio debt where the projects/assets within the portfolio would have individually qualified for the rule? Do you have any concerns with this approach?

In our view this illustrates yet another reason to prefer a more general third-party debt test (where the particular eligibility of each asset is not necessary to apply the rule). Generally speaking, we consider a 'portfolio' based option to be preferable rather than fully restricting the recourse on an asset-by-asset (or project-by-project) basis.

The example used in para 5.33 of the Issues Paper is illustrative. This example concerns a business that has completed one wind farm and includes that wind farm in a security package when seeking debt finance for its next wind farm. We agree with Officials that in principle such debt financing should be covered by the exemption.

However, because Officials' proposal is that only assets constructed after the effective date (e.g. 1 April 2026) should qualify, mixing "pre-effective date" assets into a portfolio with new eligible assets could disqualify the debt entirely. We consider this approach could be unnecessarily restrictive in practice (and yet again speaks in favour of a wider third-party debt rule). The need for an investor to carefully design a security package around a portfolio of qualifying assets only strikes us as unnecessarily restrictive.

Q5.11 Do you consider that limited recourse should extend to cover equity that has been committed by investors to an infrastructure project (or investment)? Why?

We agree with the suggestion that equity that has been definitively committed (but not yet advanced) by investors should be within the scope of limited recourse rules. To the extent that equity has been definitively committed, it is effectively an asset of the project vehicle. There is a natural constraint here, insofar as the third-party lender's security arrangements will take such legal aspects into account. Provided the lender is able to obtain recourse to investor-committed funds, then we see no compelling reason to exclude the amount.

Q5.12 Is there anything else that limited recourse should be extended to cover?

The New Zealand assets that the lenders can have recourse to should include membership interests in the borrowing entity or to another member of its New Zealand group (provided the entity holds eligible New Zealand assets itself). This should include interests in subsidiary entities. For example, if the borrower entity holds 100% of the shares (or limited partnership interests) in the project company (or limited partnership) then the lenders should have recourse to those equity interests and/or future income streams derived from those entities.

This is broadly in line with the discussion in the context of option 2, at para 6.25 of the issues paper. We note that in para 6.25, it is suggested that if the other New Zealand group entity "owns a foreign asset", then membership interests in that entity should not be considered a New Zealand asset for purposes of the limited recourse rules. We consider an approach where the entity owning *any* out-of-scope asset fully disqualifies it from inclusion in the security package is overly harsh. We consider there should be at least *some* de minimis level of other assets in the entity (for example, at a minimum 5-10% of the entity's balance sheet by value could potentially be invested in "out of scope" assets before membership interest in that entity are disqualified; a higher threshold such as 25% would potentially be appropriate).

Length of concession

Q5.13 Do you consider that any new rule should or should not have a fixed end date? Why?

We do not consider there should be a fixed end date. As discussed above, we consider that subsequent investors should be entitled to the concession (provided relevant criteria is otherwise met) to avoid locking in existing investors and increase the attractiveness of in-scope assets to foreign investors. This can help free up capital of the initial investors, potentially to be recycled into new projects (with new owners taking over mature assets).

We expect there would still be a natural end to the application of the concession, given the third-party debt and limited recourse criteria. As assets age and depreciate, we expect the willingness of third-party lenders to agree to high gearing ratios will diminish. To the extent assets still produce significant income streams to secure high levels of debt, provided that debt remains economical in commercial terms then we do not consider a fixed end date should apply (noting such cut-offs will inherently be arbitrary).

Project level

Q5.14 Do you think any new rule should apply at the thin capitalisation group level or the project/entity level? Why?

As noted at para 5.38, the PPP rule allows investors to treat multiple projects separately, to the extent they have investments in several qualifying projects.

We agree that a similar approach should be adopted for private infrastructure. We also agree that where debt is borrowed for a portfolio of qualifying projects, there should be an ability to apply the

rules to the whole portfolio. These should be options available at the election of each affected taxpayer.

Optional election

Q5.15 Do you agree that taxpayers should have an optional election, when the taxpayer could first apply the targeted rule to the infrastructure project, to apply the rule to the project?

Yes, the election should be optional.

Consideration should be given to how the election would be made for tax-transparent project vehicle, e.g. a limited partnership. Given each limited partner is the taxpayer to whom the thin cap rules may apply (or not), it would seem preferable that each partner could choose to make an election rather than requiring the partnership to file a universal election. Otherwise consideration would also need to be given to the impact of partners entering and exiting the partnership, and whether subsequently entering partners would also be bound to apply it. Where an investor has partnership interests in multiple partnerships/different projects, their ability to apply across a portfolio would also depend on their ability to make elections independent of the partnerships themselves.

Q5.16 Should there be an opportunity to switch the election?

Yes, we support the opportunity for taxpayers to change elections from one year to another.

This may present issues for enforcing and tracking compliance, and accordingly we would suggest some manner of overt election should be required (rather than simply electing by taking positions in tax returns).

Chapter 6 - General rule

General considerations

Q6.1 Do you think a general rule that applies to third-party limited recourse debt is a viable solution to the problems identified in Chapter 3?

We consider this is a superior option to a rule targeted at infrastructure.

There are natural limits to who may benefit from the rule. In particular, only those assets which may support high levels of limited recourse third-party debt will qualify. This should broadly cover the types of infrastructure assets the rule is aiming to target, while, among other things, avoiding the definitional issues and arbitrary line drawing inherent in that exercise.

Q6.2 Do you consider that a general rule is too broad (relative to the problem)?

No. Provided the settings are appropriately designed, we consider the broader approach to be advantageous for the various reasons set out in this submission.

Q6.5 Apart from infrastructure, are there other sectors/investments/projects that can obtain third-party debt funding above 60% on limited recourse terms and without foreign investor guarantees? What are they? Is application of the rule appropriate in such scenarios? Why?

As noted in our response to Q.3.2 above, in our experience, any investments which generate long term stable cashflows can be highly leveraged. Examples of these assets may include:

- Renewable energy projects, particularly where there is a power purchase agreement / offtake agreement
- Datacentres
- Electricity distribution boards
- Electricity and/or communication towers
- Fibre optic cabling
- Social housing (particularly where supported by concession agreements with central / local Government)
- University accommodation (particularly where it is subject to a concession agreement)

We consider the application of a general rule in such scenarios is appropriate. In practice, such projects are generally able to secure limited-recourse debt from third-party lenders and those lenders are willing to lend at more than 60% of the asset value. As such, the level of debt may not be considered excessive in commercial terms (as is noted in the Issues Paper) and may be "overtaxed" under current tax settings.

Use of debt funding

Q6.10 Do you think the above criteria is effective in ensuring that the debt funding is only used for a New Zealand business operation? If not, what should be the appropriate criteria?

We are supportive of the intention of the above criteria to ensure interest deductions should be available to the extent debt funding is applied to NZ business operations. This is consistent with prevention of base erosion profit shifting by multinational groups.

However we consider further clarity is required as to how an entity is to demonstrate that the debt funding is applied to fund commercial activities in connection with NZ. We recommend that Inland Revenue provide clear and practical guidance for taxpayers on the documentation requirements associated with this rule.

Tax residence of borrower entity

Q6.11 Do you think this requirement is appropriate? If not, why?

We do not consider the NZ borrower should be required to be NZ tax resident to apply the exemption. The rule should be available for any taxpayer to whom the thin capitalisation rules apply, e.g. it should also be available for NZ branches of non-resident companies. This is consistent with the existing PPP rule.

We note that in practice it is common for non-resident investors to invest in New Zealand assets via limited partnerships (or in some cases general partnerships or unincorporated joint ventures). Such investments are subject to the thin cap rules.

Limiting the exemption to NZ tax residents would significantly reduce the scope of persons eligible for the exemption, and in particular for the very foreign investors these changes are seeking to court. The objective of attracting FDI may be materially impacted by this decision.

Optional election

Q6.14 Should entities be allowed to change their thin capitalisation test from one year to another? If not, why?

Yes, we are supportive of the ability for taxpayers to change their thin capitalisation test at their election from one year to another.

This may present issues for enforcing and tracking compliance, and accordingly we would suggest some manner of overt election should be required (rather than simply electing by taking positions in tax returns).