Shovels ready

Shovel-ready projects are today's recipe for New Zealand's construction-led recovery. Our infrastructure deficit is well known, as are the many challenges for investment. COVID-19 presents an opportunity to reset some of that deficit and those challenges.

The Government's declaration of it being a sufficiently rainy day may well be the trigger for this change. We have worked through an overview of some of the participants, the tax settings and some of the challenges related to infrastructure below. We hope tax is not forgotten in this reset opportunity.

Transaction types and participants

It is difficult to provide a single definition of an infrastructure transaction from a tax perspective. There is no special regime like there is for other sectors. Even if there was, it would quickly find a boundary, with infrastructure participants looking to find infra-like qualities in many assets.

The participants are also not capable of a consistent definition. The asset owner might be a taxpayer or an exempt entity such as a local authority (or maybe it's in a CCO, and so tax is back on the table again). The financing could be from a tax exempt entity (e.g. ACC), a taxable sovereign superannuation fund, an onshore or offshore bank – or the Government (who may or may not charge interest). There is also a large variety of equity participants.

There is one unifying principle across all infrastructure projects, and that is complexity in the detail; however, certainty is needed in order to rely on the model that was due diligenced. Where there is an element of uncertainty, it will be priced in and can destroy the risk versus reward or cost profile that infrastructure assets should provide. Tax should not be an element of uncertainty.

Getting tax certainty

From an administrative perspective, tax certainty is sought by obtaining a binding ruling under the Tax Administration Act 1994. A stoic requirement for the Inland Revenue ruling team is that they need to have an actual 'transaction' to rule on. This needs delicate management, as often the (up to) three-month process of obtaining a ruling is an unavailable luxury during a strict timetable – from when the transaction structure and detail are sufficiently final.

Inland Revenue is increasingly seeing the commercial need for certainty and finding ways to help. This might be through using the indicative view process to gauge expected outcomes, or recent examples where we have seen Inland Revenue invest in starting their process much earlier and working with the taxpayer as the transaction evolves.

Which entity to use?

Despite the different transaction types and participants, where new infra equity is required (or debt needs to be

navigated to the right balance sheet) a new vehicle is generally required. Multiple entities might be suggested to help give the financiers a clear line to security, or to help quarantine different risks. From a tax perspective, the choices are relatively limited. Either a Limited Partnership (LP) is used (which is flow through for tax purposes) or a company (which is respected as a taxpayer).

Both have their advantages and disadvantages. An LP means that the tax attributes flow through to the investor, so for a tax exempt equity participant, an LP will be preferred. Against this are the clunky attributes of an LP, including where an interest is transferred, or a new injection of capital is made. These transactions can create compliance complexity with partners triggering deemed disposals of the underlying assets (and the tax consequences that flow from that). Traditionally, a company has not been preferred for different reasons - one of which is an expectation of different possible shareholders over the life of the asset and the risk of either the introduction of new issues, such as thin capitalisation, or the loss of tax attributes such as the risk of losses being forfeited. The newly announced override for carrying forward losses for companies that carry on the 'same or similar business' could be a catalyst to revisit this preference.

Depreciable property or financial arrangements

A traditional investor in infrastructure will often suffer a tax profile of early stage losses as significant capital expenditure is incurred/depreciated and interest is incurred, with low early stage income. Therefore managing and preserving expected losses is critical to executing on the model.

There is limited ability to smooth the volatility of the above tax profile within the depreciation rules, aside from requesting a specific depreciation rate determination; however, that is still referenced to the specific asset in question, rather than the wider economic reality of the project. Depending on the project, middle stage volatility can also mean that income could be derived much earlier as amounts that economically represent 'principal and interest' are taxed in full as income, with the depreciation deductions equalising in later years.

The financial arrangement rules provide a much more flexible ability to obtain a determination from Inland Revenue to smooth or change the timing of interest deductions (e.g. to align to income). This 'determination' flexibility has also meant that there is a preference to try and tie the various parts of a broader transaction to be seen as a financial arrangement from an income recognition perspective – to respect a 'principal and interest' return (rather than a depreciable asset with all amounts received being recognised as income). This means that a sensible economic yield can be found for tax purposes (and no risk of stranded losses).

Another issue we see in some 'depreciable property' projects, is uncertainty in relation to being able to depreciate the asset. The depreciation rules do not have a back stop 'black hole' amortisation regime like other countries. While the new building depreciation rules should help, complexity is often found in land-related assets/fixtures. First, whether the taxpayer owns the land or building asset – a single asset might be buried or part of the taxpayer's land, their private neighbours land, and public land. For tax purposes, the rules generally require the taxpayer to own the asset or fall within the leasehold improvement test (i.e. they lease the land). Second, the schedule of land improvements includes many boundaries and is quickly out of date, not being principle based – e.g. a swale is not caught, but a reservoir is; a road is, but a driveway isn't.

Thin capitalisation

One of the first questions that a prospective non-resident investor will ask is what will the thin capitalisation regime mean for the project in relation to the amount of debt that can be introduced. The thin capitalisation rules are complex to work through but are a significant variable in the transaction economics.

At a policy level, it was agreed the Public Private Partnership (PPP) model should be able to have as much third part debt as the nature of the asset or transaction could support. This meant that very prescriptive rules were introduced for the 'PPP' model transaction to alleviate the thin capitalisation burden. As PPPs have fallen out of favour of the Government with other transaction models preferred, the concession has become redundant for new transactions. There is a long list of policy demands that Inland Revenue are working through, but hopefully a more principle based concession for infrastructure projects will provide more agility. In the meantime, taxpayers might need to refocus on finding the right definition of their transaction and it being a financial arrangement which may have a preferred outcome.

The restricted transfer pricing rules can also be a new shock to the infrastructure system. The restricted transfer pricing rules were one of the New Zealand Government's reaction to base erosion and profit shifting (BEPS). In effect, where there is cross-border related party debt, the starting point to calculate an interest deduction is based on the 'best credit rating in the world wide group' – where a bank or sovereign is involved – this will often be a very high grade. Where that bank/sovereign is providing the debt financing for the project, the rules can bite, as the outcome is often double taxation (as the jurisdiction of the lender will often demand a lower credit rating – closer to the borrower's standalone position).

Tax economics

The mix of debt and equity will drive the tax economic cost to reflect in the model, with the return on equity expecting to suffer tax at the New Zealand corporate tax rate of 28%.

For external imported debt (not associated with the borrower), New Zealand has the option of the Approved Issuer Levy (AIL) regime. Where AIL applies, then the non-resident withholding tax rate is replaced with a 2% levy. New Zealand law only includes a very narrow type of widely held debenture to be more concessionary, with an AIL rate of 0%. This type of regime could support a wider program of infrastructure bonds – if there was a coordinated platform (instead, the regime is not often used).

Where debt is from an associated party then the AIL regime is not available, and withholding tax should be expected (at the treaty rate, otherwise you should assume full profit taxation under domestic law).

Labour force

A significant economic expectation from the investment in infrastructure will be employment opportunities. Our experience from other intense infrastructure environments is that New Zealand often has a limited supply of the right technical expertise. In order to accelerate the broader employment opportunities, global expertise will often be imported.

New Zealand does not have infrastructure specific rules in relation to individuals relocating for a particular project. Under domestic law, there is an exemption for short term visitors (92 days). Under different treaties this might be extended to 183 days. For both, there are careful eligibility criteria to work through e.g. under the Australia New Zealand Double Tax Agreement (DTA), if it amounts to a secondment then the test is 90 days.

For the non-resident employer there can also be implications from its employees being on the ground. It is likely to give rise to New Zealand-sourced income under domestic law. The detail of any DTA will need to be studied carefully. Taking the Australia New Zealand DTA as an example, a building or construction site that lasts more than six months will generally create a permanent establishment. Similarly, a permanent establishment can arise from the operation of substantial equipment or having employees on the project or connected projects for 183 or more days.

The above tests are only an introduction to the complexity that non-resident participants need to manage. It is difficult to get upfront certainty as plans and timelines change, and day counts can be a tail that wags the tax dog for both the employee and the employer.

Summary

New Zealand is an importer of capital and skills. The current COVID-19 conversation is about identifying regulatory constraints and bulldozing these into a specific program for shovel-ready projects. We will wait to see whether there might also be a modern response to the right tax settings to help enable the cause. Such would be welcome to ensure that the New Zealand tax system does not act as an impediment to New Zealand's road to recovery. Otherwise, we expect that each significant project will need to navigate the many areas of tax structuring and compliance to help support an investable model. The risk is that other countries might compete more strategically, with targeted concessions and presenting an easier environment to actually be shovel-ready. As an early emerger from COVID-19, New Zealand has the opportunity to steal a march in the inevitable competition for skilled infrastructure partners; but only if our settings, including tax, are appropriate.

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