

NRWT: related party and branch lending

*An officials' issues paper on possible changes to the non-resident
withholding tax rules*

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NRWT: related party and branch lending – an officials’ issues paper on possible changes to the non-resident withholding tax rules.

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CHAPTER 1

Introduction

- 1.1 In common with many other countries, New Zealand taxes non-residents on their New Zealand-sourced income. New Zealand companies owned by non-residents pay income tax on their net profits in the same way that all New Zealand taxpayers do. Income from interest, dividends and royalties, known as non-resident passive income, earned in New Zealand directly by non-residents is subject to non-resident withholding tax (NRWT).
- 1.2 Applying income tax and NRWT in this way is intended to ensure an appropriate level of taxation on non-resident investors.
- 1.3 Without non-resident withholding tax, non-residents would be able to shift profits out of New Zealand, paying little or no tax. This would not be consistent with New Zealand's tax policy settings and would clearly be an unfair outcome for New Zealand.
- 1.4 However, since the NRWT rules were first formulated, financial transactions have evolved and become more sophisticated. Taxpayers have developed various mechanisms for deferring or circumventing NRWT.
- 1.5 The Government announced in November 2014 that it would undertake consultation aimed at updating and strengthening New Zealand's NRWT rules on related party debt. This issues paper identifies a number of issues with the application of the current NRWT rules and suggests a number of complementary changes to address these concerns.

Preventing arbitrage of NRWT rules with financial arrangement rules

- 1.6 Officials suggest that for certain related party debt structures that would have generated financial arrangement income of a non-resident if that non-resident was subject to the financial arrangement rules, an NRWT liability will be triggered and determined by reference to the financial arrangement rules rather than the existing rules.

Preventing associated persons accessing the AIL rules

Back-to-back loans and other forms of indirect funding

- 1.7 We suggest that NRWT (rather than approved issuer levy (AIL)) be paid when New Zealand-sourced interest is paid to a third party if it is part of an arrangement for that third-party lender to be provided funds by a non-resident associated person of the New Zealand borrower.

Persons acting together

- 1.8 We suggest that NRWT (rather than AIL) be paid when New Zealand-sourced interest is paid to a non-resident who is not associated with the borrower, but is part of a group of persons who are acting together and would be associated with the borrower if they were a single entity. This would be similar to the non-resident owning body changes recently introduced to the thin capitalisation rules.

Eligibility for AIL

- 1.9 In order to deal with issues that have arisen with the improper substitution of AIL for NRWT on interest to related persons, officials wish to explore limiting the ability to pay AIL to loans where there is a much lower risk of undisclosed association. The suggestion in this paper is to limit AIL to loans which are either to or from a financial intermediary or raised from a group of 10 or more non-associated persons.

Restricting the branch exemptions

Offshore branch exemption

- 1.10 Officials suggest limiting the existing offshore branch exemption so that interest paid by the offshore branch of a New Zealand resident is subject to NRWT or AIL to the extent that the interest is paid on money which is lent to a New Zealand resident.

Onshore branch exemption

- 1.11 We suggest limiting the existing onshore branch exemption from NRWT so that it applies only to interest that is received by a non-resident in connection with a business carried on through a fixed establishment in New Zealand. Where a non-resident operates a New Zealand branch, New Zealand-sourced interest income not connected with their New Zealand branch would be non-resident passive income (NRPI), subject to NRWT or AIL.

Banking related-party lending

- 1.12 We suggest allowing members of New Zealand banking groups to access the AIL rules on interest payments to their non-resident associates. This recognises that the owners of New Zealand banks are themselves margin lenders, whose funding in the main is sourced from unrelated lenders. The tax system would be improved by providing them with a transparent way to borrow from offshore with an appropriate level of tax, rather than leaving them to rely on the offshore and onshore branch exemptions, neither of which has a policy which supports its use in this context.

- 1.13 New Zealand aims to ensure that tax rules are not unduly complex or impose excessive compliance costs. The suggested NRWT changes in this issues paper are aimed primarily at companies using complex and sophisticated transactions to circumvent the NRWT rules. In order to help ensure fairness and practicality, taxpayers are invited to make a submission on any aspect of matters discussed in this paper.
- 1.14 Subject to consultation, amendments to the NRWT rules could be included in the next tax bill which is currently scheduled for introduction in late 2015.

How to make a submission

- 1.15 Officials invite submissions on the proposed reforms and points raised in this issues paper. Submissions should be addressed to:

NRWT: related party and branch lending
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Or email policy.webmaster@ird.govt.nz with “NRWT: related party and branch lending” in the subject line. Electronic submissions are encouraged. The closing date for submissions is 16 June 2015.

- 1.16 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.17 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Background

- 2.1 New Zealand has a policy of taxing non-residents on income that has a New Zealand source. When a non-resident has a branch or subsidiary in New Zealand, tax can be imposed on the income of that branch or subsidiary in the same way as it would be on New Zealanders. When the non-resident does not have a New Zealand presence, it is substantially more difficult for New Zealand to collect normal net income tax from the non-resident. Instead, a gross withholding tax is imposed on the payer of certain types of income, typically being a resident that New Zealand can enforce tax obligations upon (though the non-resident payee also has a liability to pay this tax if it is not withheld). This withholding tax is called NRWT. For interest payments, the rate of NRWT is usually 10%¹ of the interest paid.
- 2.2 New Zealand's policy on taxing non-residents and the use of withholding taxes for income when the non-resident does not have a presence in New Zealand is intended to ensure that an appropriate level of tax is paid and is broadly consistent with the OECD norm.

Policy framework

- 2.3 From an economic perspective there is little difference between debt and equity. However, interest payments on debt are deductible whereas dividends are not. Tax therefore can create a cross-border bias in favour of debt over equity.
- 2.4 In the case of cross-border related-party investment, NRWT reduces this bias by subjecting related-party interest payments to some amount of tax (usually 10%).
- 2.5 New Zealand is often characterised as a small, capital importing country. It is sometimes suggested it is not in the best interests of such countries to impose any tax (corporate tax on profits or NRWT on related-party interest payments) on non-resident direct investment. It is argued that the tax will reduce investment in New Zealand and therefore its capital stock. New Zealand would have fewer machines such as tractors, buildings and computers, making labour less productive and resulting in lower wages. Based on some strong assumptions, it is claimed that a tax on non-resident investment is borne entirely by New Zealanders.

¹ The domestic law rate of NRWT on interest is 15%; this is usually reduced to 10% under a double tax agreement.

- 2.6 Nevertheless, New Zealand has decided to tax non-resident direct investment. This decision has been frequently tested, most recently by the Savings and Investment Review conducted by the Treasury and Inland Revenue in 2012. That review concluded it is in New Zealand's best interests to tax direct investment by non-residents. If New Zealand reduced the tax on non-residents it would lose more from giving up tax revenue from non-residents than it would gain from increased investment by non-residents.
- 2.7 This conclusion applies to related-party debt, which can be seen as a substitute for equity. However, it is unlikely that it would be in New Zealand's best interest to impose NRWT on third-party debt. Third-party debt is unlikely to be a close substitute for equity. At the same time, imposing NRWT on third-party borrowing would be likely to increase the cost of debt for New Zealanders.
- 2.8 In 1991 the effect of NRWT on the cost of capital for New Zealand borrowers was recognised and AIL was introduced to lower that cost. Lending by non-residents to unassociated New Zealand residents is subject to AIL rather than NRWT.
- 2.9 While the imposition of AIL may still result in a small increase in the cost of borrowing from offshore, the economic distortion this creates is likely to be minimal. It also may reduce the general tax bias favouring non-resident debt investment over non-resident equity investment.
- 2.10 We continue to be relatively comfortable with the AIL, imposed at an effective rate of 1.44%², applying to interest on third-party borrowing.
- 2.11 Paragraphs 6.26 to 6.35 of this paper explore special rules for when New Zealand-registered banks borrow from related banks offshore. In the case of banks, it is suggested that AIL will be available even for related-party borrowing. The basis for this is that, as banks are margin lenders (i.e. they are largely debt financed) and conduits for ultimately unrelated non-resident lenders and domestic borrowers, there is less risk that the related-party debt will actually be in-substance equity. Rather, it is more likely to be on-lent debt sourced by the related non-resident bank. In that case, the arguments for a lower rate of tax are similar to those for third-party debt generally.

Link with the thin capitalisation rules

- 2.12 There is an interface between the thin capitalisation rules and NRWT because they both have an impact on the effective taxation of inbound investment income. Thin capitalisation rules restrict the amount of interest deductions that can be claimed by a New Zealand subsidiary of a non-resident owned group. NRWT imposes a tax on interest payments from a New Zealand subsidiary to its non-resident owner and associates.

² The rate of AIL is 2%; however, this is deductible for income tax. At a 28% company tax rate the effective rate is 1.44%.

- 2.13 New Zealand has a worldwide group debt test in the thin capitalisation rules which is designed, in part, to prevent debt being used as a substitute for equity. A New Zealand subsidiary of a multinational group is only able to deduct the interest on a related-party loan under the worldwide group debt test if the amount of that loan can be viewed as having been borrowed from a third party by a group member and on-lent to the subsidiary.
- 2.14 As things stand, however, the worldwide group test is rarely applied because firms stay within a “safe harbour” which allows them to claim deductions on all debt up to a threshold of 60% of assets without reference to their worldwide gearing position.
- 2.15 The OECD is currently examining rules similar to ours in the context of the BEPS Action Plan. It is possible that, as a result of this work, countries could substantially tighten their thin capitalisation rules well beyond our existing rules and the current international norm. At one end of the range, new rules could require New Zealand subsidiaries to use the worldwide group debt test as a matter of course to determine interest deductibility. In that event we would need to consider the overall picture in relation to the taxation of inbound direct investment and the extent to which it is necessary to continue to impose NRWT on interest.

Avoidance concerns

- 2.16 Interest, dividends and royalties sourced in New Zealand and paid to non-residents are known as NRPI and are subject to non-resident withholding tax. Through Inland Revenue compliance activity, officials have become aware that the NRWT rules have limited application in relation to interest, due to the wide variety of transactions available to prevent, or delay, the payment of interest with a New Zealand source. This is explored in Chapter 3.
- 2.17 This ability to circumvent the NRWT rules contrasts with New Zealand’s comprehensive financial arrangement rules that ensure financing income is taxable to New Zealand residents over the term of an arrangement on some form of economic accrual basis.
- 2.18 Officials believe that the combined effect of the transactions outlined below is that NRWT has largely been regarded as a voluntary tax for those with sufficient resources to avoid it. Transactions to avoid the imposition of NRWT are not economically efficient. They would not make good business sense in the absence of tax as a factor. Their tax consequences are often uncertain because of the general anti-avoidance provision. Removing the tax incentive to structure into these transactions will level the playing field for other businesses who are unwilling or unable to undertake such transactions. Such transactions also risk bringing the tax system into disrepute.

- 2.19 Due to the large number of potential ways to avoid NRWT it is not considered efficient or effective to introduce specific rules to deal with each specific type of transaction. This is because each transaction would require detailed provisions and in many cases the introduction of these provisions would create the incentive for these transactions to be subtly modified so they did not fall within the new provisions.
- 2.20 Instead this issues paper sets out suggestions intended to cover a wide range of transactions which currently avoid, or significantly defer, the imposition of NRWT.
- 2.21 The suggested changes in this issues paper are aimed at helping ensure a more appropriate amount of tax is paid by non-residents on their New Zealand-sourced income, thus better aligning taxation with real economic activity and reducing current asymmetries.
- 2.22 This paper does not deal with all tax issues arising from related-party debt. In particular, it does not deal with cross-border hybrid issues. The timetable for dealing with those issues is linked to the OECD's timetable. Consultation is likely to commence on them by early 2016.
- 2.23 This paper does not consider the potential application of section BG 1, the general anti-avoidance provision in the Income Tax Act 2007, to any of the examples discussed.

CHAPTER 3

Problems with definition and recognition of income under the NRWT rules

- 3.1 Liability to NRWT is triggered when New Zealand-sourced “interest” is “paid”. “Interest” is defined as a payment for “money lent”, and “pay” is defined to include, in relation to an amount and a person, distributing to, crediting for, or dealing with that amount on the person’s behalf. These definitions have not been changed since 1983. In the case of a foreign currency loan, the NRWT rules do not take into account the effect of foreign currency fluctuations on the NZ\$ value of the money lent.
- 3.2 The financial arrangement rules, which apply to determine liability to income tax, define financial arrangement income and expense under a completely separate set of rules, based much more on economic substance. These rules require financing income and expense to be determined with regard to “financial arrangements” (rather than “money lent”), and require it to be calculated using either financial reporting methods or economic accrual methods such as yield to maturity or straight line. Using these methods, foreign currency fluctuations are taken into account.
- 3.3 The predominantly cash basis and single instrument approach of the NRWT rules has a number of consequences, including that:
- what is treated by a New Zealand-resident borrower as a financial arrangement may not involve money lent, and therefore the return on the arrangement may not be subject to NRWT;
 - income is not correctly measured or allocated to income years for non-residents; and
 - significant mismatches can arise between New Zealand-resident borrowers and non-resident lenders.
- 3.4 These consequences can be particularly serious for the tax base where the borrower and lender are associated, and can structure their arrangements with less regard for commercial matters and more regard for tax benefits. For example:
- NRWT can be deferred for a non-resident lender for a substantial period, with no effect on the availability to a New Zealand-resident borrower of a deduction on some form of accrual basis under the financial arrangement rules; and
 - because NRWT is imposed on a cash basis, it is possible for a non-resident associated lender to earn interest as an economic matter but avoid NRWT altogether by selling a loan shortly before interest is due to be paid.³

³ Although section GB 26 may deal with aspects of this issue, it will not deal with all of the concerns.

Suggestions for addressing the problem

- 3.5 Officials have three suggestions for removing the potential for these kinds of mismatches and protecting the tax base more generally. They apply only to arrangements between associated persons. The first broadens the kind of arrangements that will give rise to NRPI, so that there is a better alignment between NRPI and financial arrangement expenditure. The second brings the rules for determining the amount of NRPI more into line with the financial arrangement rules. The third brings the time of recognition of NRPI more into line with the financial arrangement rules, for arrangements that involve a deferral of payments as compared with income measured under the financial arrangement rules.

Broadening arrangements giving rise to NRPI

- 3.6 NRPI only arises where there is “money lent” as defined in section YA 1. Although the “money lent” definition is broad, it may not apply in all situations where there is an amount of financing provided under a financial arrangement. This means that a New Zealand borrower may incur financial arrangement expenditure where the non-resident counterpart to the financial arrangement has no NRPI.
- 3.7 In order to prevent this outcome being used to avoid the imposition of NRWT, we propose to widen the definition of “money lent” to include any amount provided to a New Zealand resident by an associated non-resident under a financial arrangement which provides funding to the resident, and under which the resident incurs financial arrangement expenditure. This definition will only apply if the other limbs of the “money lent” definition do not.

Reducing quantum mismatches between NRPI and financial arrangement expenditure

- 3.8 In some cases, the financial arrangement rules may result in a different amount of income being calculated than the amount under the existing “interest” definition. Two examples are:
- a purchase of goods on credit where there is no explicit interest charge but the value of the goods under the financial arrangement rules is less than the amount payable by the purchaser, resulting in financial arrangement income to the vendor; and
 - an optional convertible note which pays coupon interest at a rate below the rate specified in Determination G22A.
- 3.9 In order to prevent this outcome being used to avoid the imposition of NRWT, we propose to widen the definition of “interest” to include a payment (whether of money or money’s worth) received by a non-resident from an associated New Zealand resident, to the extent that the payment gives rise to expenditure to the New Zealand resident under the financial arrangement rules.

- 3.10 For example, take a zero coupon optional convertible note (OCN) subject to Determination G22A, issued by a New Zealand resident to an associated non-resident. Under this suggestion, the issuer would be treated as paying interest to the OCN holder when the notes were converted into shares or were redeemed in cash. The amount of the interest would be the excess of the cash redemption amount over the deemed issue price of the OCNs, applying Determination G22A, and it would be subject to NRWT (but in advance of the time of payment if the suggestions in this document are adopted).⁴

Avoiding timing mismatches between NRPI and financial arrangement expenditure

- 3.11 It is suggested that for a financial arrangement between a resident and a non-resident associated person which:

- involves a deferral of cash payments (so that income accrues in an economic sense but is not paid); and
- provides funding to the resident,

NRWT would be imposed annually, on an amount equal to the financial arrangement income that would have arisen to the non-resident if it were subject to the financial arrangement rules. However, in the case of a foreign currency loan, the income subject to NRWT would be calculated in the foreign currency, so that the current non-taxation of foreign currency gains and losses under the NRWT regime would be maintained. Doing otherwise might be inconsistent with tax treaty obligations.

Further detail on timing mismatches: non-resident financial arrangement income

- 3.12 In the remainder of this chapter, we consider in more detail, the rules that would apply to impose NRWT on accruing income, rather than on payments.
- 3.13 NRWT is payable on (inter alia) payments of NRPI. We suggest retaining this linkage and expanding the definition of interest to include non-resident financial arrangement income (NRFAI), which would be a subset of NRPI.
- 3.14 NRFAI would arise in relation to financial arrangements involving deferral of income where a non-resident person provides funding to an associated New Zealand resident. The amount of NRFAI would have to be determined according to a YTM or expected value method. In many cases this could be the same method as that used by the borrower to calculate its expenditure.⁵
- 3.15 The definition of “pay” would also be expanded to include the accrual of amounts of income calculated as NRFAI.

⁴ We recognise that under the currently applicable Determination G22A, a “low interest” OCN between members of the same wholly owned group does not give rise to any additional discount income to the holder.

⁵ However, foreign currency fluctuations would not be treated as NRFAI – this is discussed later in this chapter.

Association

- 3.16 For the purpose of NRFAI, the existing association test for accessing the AIL regime in section RF 12(1)(a)(ii) would be applied. It would also encompass the back-to-back and “acting together” association suggestions outlined in Chapter 4. The former element is intended to ensure a taxpayer cannot insert a third-party into what is otherwise a related-party transaction to avoid it being subject to NRWT.

Coverage of non-resident financial arrangement income

- 3.17 NRFAI would apply only where the payments (as defined under the expanded NRWT rules for interest) under the arrangement are such that they lag behind the economic accrual of income. A typical example is a zero coupon note, issued at a discount.
- 3.18 There would typically be no need for NRFAI, for example, in relation to a loan where interest is paid semi-annually, and the principal advanced is due to be repaid five years after the date it was lent. However, if the interest is not in fact paid when due, then the income on the loan would become subject to NRFAI.
- 3.19 In order to differentiate between these two situations, we suggest that NRFAI would not arise in relation to an arrangement if, in all years up to and including the year in question⁶, the interest subject to NRWT is at least 90% of the income that would be calculated either under the YTM or effective interest method using the currency of the arrangement. Allowance would be made for arrangements entered into during the year, to recognise that interest is usually paid in arrears.

Non-resident financial arrangement income and NRWT

- 3.20 NRFAI on an arrangement that a New Zealand taxpayer⁷ is party to during an income year will trigger an NRWT liability for both the payer (as agent) and the payee at the same rates that apply under the current NRWT rules. This liability would arise in the NRWT return period that includes the New Zealand taxpayer’s balance date.

⁶ Separate transitional rules would apply to existing arrangements. These rules are covered in paragraphs 3.37 to 3.42.

⁷ In this context a New Zealand taxpayer includes a New Zealand resident as well as a non-resident engaged in business in New Zealand through a fixed establishment in New Zealand.

Example 1

NZ Sub Ltd has a March balance date and is wholly owned by Aus Parent Ltd. On 1 April 2018 NZ Sub Ltd issues a five year zero-coupon bond to Aus Parent Ltd. This bond has an issue price of \$100 and a maturity value of \$150 on 31 March 2023.

In the year to 31 March 2019, no interest would arise under the traditional interest definition. Accordingly, the difference between NRPI from interest payments and NRPI from NRFAI using YTM is more than 10%. As NZ Sub Ltd and Aus Parent Ltd are associated, the bond gives rise to NRFAI. NZ Sub Ltd's March NRWT returns include the following amounts:

NRWT return	NRFAI	NRWT
March 2019	\$8.45	\$0.85
March 2020	\$9.16	\$0.92
March 2021	\$9.93	\$0.99
March 2022	\$10.77	\$1.08
March 2023	\$11.68	\$1.17

Preventing double New Zealand taxation on interest payments

- 3.21 To prevent a single amount of interest income being subject to NRWT twice – first as NRFAI and again when an interest payment under the current law is made – it will be necessary to have a carve-out for certain payments that are currently subject to NRWT.
- 3.22 The general rule will be that a taxpayer making a payment under an arrangement that generates NRFAI will not be required to withhold NRWT from the payment.

Example 2

NZ Sub Ltd has a March balance date and is wholly owned by Aus Parent Ltd. On 1 April 2018 NZ Sub Ltd issues a five year 5% annual coupon bond to Aus Parent Ltd. This bond has an issue price of \$80 and a face value of \$100 on 31 March 2023.

In the year to 31 March 2019, the amount of interest under the traditional interest definition is \$5, whereas the amount of financial arrangement income applying YTM is \$8.26. As the difference between NRPI from interest payments and NRPI from NRFAI using YTM is more than 10%, and NZ Sub Ltd and Aus Parent Ltd are associated, the bond gives rise to NRFAI. NZ Sub Ltd is not required to withhold NRWT on the cash interest payments to Aus Parent Ltd.

NZ Sub Ltd's March NRWT returns include the following calculations:

NRWT return	Cash interest	NRWT on cash interest	NRFAI	NRWT on NRFAI
March 2019	\$5	\$0	\$8.26	\$0.83
March 2020	\$5	\$0	\$8.59	\$0.86
March 2021	\$5	\$0	\$8.96	\$0.90
March 2022	\$5	\$0	\$9.37	\$0.94
March 2023	\$5 + \$20 redemption	\$0	\$9.82	\$0.98

Effect on obligations to the lender

- 3.23 When a person withholds tax from a payment it is treated as received by the payee under section RA 9. This is necessary so the payer can withhold the amount of tax while still fulfilling their payment obligation under the arrangement. Where a borrower under an arrangement that generates NRFAI pays NRWT on that NRFAI, the borrower will need to determine how to make allowance for that payment in terms of its obligations to the lender. In many cases, the borrower might take account of the payment of NRWT on NRFAI by reducing its next interest payment to the lender. Since the parties will by definition be related, this should be able to be dealt with between them.

Example 3

For the bond referred to in example 2, NZ Sub Ltd has the following obligations under the current NRWT rules:

Month	Cash outlay by NZ Sub Ltd	NRWT on interest	Cash interest to Aus Parent Ltd
March 2019	\$5	\$0.50	\$4.50
March 2020	\$5	\$0.50	\$4.50
March 2021	\$5	\$0.50	\$4.50
March 2022	\$5	\$0.50	\$4.50
March 2023	\$5 + \$20 redemption	\$0.50 + \$2 = \$2.50	\$4.50 coupon + \$18 redemption
Total	\$45	\$4.50	\$40.50

As this bond is now within the NRFAI rules, Aus Parent Ltd and NZ Sub Ltd agree that the total cash interest payments by NZ Sub Ltd should remain the same, and reduce the cash payment to Aus Parent Ltd accordingly:

Month	Cash outlay by NZ Sub Ltd	NRWT on NRFAI	Cash interest to Aus Parent Ltd
March 2019	\$5	\$0.83	\$4.17
March 2020	\$5	\$0.86	\$4.14
March 2021	\$5	\$0.90	\$4.10
March 2022	\$5	\$0.94	\$4.06
March 2023	\$5 + \$20 redemption	\$0.98	\$24.02
Total	\$45	\$4.50	\$40.50

Alternatively Aus Parent Ltd and NZ Sub Ltd could agree that the cash interest payments received by Aus Parent Ltd stay the same. This would mean a higher cash cost to NZ Sub Ltd during the term of the bond. In this case the amount paid on redemption would reflect the higher cash cost over the term:

Month	Cash outlay by NZ Sub Ltd	NRWT on NRFAI	Cash interest to Aus Parent Ltd
March 2019	\$5.33	\$0.83	\$4.50
March 2020	\$5.36	\$0.86	\$4.50
March 2021	\$5.40	\$0.90	\$4.50
March 2022	\$5.44	\$0.94	\$4.50
March 2023	\$23.48	\$0.98	\$4.50 coupon + \$18 redemption
Total	\$45	\$4.50	\$40.50

Foreign currency loans and NRFAI

- 3.24 As with the current rules, the calculation of NRFAI on foreign currency loans would not take into account changes in the NZ\$ value of the amount borrowed. It is proposed that where a loan giving rise to NRFAI is denominated in foreign currency, the NRWT obligation be determined by:
- first, calculating foreign currency income applying a YTM or effective interest method;
 - second, using the exchange rate on the borrower's balance date to determine the amount of NZ\$ NRPI; and
 - third, applying the NRWT rate to the NZ\$ amount to determine the amount of NRWT owed.
- 3.25 Although this method gives the same total amount of foreign currency NRPI as the existing rule, the amount of NZ\$ NRPI and hence NRWT may be different because of the different conversion date (since under the current rules, conversion occurs when the foreign currency interest is paid).
- 3.26 One option would be for this difference to be left unaddressed. The other would be for a wash-up calculation to be undertaken. If the NZ\$ value of the amount of interest paid exceeds the NRFAI, the taxpayer would owe additional NRWT, and in the reverse situation, the NRWT previously paid could be adjusted downwards.
- 3.27 Given that the real economic cost of NRWT under the suggested new rules will be quite different from the cost under the existing rules (because of the different timing of the tax obligation), we do not consider it is necessary to introduce a special rule, with its own complexities, for the purpose of equalising the nominal amounts.
- 3.28 Officials invite submissions on this point.

Example 4

NZ Sub Ltd has a March balance date and is wholly owned by Aus Parent Ltd. On 1 April 2018 NZ Sub Ltd issues a five-year zero coupon bond to Aus Parent Ltd. This bond has an issue price of AU\$100 and a face value of AU\$150 on 31 March 2023.

As the difference between NRPI from interest payments and NRPI from NRFAI using YTM is more than 10%, and NZ Sub Ltd and Aus Parent Ltd are associated, the bond gives rise to NRFAI.

Assume the exchange rate at each balance date is:

Balance date	NZD/AUD exchange rate
March 2018	0.9123
March 2019	0.9567
March 2020	0.8935
March 2021	0.9123
March 2022	0.9236
March 2023	0.8576

In NZ Sub Ltd's March NRWT returns it has to return the following amounts:

NRWT return	AU\$ NRFAI	NZ\$ equivalent NRFAI	NRWT on NZ\$ NRFAI
March 2019	\$8.45	\$8.83	\$0.88
March 2020	\$9.16	\$10.25	\$1.03
March 2021	\$9.93	\$10.88	\$1.09
March 2022	\$10.77	\$11.66	\$1.17
March 2023	\$11.68	\$13.62	\$1.36
Total	\$50.00	\$55.25	\$5.52

This compares with the current law where NRWT is imposed on actual payments which are:

NRWT return	AU\$ interest	NZ\$ equivalent interest	NRWT on NZ\$ interest
March 2023	\$50	\$58.30	\$5.83

Without a wash-up the \$0.31 difference will not be payable.

Non-deductible interest

- 3.29 Under the existing NRWT rules there is no exemption from withholding NRWT just because an amount of interest is not deductible to the New Zealand-resident borrower (for example if the New Zealand borrower is a tax-exempt charity). We suggest that this principle is maintained for arrangements that generate NRFAI.

- 3.30 A New Zealand borrower who exceeds the thin capitalisation thresholds will derive an amount of income under the formula in section FE 6(2). In substance, this amount is equal to the amount of interest the thin capitalisation rules disallow. Under the current NRWT rules, a New Zealand borrower deriving an amount of income under the thin capitalisation rules is still required to withhold NRWT on the interest payment. We suggest that this principle is maintained for arrangements that generate NRFAI.

Australian provision

- 3.31 Like New Zealand, Australia has both a withholding tax system based on payments and a domestically applicable regime for taxing some financial instruments on an accrual basis (referred to as “taxation of financial arrangements” or *TOFA*). Australia also has a provision (section 26-25 of the ITAA 1997) which denies an Australian a deduction for interest paid to a non-Australian if withholding tax is not paid on that interest. This rule has been in place for many years.
- 3.32 The Australian provision can be viewed as aimed at achieving something similar in broad policy terms as the proposal in this chapter of the issues paper. But rather than accelerating NRWT to (broadly) match the deduction under the financial arrangement rules (as we suggest), the Australian rule is deferring the deduction to match the timing of the NRWT obligation.
- 3.33 The key difference in terms of the focus of the Australian rule (compared with our proposal) is that the aim is to buttress the borrower’s obligation to withhold NRWT. It may be that at the time this rule was enacted the deduction and the NRWT obligation would generally have fallen in the same year. It is understood that in a case where a deduction arises under *TOFA* but there is no payment and hence no NRWT obligation until a later year, the deduction is still claimed. However, if NRWT is not paid when the relevant amount eventually is paid, it is possible that the deduction would be reversed.

Foreign tax credits

- 3.34 If this suggestion were adopted, officials do not believe it would adversely affect a foreign lender’s ability to claim a tax credit for NRWT in its home jurisdiction. It may mean NRWT is paid in a year before there is a liability for income tax on that income in a lender’s home jurisdiction. That earlier time of payment should not affect whether the taxpayer can claim a credit for NRWT paid. For example, under section LJ 2, a New Zealand resident is entitled to claim a credit for foreign tax imposed on foreign-sourced income regardless of when the foreign tax is paid.
- 3.35 It may also be the case that a foreign lender’s home jurisdiction has its own form of the financial arrangement rules, and that this suggested change in fact brings NRWT closer in line with the timing of the lender’s income tax obligation.

Application dates

- 3.36 It is suggested that the reforms outlined in this chapter would apply to financial arrangements entered into, on or after enactment of the legislation. This is expected to be in the second half of 2016.

Transitional treatment of existing financial arrangements

- 3.37 Financial arrangements entered into before the enactment of the legislation will be required to apply the new rules for income years following enactment. This is reasonable, since the arrangements are between associated persons. Transitional rules for these arrangements are covered in the paragraphs below.

- 3.38 A taxpayer with an existing financial arrangement, applying the new rules for the first time, will calculate their NRWT liability for that first year as if they had applied the new rules in previous years.

- 3.39 In the year that the financial arrangement matures, the taxpayer will be required to calculate a wash-up to ensure that the appropriate amount of NRWT has been paid. Generally, this formula will be:

$$\text{NRWT liability if financial arrangement had} \quad - \quad \text{NRWT actually paid on} \\ \text{always been subject to new rules} \quad \quad \quad \text{financial arrangement}$$

- 3.40 This wash-up would also be triggered:

- if the lender ceased to be associated or was replaced by an unassociated lender; or
- immediately prior to the migration of the New Zealand borrower.

- 3.41 For pre-existing arrangements which would be brought into the NRWT rules by the suggested changes but that do not currently give rise to NRPI, officials do not consider it appropriate to impose NRWT on income arising before the income year following enactment. Accordingly, the wash-up formula in paragraph 3.39 would not apply.

- 3.42 However, it is possible in relation to such arrangements that the new rules could be circumvented. A borrower could make a prepayment before the beginning of the income year following enactment. This would pre-pay funding costs likely to accrue during and after that year. The prepayment would not be subject to NRWT (subject to possible application of the general anti-avoidance rule), although it economically relates to a period when NRWT is intended to be imposed. Accordingly, we suggest a specific provision which would apply if a New Zealand-resident party to a financial arrangement makes or has made a payment to an associated person, and that payment has the effect of pre-paying for funding provided to the New Zealand resident for a period that ends after the first day of the income year following enactment. For NRWT purposes, the portion of the payment that as an economic matter relates to the period falling on or after that first day will be treated as paid on that day, and would give rise to an NRWT obligation accordingly.

Example 5

NZ Sub Ltd has a March balance date and is wholly owned by Aus Parent Ltd. On 1 April 2015 NZ Sub Ltd issues a five year 5% annual coupon bond to Aus Parent Ltd. This bond has an issue price of \$80 and a face value of \$100.

In the 31 March 2016 and 2017 years NZ Sub Ltd had been paying NRWT on the \$5 cash interest payments. In the year to 31 March 2018, the amount of interest under the traditional interest definition is \$5, whereas the amount of financial arrangement income applying YTM is \$8.26. As the difference between NRPI from interest payments and NRPI from NRFAI using YTM is more than 10%, and NZ Sub Ltd and Aus Parent Ltd are associated, the bond gives rise to NRFAI. NZ Sub Ltd is not required to withhold NRWT on the cash interest payments to Aus Parent Ltd.

NZ Sub Ltd's March NRWT returns include the following calculations:

NRWT return	Cash interest	NRWT on cash interest	NRFAI	NRWT on NRFAI	NRWT on wash-up
March 2016	\$5	\$0.50	\$0	\$0	
March 2017	\$5	\$0.50	\$0	\$0	
March 2018	\$5	\$0	\$8.96	\$0.90	
March 2019	\$5	\$0	\$9.37	\$0.94	
March 2020	\$5 + \$20 redemption	\$0	\$9.82		\$1.66 ⁸

Questions for submitters

- 3.1 Does an NRWT liability arising in the NRWT return period that includes a taxpayer's balance date provide sufficient time for a taxpayer to calculate and pay the NRWT owing?
- 3.2 Do any practical difficulties arise on the effect of obligations to the lender as set out in paragraph 3.23 and example 3?
- 3.3 Is it necessary for differences between NRWT if calculated on actual interest payments on foreign currency arrangements, and NRWT calculated on NRFAI, to result in an adjustment to NRWT?
- 3.4 Is the approach of imposing NRWT on NRFAI arising after the beginning of the income year following enactment appropriate?
- 3.5 Is the suggested wash-up adjustment the best way to bring existing arrangements into the NRFAI regime?

⁸ Calculated as \$4.50 - \$2.84 = \$1.66.

CHAPTER 4

Defining when payments are to a related person

- 4.1 New Zealand borrowers that meet the requirements of section RF 12(1)(a) of the Income Tax Act 2007 can pay AIL on a payment of interest that is NRPI. When AIL is paid this NRPI qualifies for a zero-rate of NRWT.
- 4.2 The requirements of section RF 12(1)(a) include that the borrower is not associated⁹ with the lender. The reason for this restriction is that related-party lending can be a substitute for equity from a parent and be used to increase interest deductions thereby reducing the taxable profit that would arise if the parent invested with equity. AIL at 2% on related party interest would be inappropriately low when that interest deduction reduced the New Zealand borrower's taxable income, which is generally subject to a 28% or higher income tax rate.
- 4.3 We consider the current restrictions on related parties accessing the AIL rules are not sufficiently robust, which allows associated persons to structure into the AIL rules when the policy intention is that the interest payments should be subject to NRWT.
- 4.4 This chapter explores changes to ensure NRPI (including NRFAI as discussed in the previous chapter) paid directly or indirectly to an associated non-resident cannot access the AIL rules. These suggestions would also be used to determine whether NRFAI was generated by that arrangement.

Back-to-back loans

- 4.5 Unlike some other areas of New Zealand's tax legislation,¹⁰ the AIL rules do not look through to the ultimate lender to a New Zealand borrower. This allows a New Zealand borrower to interpose one or more third parties into what would otherwise be a loan from an associated person. An example of such an arrangement is a back-to-back loan.
- 4.6 Under the current legislation, subject to the potential application of the general anti-avoidance provision, a New Zealand borrower can claim it has borrowed from a non-associated third party and therefore access the AIL rules even when that third party has itself borrowed from a company that is associated with the New Zealand borrower.
- 4.7 In practice, due to the fungibility of money, it will often be difficult for Inland Revenue to identify specific funding flows through a third party.

⁹ Except by being a beneficiary of a trust established for the main purpose of protecting and enforcing beneficiaries' rights under the registered security – this exception is not relevant for the purpose of this issues paper.

¹⁰ See for example section FE 18(3B)(b) of the Income Tax Act 2007 in relation to thin capitalisation, and article 11(4)(b) of the New Zealand/Australia DTA.

4.8 However, we do not intend that all interest paid by a New Zealand borrower should be unable to access the AIL rules just because an associated person has deposited with or lent money to the person lending money to the New Zealand borrower.

4.9 The two main reasons for this are:

- the New Zealand operations of a worldwide group may only be a minor part of the entire operation. It would often be impractical for the New Zealand group entity to keep track of all worldwide financing decisions of their group to ensure no other part of the group had lent money to a person whom the New Zealand entity had borrowed from; and
- where a New Zealand company borrows from the same entity that another part of their worldwide group has deposited/lent money to without the New Zealand company's knowledge, it is more difficult to argue that this funding is a replacement for equity funding that would have otherwise been provided to the New Zealand company.

Other multi-party arrangements

4.10 Arrangements have also been entered into which are not back-to-back loans in the conventional sense but which also involve the indirect provision of funding by a non-resident lender to a resident associated borrower without the imposition of NRWT, while maintaining an income tax deduction calculated under the financial arrangement rules. A typical structure involves:

- a loan from a New Zealand-resident bank to a New Zealand borrower. The loan is interest only with a bullet repayment of principal, and has a five year term; and
- shortly thereafter, the assignment by the bank of the right to receive the loan repayment on maturity to the non-resident parent of the New Zealand borrower. This assignment is contemplated at the time the loan is made.

4.11 In substance, this is a loan to the New Zealand borrower from:

- the bank, for an amount equal to the amount of the loan less the amount received from the non-resident parent for the assignment. This loan is repaid on a principal and interest basis (like a table mortgage) by way of the interest payments; and
- the non-resident parent, for an amount equal to the assignment price. This loan is in the nature of a zero coupon bond issued at a discount, where both "principal" and "interest" are repaid on maturity of the loan.

Addressing the problem

- 4.12 To deal with both back-to-back loans and other multi-party arrangements, officials suggest that payments by a New Zealand resident to another person be deemed to be in whole or in part NRPI paid to an associated person when the following requirements are present:
- a New Zealand resident (the borrower) is provided with funds by a lender (the direct lender) under a financial arrangement; and
 - a non-resident associate of the borrower (the indirect lender) provides funds, directly or indirectly, to the direct lender in order for those funds to be passed on to the borrower; and
 - an arrangement was entered into between any two of the borrower, the direct lender and the indirect lender or anyone associated with any of them, by virtue of which either provision of funds, or the terms of either provision of funds, is dependent on or related to the other provision of funds.
- 4.13 For purposes of determining the borrower's liability to withhold NRWT, it would be treated as borrowing from the indirect lender the amount provided by the indirect lender (except to the extent not provided directly or indirectly to the borrower), and as paying to the indirect lender the total amount paid to the indirect lender under the arrangement (except to the extent not provided directly or indirectly by the borrower). Any excess of the amount paid to the indirect lender over the amount provided by them would be NRPI liable to NRWT, which the New Zealand borrower would have to pay. The deferral test described in Chapter 3 would be applied to determine whether the borrower would have to pay NRWT on the basis of NRFAI or interest payments.
- 4.14 Our suggestion is that this would also cover funding chains where there are multiple non-associated parties.

Example 6

NZ Sub Ltd has a March balance date and is wholly owned by Aus Parent Ltd. On 1 April 2018 NZ Sub Ltd issues a five year 5% annual coupon bond to NZ Third Party Ltd. NZ Sub Ltd and NZ Third Party Ltd are not associated. This bond has a face value of \$100 and is issued for \$100.

On 1 April 2018 NZ Third Party Ltd agrees to sell the principal component of the bond to Aus Parent Ltd on 31 March 2023. Aus Parent Ltd pays NZ Third Party Ltd \$80 on 1 April 2018 and will receive \$100 from NZ Sub Ltd when the bond matures on 31 March 2023. NZ Third Party Ltd will continue to receive the \$5 annual coupon payments.

Under the current definition there is no money lent from Aus Parent Ltd to NZ Third Party Ltd or NZ Sub Ltd therefore no NRWT is payable. Under the proposed rules Aus Parent Ltd will be treated as providing \$80 to NZ Sub Ltd and NZ Sub Ltd will be treated as paying Aus Parent Ltd \$100 at the end of the five-year period. The \$20 excess will be treated as interest.

This transaction will be treated as made up of two separate loans:

- A \$20 loan from NZ Third Party Ltd repaid by five annual payments of \$5.
- An \$80 loan from Aus Parent Ltd repaid by a single \$100 payment in five years' time.

As NZ Third Party Ltd is not a non-resident, only the second of these will be subject to NRWT.

In the year to 31 March 2019, no interest arises under the traditional interest definition for the portion that is related-party funding, whereas the amount of financial arrangement income applying YTM is \$3.65. As the difference between NRPI from interest payments and NRPI from NRFAI using YTM is more than 10%, and NZ Sub Ltd and Aus Parent Ltd are associated, the bond gives rise to NRFAI.

NZ Sub Ltd's March NRWT returns include the following calculations:

NRWT return	NRFAI	NRWT on NRFAI
March 2019	\$3.65	\$0.37
March 2020	\$3.82	\$0.38
March 2021	\$3.99	\$0.40
March 2022	\$4.17	\$0.42
March 2023	\$4.36	\$0.44

Example 7

NZ Sub Ltd has a March balance date and is wholly owned by Aus Parent Ltd. On 1 April 2018 NZ Sub Ltd issues a five-year 5% annual coupon bond to Aus Third Party Ltd. NZ Sub Ltd and Aus Third Party Ltd are not associated. This bond has an issue price of \$100 and a face value of \$100.

Also on 1 April 2018 Aus Third Party Ltd agrees to sell the bond to Aus Parent Ltd on 31 March 2023. Aus Parent Ltd pays Aus Third Party Ltd \$80 on 1 April 2018 and will receive \$100 from NZ Sub Ltd when the bond matures on 31 March 2023. Aus Third Party Ltd will continue to receive the \$5 annual coupon payments.

Under the traditional definition there is no money lent from Aus Parent Ltd to NZ Sub Ltd therefore no NRWT is payable. There is money lent from Aus Third Party Ltd to NZ Sub Ltd and NZ Sub Ltd has elected to pay AIL.

Under the proposed rules, as for the previous example, the transaction will be treated as a loan from Aus Parent Ltd to NZ Sub Ltd.

This transaction will be treated as made up of two separate loans:

- A \$20 loan from Aus Third Party Ltd repaid by five annual payments of \$5.
- An \$80 loan from Aus Parent Ltd repaid by a single \$100 payment in five years' time.

As Aus Third Party Ltd is a non-associated non-resident the interest portion of the payments to it can have AIL paid on it while the in-substance loan from Aus Parent Ltd will be liable for NRWT.

In the year to 31 March 2019, no interest arises under the traditional interest definition for the portion that is related party funding, whereas the amount of financial arrangement income applying YTM is \$3.65. As the difference between NRPI from interest payments and NRPI from NRFAI using YTM is more than 10%, and NZ Sub Ltd and Aus Parent Ltd are associated, the bond gives rise to NRFAI. NZ Sub Ltd is entitled to pay AIL on the payments to Aus Third Party Ltd.

NZ Sub Ltd's NRWT and AIL payments can be calculated as follows:

NRWT return	Cash interest	YTM on third party funding	AIL on third party funding	NRFAI	NRWT on NRFAI
March 2019	\$5	\$1.59	\$0.0318	\$3.65	\$0.37
March 2020	\$5	\$1.32	\$0.0264	\$3.82	\$0.38
March 2021	\$5	\$1.02	\$0.0204	\$3.99	\$0.40
March 2022	\$5	\$0.71	\$0.0142	\$4.17	\$0.42
March 2023	\$5	\$0.37	\$0.0074	\$4.36	\$0.44

Acting together

- 4.15 The current association tests for accessing the AIL rules rely on the associated persons definition in subpart YB of the Income Tax Act 2007. One of the tests in the associated persons definition states that two companies are associated if a group of persons exists whose total voting interests in each company are 50% or more.
- 4.16 This means that where two or more companies each have ownership interests of less than 50% in a New Zealand borrower, these companies will not be associated with that borrower unless they are themselves associated.
- 4.17 There are many instances where this is a desirable outcome – such as portfolio investments in listed companies. For this reason we do not recommend general changes to the associated persons definition.
- 4.18 However, we are aware of a number of transactions where two or more non-associated persons (investors), each with less than 50% of ownership interests in a New Zealand borrower, together provide debt funding to that borrower under an arrangement. Even though these investors may be genuinely not associated (for example three pension funds with different owners) they may make decisions about the borrower collectively, and in economic substance operate in a similar manner as if they were a single owner.
- 4.19 By operating in this manner the investors can make decisions in a similar manner to a single owner such as inserting high levels of debt (subject to thin capitalisation requirements) in proportion to their ownership interests and thereby receive a return on their total (equity + debt) investment with a large portion of this being deductible in New Zealand.
- 4.20 This problem is not unique to the NRWT/AIL rules. Until recently, the same structure could be used without engaging the thin capitalisation rules. Before the recent amendments, two or more non-associated persons (investors) could put high levels of debt into a New Zealand borrower in a co-ordinated fashion without subjecting the borrower to the thin capitalisation rules, as each investor was not associated and did not own 50% or more of the borrower.
- 4.21 The 2014 amendments to subpart FE of the Income Tax Act 2007¹¹ introduced the definition of a non-resident owning body, and provided that if a New Zealand company was owned by a non-resident owning body, it would be subject to the thin capitalisation rules. A non-resident owning body includes a group of independent owners acting together to fund a New Zealand resident. A copy of this definition is included in Appendix 2.
- 4.22 We suggest introducing the same concept for purposes of determining whether interest paid by a New Zealand resident is paid to an associated person. Changes will be made to the concept to the extent necessary to reflect its different application.

¹¹ Enacted by the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014.

- 4.23 The main change is that the non-resident owning body definition applies to a group of non-residents. The non-resident requirement is necessary for thin capitalisation but is not sufficient for the purpose of the AIL rules. Where a group of investors with a more than 50% share of ownership interests act together to fund a New Zealand borrower and one or more of those investors is a non-resident, that investor should not be able to access the AIL rules even when one or more of the other investors in that group is a New Zealand resident. Therefore the restriction on accessing the AIL rules will apply to non-resident members of a group that is acting together even where other investors in that group are New Zealand-resident.

Application dates

- 4.24 We suggest that the reforms outlined in this chapter apply to financial arrangements entered into on or after enactment of the legislation. This is expected to be in the second half of 2016.

Transitional treatment of existing financial arrangements

- 4.25 Financial arrangements entered into before the enactment of the legislation will be required to apply the new rules for income years following enactment.
- 4.26 As with the ideas explored in Chapter 3, there would be a rule to ensure that prepayments of financing expenses relating to income years following enactment are subject to NRWT.

Questions for submitters

- 4.1 Do you agree with the suggestions to impose NRWT on back-to-back loans and other multi-party arrangements involving associated lenders?
- 4.2 What practical issues and difficulties do you see with the imposition of NRWT, whether on actual payments or on NREAI, in this context?
- 4.3 Do you agree that interest paid to a non-resident member of a group of investors acting together (as defined for the thin capitalisation rules) should be subject to NRWT?
- 4.4 Do you agree that the changes discussed in this chapter should apply on or after the year commencing after enactment of a bill containing such proposals?

CHAPTER 5

Eligibility for AIL

- 5.1 In order to access the AIL rules a New Zealand borrower must be an approved issuer and must make a payment of NRPI to a non-associated person on a registered security.
- 5.2 There are currently very few requirements for a person to become an approved issuer or to register a security. There is no legislative requirement that an approved issuer cannot register a security that is issued to an associated party. Instead interest is unable to legally have AIL paid on it when it is paid to an associated party.
- 5.3 A consequence of these limited requirements is that certain New Zealand taxpayers borrow from non-resident associates and use the AIL rules even though this interest does not meet the legislative requirements. While this approach is not in accordance with current law it can only be prevented after being detected by Inland Revenue.

Registration requirement

- 5.4 In order to reduce the level of non-compliance, we suggest additional requirements to the application to register a security. A security will only be able to be registered if, at the time the application to register it is made, it is expected that more than 75% of the total borrowing will be from non-associated persons who are one or more of:
- a financial institution in the business of lending money to the public; or
 - 10 or more persons who are not associated with each other.
- 5.5 Approved issuers that are a financial institution in the business of lending money to the public will not be required to meet this test and will be able to continue to register securities as they do currently.
- 5.6 For the purpose of these tests it is suggested that:
- a member of a registered banking group would be treated as in the business of lending money to the public; and
 - any other financial institution will be in the business of lending money to the public if they, or a group they are a member of, have outstanding lending to at least 100 persons.
- 5.7 We anticipate that these criteria will encompass the majority of current non-resident lending by non-associated persons. However, there may be other situations where it is demonstrably clear from the nature of the parties or the way or market in which funds are raised that there will be no association between the New Zealand borrower and foreign lender. For example, private

placements in the international financial markets are transactions which could automatically qualify for AIL registration.

- 5.8 We invite submissions on how to frame criteria which would qualify a security for AIL registration in addition to those set out above. We also invite submissions from any parties who consider they would be unduly affected by these suggested changes. Where this is the case we also invite submissions on what easily verifiable information may be available to satisfy the Commissioner that the issuer of the security is not associated with the likely holder(s).
- 5.9 We suggest that this would initially only apply to securities registered after the suggested application date and would not affect currently registered securities.
- 5.10 Issuers of securities that were registered before the suggested application date would have to reapply under the new requirements within two years of the enactment date. If they do not reapply, or do not meet the criteria, the registered security status would be lost and NRWT would become payable on interest after that date.

AIL return

- 5.11 Currently the AIL return (IR 67A) does not identify who the payee is of the interest subject to AIL. In order to improve the ability to audit for AIL, or identify cases for audit, it would be beneficial if the return identified the payee, as is currently required for the NRWT annual reconciliation (IR 67S). Inland Revenue's current computer system limitations prevent this from being cost effective at present, however, officials will reconsider this in the future.

Questions for submitters

- 5.1 Is 75% an appropriate threshold for registered security applications? If you consider a different threshold is appropriate how would you justify this?
- 5.2 Are there any other groups of security holders or issuers you consider should automatically qualify for holding or issuing registered securities?
- 5.3 What criteria could be used to enable private placements in the international financial markets to qualify for registration?
- 5.3 Are there any other robust tests which could be used to determine that a security will not be issued to persons associated with a New Zealand borrower?
- 5.4 Is two years an appropriate period to allow existing registered securities to re-register under the new application process?

CHAPTER 6

How branches interact with the NRWT rules

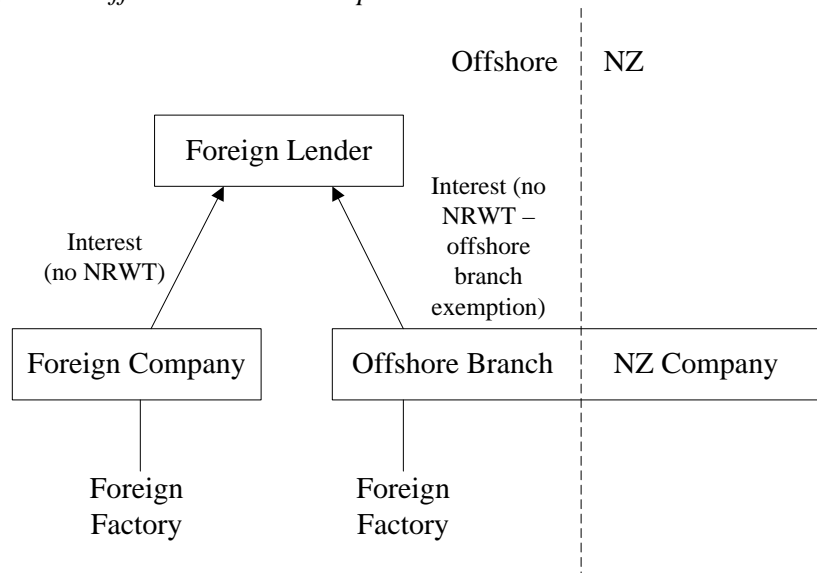
- 6.1 The legislation currently has exemptions from NRPI for interest payments that are made by foreign branches of New Zealand companies or are made to foreign companies with New Zealand branches. Both exemptions are so wide in scope that they currently exempt certain interest payments that are not consistent with the policy intent for the taxation of New Zealand-sourced income earned by non-residents.

Offshore branch exemption

Issue

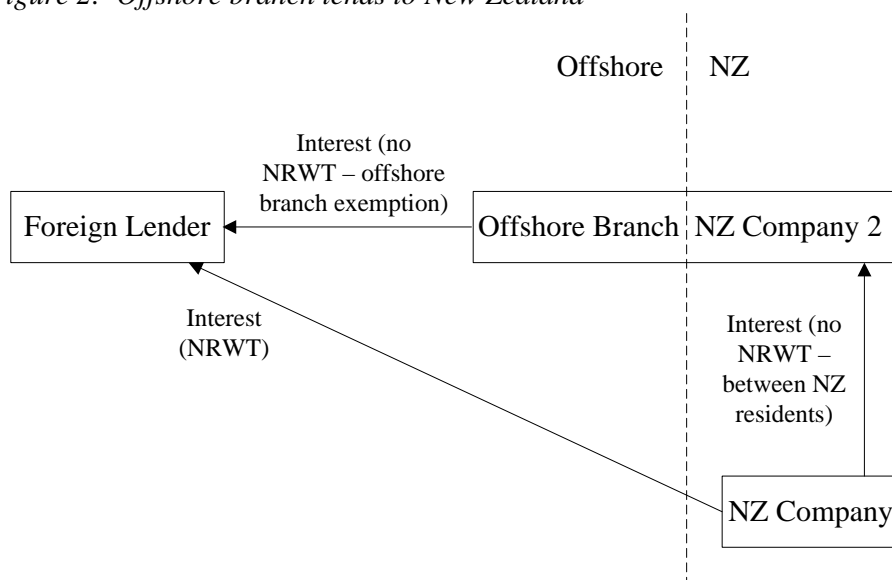
- 6.2 NRPI includes only income that has a New Zealand source. One of the exclusions from having a New Zealand source is the offshore branch exemption. This applies where the interest is derived from money lent outside New Zealand to a New Zealand resident that uses that money for the purposes of a business it carries on through a fixed establishment offshore.
- 6.3 This exemption is intended to apply to a New Zealand resident operating an active business through a branch in another country. If that offshore branch borrows money to fund its offshore operations the interest on this funding should not be subject to NRWT. This treatment ensures that the offshore branch of a New Zealand company does not have to pay NRWT when a foreign incorporated subsidiary borrowing for an equivalent business would not have to. This is shown in figure 1.

Figure 1: Offshore branch exemption



- 6.4 However, this exemption also applies where a New Zealand company sets up an offshore branch which borrows money for the purpose of providing funding to New Zealand borrowers, who may be related or unrelated to the New Zealand company.
- 6.5 In this circumstance a New Zealand resident can borrow from a non-resident lender through an offshore branch of a second New Zealand resident without that borrowing incurring NRWT. If the first New Zealand resident had borrowed directly from the non-resident lender, the interest would be liable for NRWT (or AIL). As these are economically the same transaction they should have the same tax treatment. This is shown in figure 2.

Figure 2: Offshore branch lends to New Zealand

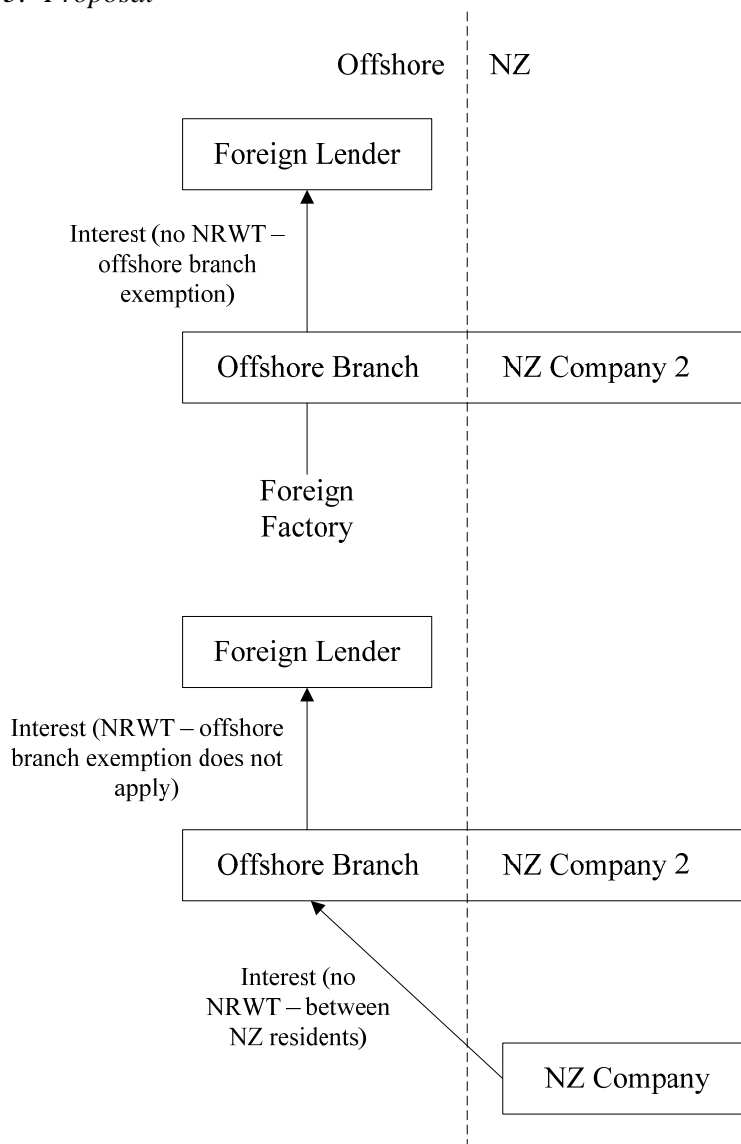


- 6.6 This structure has been adopted by a number of participants in the New Zealand financial sector as a means for funding their New Zealand operations. We are not aware of it currently being used by any non-financial sector entities.
- 6.7 Australia also has an offshore branch exemption from NRWT. However, section 128B(2A) of the Income Tax Assessment Act 1936 prevents this exemption being used in relation to money which is then on-lent to Australia. This is achieved by imposing NRWT on interest paid by an Australian resident (or a non-resident in connection with an Australian branch) to an offshore branch of an Australian resident.

Addressing the problem

- 6.8 Officials wish to explore addressing this issue by defining interest paid by the offshore branch of a New Zealand resident as New Zealand-sourced income, except where that interest is paid on money borrowed for the purpose of a business outside New Zealand, which does not involve lending to New Zealand residents. This is shown in figure 3.

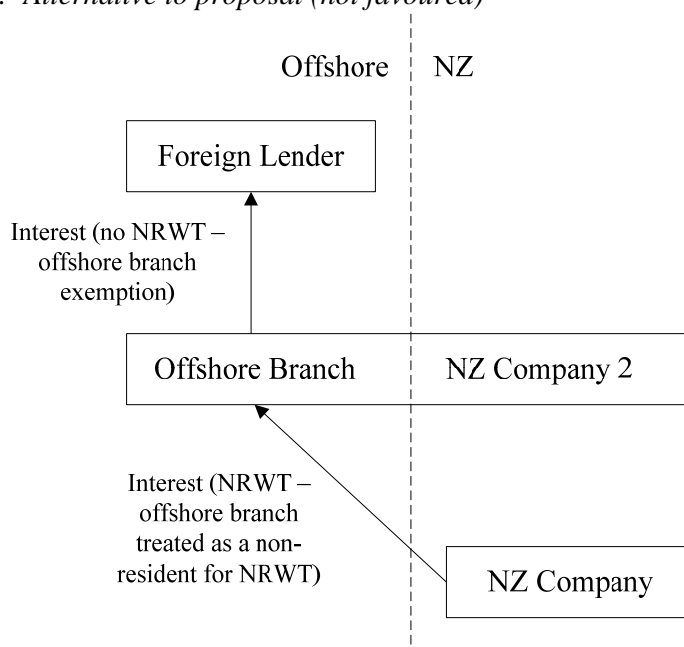
Figure 3: Proposal



- 6.9 This approach will remove the incentive to use an offshore branch for the purpose of removing AIL on international debt funding of New Zealand residents. This will create a consistent tax treatment for those who pay AIL on such funding because they do not have the scale, and/or other commercial reasons, to justify an offshore branch.
- 6.10 To ensure that such interest is appropriately subject to New Zealand tax, we intend also to require that if NRWT is not actually paid on such interest, payment of AIL will be mandatory.
- 6.11 An alternative approach would be to impose NRWT (or AIL) on interest payments on amounts borrowed by a New Zealand resident from an offshore branch of another New Zealand resident. This is shown in figure 4. However, in this case it would seem difficult to also subject the interest earned by the second New Zealand resident to net income tax. Giving the second resident a tax exemption is not consistent with the taxation of New Zealand residents on their worldwide income. There might also be an

argument that where the borrower and the branch are associated but the ultimate lender is not, AIL should be payable rather than NRWT. For these reasons we prefer the approach outlined above; we invite submissions on this point.

Figure 4: Alternative to proposal (not favoured)



Application date

- 6.12 Officials suggest that the reforms outlined in this chapter would apply to financial arrangements entered into on or after enactment of the legislation. This is expected to be in the second half of 2016.

Transitional

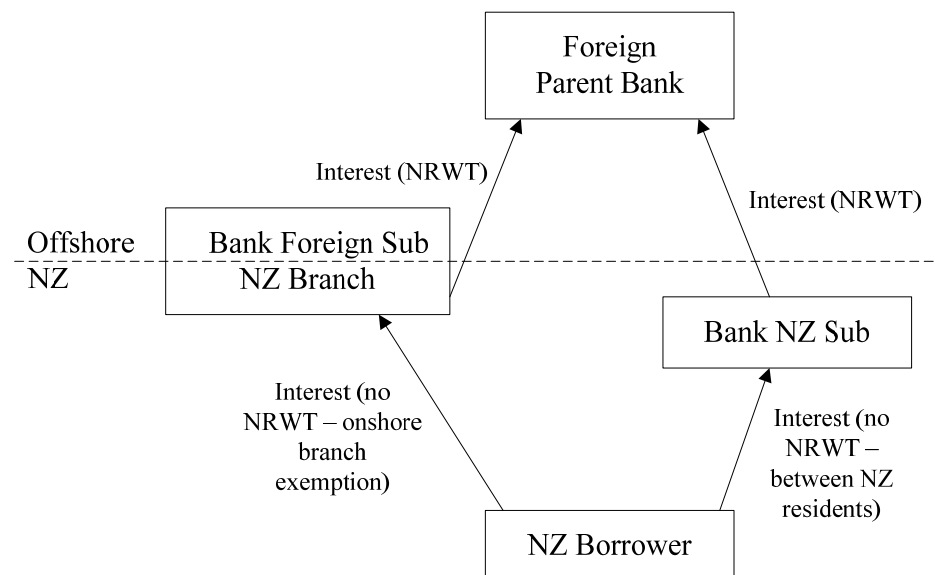
- 6.13 For financial arrangements entered into by offshore branches of New Zealand banking groups before enactment of the changes, we intend to impose AIL on interest payments made in income years beginning more than five years after enactment of the legislation. This provides an extended period of grandparenting, after which it is appropriate to apply the new rules to all arrangements. Consideration will also be given to whether a prepayment rule is required.
- 6.14 For any existing arrangements of offshore branches of non-bank groups, we suggest imposing NRWT or AIL (depending on whether or not the lender to the branch is associated with the borrower) on interest payments made in income years following enactment. There will also be a prepayment rule.

Onshore branch exemption

Issue

- 6.15 New Zealand-sourced interest income derived by a non-resident is not NRPI when the non-resident lender is engaged in business in New Zealand through a fixed establishment in New Zealand. This exemption from NRPI is known as the onshore branch exemption.
- 6.16 When NRWT, and this exemption, were introduced in 1964 many retail borrowers funded their home mortgages through banks and other institutions that operated in New Zealand as a branch of their overseas parent. These branches pay income tax on their branch income in a similar way to New Zealand residents. This exemption meant these retail borrowers did not have to deduct NRWT from interest paid to New Zealand based lenders. This is shown in figure 5.

Figure 5: Onshore branch exemption

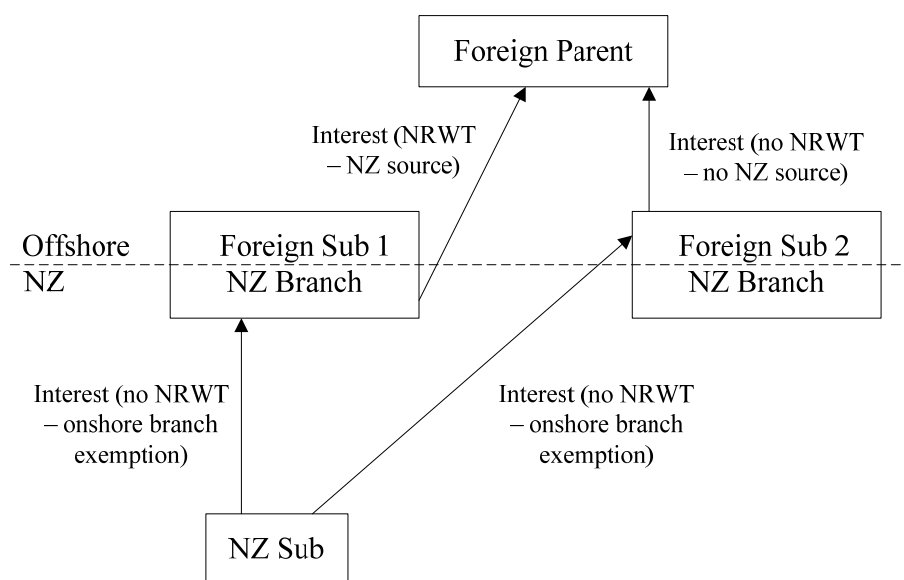


In figure 5, both NZ Branch of Bank Foreign Sub and Bank NZ Sub are subject to New Zealand income tax on their New Zealand net income.

- 6.17 However, the exemption from NRWT also applies to lending by an entity with a New Zealand branch where the lending is not made through the New Zealand branch. As with the New Zealand branch income, this non-branch (but New Zealand-sourced) income is subject to New Zealand net income tax. This treatment of non-New Zealand branch income can be contrasted with the offshore branch exemption which does not apply to all interest paid by a resident company with an offshore branch, but only to interest on money borrowed which is “used by [the branch] for the purposes of a business they carry on outside New Zealand”.
- 6.18 There are at least two problems with this extension of the onshore branch exemption.

- 6.19 First, there is no NRWT (or AIL) on interest paid on money borrowed by the non-resident which is not for the purpose of its New Zealand branch, whereas there is NRWT (or AIL) on money borrowed for the purpose of the New Zealand branch. This means it is possible for a non-resident parent to lend money to its New Zealand subsidiary with no tax payable on the interest (other than income tax on a very slim margin). The parent can simply lend the money to the head office of a non-New Zealand group company which has a New Zealand branch. The head office of that company can then lend the money to a New Zealand group company.
- 6.20 Second, it is more difficult practically for New Zealand to audit the non-resident's non-New Zealand activities, which is necessary to ensure that net income tax is being paid on its non-New Zealand branch but New Zealand-sourced income.
- 6.21 In practice, this exemption has been used by both financial sector and non-financial sector groups to fund New Zealand entities without paying NRWT or AIL.
- 6.22 This structure is shown in figure 6.

Figure 6: Comparison of current onshore branch exemption

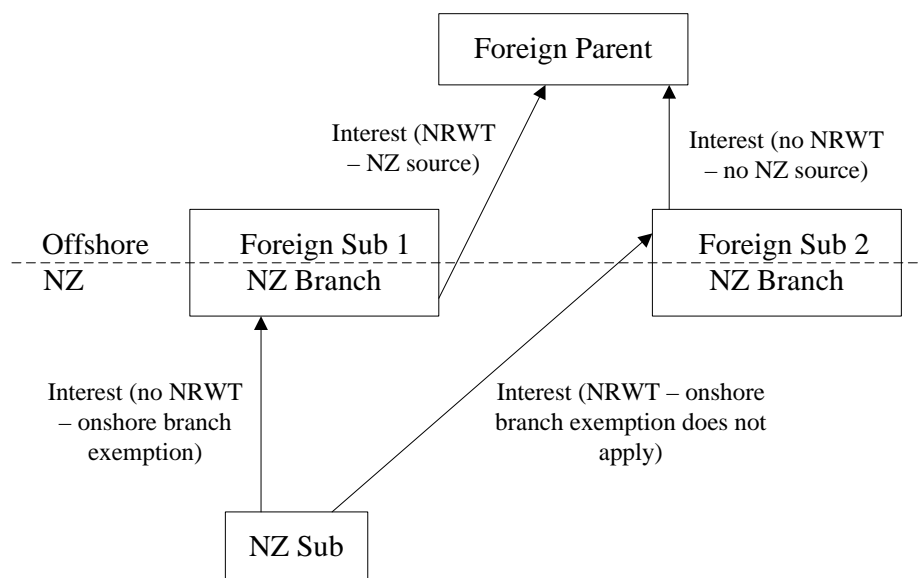


In figure 6 the net profit of Foreign Sub 1 NZ Branch and net profit from the New Zealand-sourced income of Foreign Sub 2 is subject to New Zealand income tax. However, unlike Foreign Sub 1, the interest payment by Foreign Sub 1, the interest payment by Foreign Sub 2 to Foreign Parent does not have a New Zealand source so is not subject to NRWT. Note that if NZ Sub borrowed directly from Foreign Parent, it would be required to withhold NRWT from the interest payments.

Addressing the problem

- 6.23 Accordingly, we suggest restricting the onshore branch exemption so that interest income of a non-resident with a New Zealand branch will only be exempted from being NRPI if the money lent is used by the non-resident for the purposes of a business it carries on through its New Zealand branch. This is shown in figure 7.

Figure 7: Proposal comparison for onshore branch exemption



Application date and transitional treatment

- 6.24 We suggest the same application date and transitional treatment for interest paid to a non-resident entity with a New Zealand branch¹² as we do for interest paid by a non-New Zealand branch of a New Zealand entity.
- 6.25 That is, NRWT (or AIL if the non-resident is not associated with the borrower) will apply to interest payments on all arrangements entered into after enactment of the legislation. Unless the non-resident operates in New Zealand as a registered bank, it will also apply to interest income on existing arrangements in income years following enactment. The prepayment rule, if introduced, would apply in this context. If the non-resident does operate in New Zealand as a registered bank, payments with respect to pre-enactment arrangements will be subject to NRWT/AIL if made on or after the fifth year following enactment of the legislation.

¹² Excluding interest paid to the New Zealand branch, which is not subject to any change.

Cross-border related-party borrowing by banks

6.26 On first principles, whether NRWT or AIL applies to interest paid by a New Zealand resident to either:

- the offshore branch of a New Zealand resident; or
- a non-resident with a New Zealand branch, where the interest does not relate to the branch

will be determined by whether or not the borrower and lender are associated. However, this proposition requires further examination in the case of bank lending.

6.27 For a New Zealand bank that is part of a wider worldwide banking operation there are commercial reasons why the New Zealand bank may borrow from its parent or another associated entity. This can include the better credit rating held by the larger parent, economies of scale of a single funding operation and/or better name recognition of the parent, which allows funding to be raised more cheaply.

6.28 Unlike most other industries, even when the fungibility of money prevents it being traced through to the ultimate funding source, due to the structure of a bank as a margin lender it can reasonably be considered that funding on-lent to a New Zealand bank by its parent is largely ultimately borrowed from an unrelated third party and is largely not provided by the parent bank's shareholders as a substitute for equity.

6.29 Interest on related-party funding to a New Zealand bank should be set according to transfer pricing principles such as the cost of funds to the parent bank, any difference in credit rating of the New Zealand bank, and different terms applied to the money lent to the New Zealand bank compared with its original borrowing. Accordingly the New Zealand bank has to accept (or not) the interest rate applied to that funding and has very little negotiating power over what that rate is.

6.30 If a foreign associate lends directly to a New Zealand-incorporated registered bank, the interest on this lending will be subject to NRWT. Whereas if that lending is channelled through an offshore branch of a New Zealand subsidiary or the head office of an offshore company with a New Zealand branch, this lending is not subject to NRWT.¹³ As these arrangements have the same economic substance, the NRWT treatment should be the same.

6.31 By restricting the offshore and onshore branch exemptions, as covered above, New Zealand banks will no longer be able to rely on these structures to remove their NRWT liability. However, we recognise that, as covered above, banks are margin lenders, which means that:

- they do not make large profits on any particular dollar of lending; and

¹³ Due to not having a New Zealand source or not being NRPI respectively.

- their related party lending is indirectly sourced from third parties and is not a substitute for equity investment.

Also, applying NRWT to bank interest would be likely to increase the cost of capital for all borrowers in New Zealand significantly, should the banks increase their level of related party funding into New Zealand. For these reasons NRWT is likely to be inappropriate for this lending.

- 6.32 Officials therefore suggest that banks be allowed to pay AIL on interest paid to non-resident associated lenders. This would only apply when the borrower is a member of a New Zealand banking group (as already defined for thin capitalisation purposes).
- 6.33 For the same reasons, the suggestions in Chapter 3 would not apply to registered banks either.
- 6.34 We suggest that banks would be able to pay AIL on interest payments made after the enactment of the bill containing these proposals.
- 6.35 There is no suggestion to extend this approach to non-banks, including other businesses operating in the financial sector. This is because, unlike other industries, banks already have a clear definition which removes boundary issues and provides confidence that related-party funding is not an economic substitute for equity investment. This is consistent with the current legislation where New Zealand-registered banks are subject to more rigorous thin capitalisation requirements and greater regulatory oversight by the Reserve Bank of New Zealand, than other financial sector taxpayers.

Questions for submitters

- 6.1 Should the offshore branch exemption apply to borrowing used to make loans to New Zealand residents?
- 6.2 Are there any particular reasons to apply AIL/NRWT to interest paid to an offshore branch by a New Zealand-resident borrower, rather than applying it to the interest which the offshore branch pays on money it borrows in order to make the loan to the New Zealand-resident borrower?
- 6.2 Should the onshore branch exemption apply only to borrowing through the New Zealand branch of a foreign lender?
- 6.3 Should New Zealand-registered banks be able to pay AIL on related-party funding provided by a non-resident?
- 6.4 Should the suggested changes apply from the dates identified above?

APPENDIX 1

Current law

The main rules in the Income Tax Act 2007 for applying NRWT to interest that are relevant to this issues paper are set out below.

RA 6 Withholding and payment obligations for passive income

Non-resident passive income

(2) A person who makes a payment of non-resident passive income must withhold and pay NRWT for the payment to the Commissioner under subpart RF (Withholding tax on non-resident passive income (NRWT)) by the due dates.

RA 9 Treatment of amounts withheld as received

Payments treated as received or derived

- (1) An amount withheld from a payment under this Part, unless a provision in this Part states otherwise,—
- (a) is treated as received—
 - (i) by the person to whom the payment is made; and
 - (ii) at the time the payment is made; and
 - (b) is treated for the purposes of this Act as derived by the person at the same time and in the same way as they derive the payment from which the amount is withheld; and
 - (c) includes a combined tax and earner-related payment.

RF 1 NRWT rules and their application

Meaning

- (1) The **NRWT rules** means—
- (a) this subpart; and
 - (b) section LB 5 (Tax credits for non-resident withholding tax); and
 - (c) sections LJ 1 to LJ 3, LJ 6, and LJ 7 (which relate to tax credits for foreign income tax); and
 - (d) sections LK 1 to LK 5, and LK 7 (which relate to tax credits related to attributed CFC income); and
 - (e) sections 32M, 49, 100, Part 9, and sections 165B and 185 of the Tax Administration Act 1994.

Application

- (2) The NRWT rules apply to a person who makes a payment that consists of non-resident passive income.

RF 2 Non-resident passive income

Interest, certain dividends, and royalties

(1) **Non-resident passive income** means income having a source in New Zealand that a non-resident derives and that consists of—

- (a) a dividend other than an investment society dividend;
- (b) a royalty;
- (c) an investment society dividend when the non-resident is not engaged in business in New Zealand through a fixed establishment in New Zealand;
- (d) interest when the non-resident is not engaged in business in New Zealand through a fixed establishment in New Zealand.

Inclusion: Capital value increase under inflation-indexed instruments

(1B) **Non-resident passive income** includes an amount, arising at the time of a relevant coupon payment (the **current coupon payment**) equal to the amount given by the formula in section RE 18B(4) (Capital value increase under inflation-indexed instruments: RWT cap) in relation to the current coupon payment, if that current coupon payment is—

- (a) non-resident passive income under subsection (1); and
- (b) in relation to an inflation-indexed instrument.

Exclusions

(2) The following amounts derived by a non-resident are excluded from non-resident passive income:

- (a) an amount of exempt income;
- (b) interest arising because section EI 2 (Interest from inflation-indexed instruments) applies to an inflation-indexed instrument;
- (c) an amount of excluded income under sections CX 56B and CX 56C (which relate to attributed PIE income), as applicable.

When subsection (4) applies

(3) Subsection (4) applies in an income year when a person derives non-resident passive income consisting of—

- (a) a dividend other than an investment society dividend;
- (b) a royalty for the use, production, or reproduction of, or for the right to use, produce, or reproduce, a literary, dramatic, musical, or artistic work in which copyright subsists;
- (c) interest or a royalty derived by a life insurer from a company resident in New Zealand when the interest or royalty is treated as arising as a result of the life insurer's election under section EY 49 (Non-resident life insurer becoming resident);
- (d) interest or an investment society dividend when the person paying and the person deriving the interest or dividend are not associated persons.

Final withholding

(4) If the person is a filing taxpayer, the schedular income tax liability for the corresponding tax year under section BC 7 (Income tax liability of person with schedular income) for schedular income that is non-resident passive income is determined by the amount of tax required to be withheld under this Part.

Exception: minimum amount

(5) Despite subsection (4), if a person derives non-resident passive income consisting of interest, investment society dividends, or a royalty other than those described in subsection (3), the person's income tax liability for the corresponding tax year is the greater of—

(a) the sum of the total non-resident withholding tax (NRWT) for which they are liable and the amount that would be their income tax liability for the tax year if they had not derived non-resident passive income in the tax year:

(b) the amount that would be their income tax liability in the absence of this subsection.

Company deriving minimum amount

(6) For the purposes of subsection (5) for a company, if the total amount of non-resident passive income and other income derived by the company in the corresponding tax year is not more than \$1,000, the income tax liability of the company for the tax year is the sum referred to in subsection (5)(a).

Application of financial arrangements rules

(7) The financial arrangements rules do not apply to the calculation of an amount of non-resident passive income.

RF 3 Obligation to withhold amounts of tax for non-resident passive income

Withholding amount of tax

(1) A person who makes a payment of non-resident passive income must withhold the amount of tax for the payment and pay it to the Commissioner. The obligation to withhold arises under section RA 6(2) (Withholding and payment obligations for passive income) at the time of payment

RF 12 Interest paid by approved issuers or transitional residents

When this section applies

(1) This section applies in relation to an amount of non-resident passive income that consists of—

(a) interest that—

(i) is paid by an approved issuer under a registered security; and

(ii) is derived by a person not associated with the approved issuer except by being a beneficiary of a trust established for the main purpose of protecting and enforcing beneficiaries' rights under the registered security; and

(i) is not a payment to which section RF 12B applies:

- (b) interest that—
- (i) is paid by a transitional resident in relation to money borrowed by them while non-resident; and
 - (ii) is not paid in relation to a business carried on through a fixed establishment in New Zealand; and
 - (iii) is derived by a person not associated with the transitional resident; and
 - (iv) is not a payment to which section RF 12B applies.

Zero-rating

(2) The rate of NRWT payable on the amount is 0%.

Interest paid under registered securities

(3) For the purposes of the NRWT rules, an amount of interest is paid by an approved issuer under a registered security only if it is treated as paid in relation to a registered security under section 86I of the Stamp and Cheque Duties Act 1971.

YA 1 Definitions

In this Act, unless the context requires otherwise,—

interest,—

- (a) for a person's income,—
 - (i) means a payment made to the person by another person for money lent to any person, whether or not the payment is periodical and however it is described or calculated; and
 - (ii) does not include a redemption payment; and
 - (iii) does not include a repayment of money lent:
- (b) for the RWT rules and the NRWT rules, includes a redemption payment:
- (c) in sections DB 6 (Interest: not capital expenditure), DB 7 (Interest: most companies need no nexus with income), and DB 8 (Interest: money borrowed to acquire shares in group companies),—
 - (i) includes expenditure incurred under the financial arrangements rules or the old financial arrangements rules; and
 - (ii) does not include interest to which section DB 1(1)(e) (Taxes, other than GST, and penalties) applies:
- (d) for land, has the same meaning as **estate**

money lent means—

- (a) an amount of money that a person lends in some way, including by depositing it in an account, whether or not the lending is secured or evidenced in writing:
- (b) an amount of credit that a person gives, including by not enforcing a debt, whether or not the giving is secured or evidenced in writing:
- (c) an amount of money that a person lends, or credit that a person gives, under an obligation or arrangement, whether or not secured or evidenced in writing:

(d) an amount of money that goes from a person (**person A**) to another person (**person B**) in consideration for person B's promise to pay person A an amount of money and that is less than the amount that person B promises to pay person A. For the purposes of this paragraph,—

- (i) money goes from person A when it is paid to person B:
- (ii) person B's promise is not required to be secured or evidenced in writing:
- (iii) person B includes any other person with whom person B is an associated person

pay, —

- (a) for an amount and a person, includes—
 - (i) to distribute the amount to them:
 - (ii) to credit them for the amount:
 - (iii) to deal with the amount in their interest or on their behalf, in some other way:
- (b) ... [Other definitions covered in this Section are not relevant for this purpose.]

YD 4 Classes of income treated as having New Zealand source

What this section does

(1) This section lists the types of income that are treated as having a source in New Zealand for the purposes of this Act.

Income from debt instruments

(11) The following amounts have a source in New Zealand—

- (a) interest or a redemption payment derived from money lent in New Zealand:
- (b) interest or a redemption payment derived from money lent outside New Zealand—
 - (i) to a New Zealand resident, unless the money is used by them for the purposes of a business they carry on outside New Zealand through a fixed establishment outside New Zealand:
 - (ii) to a non-resident, if the money is used by them for the purposes of a business they carry on in New Zealand through a fixed establishment in New Zealand:
- (c) income from securities issued by the government of New Zealand:
- (d) income derived from debentures issued by a local authority or public authority:
- (e) income derived from a mortgage of land in New Zealand.

APPENDIX 2

Non-resident owning body

The 2014 amendments to section FE 4 of the Income Tax Act 2007 introduced the concept of a non-resident owning body. A similar amendment is suggested for investors acting together and the AIL rules.

non-resident owning body, for a company and an income year, means a group consisting of 2 or more members who are each a non-resident or a person meeting the requirements of section FE 2(1)(cc), (d), or (db) and who each hold ownership interests in the company or have a linked trustee holding ownership interests in the company such that,—

(a) if the company, for each member of the group, owes money to the member (the member debt), or to the member's linked trustee (the trustee debt), or to a company (the subsidiary) in which the member or a linked trustee has ownership interests (the subsidiary debt),—

(i) the member debt for a member, expressed as a fraction of the total member debt for the company, corresponds to the ownership interests or direct ownership interests held by the member, expressed as a fraction of the ownership interests or direct ownership interests held by the members of the group:

(ii) the requirements of subparagraph (i) would be met if each of 1 or more members of the group were treated as holding the ownership interests in the company held by the member, and by linked trustees, and were treated as being owed the member debt, the trustee debt, and an amount for a subsidiary debt equal to the product of the subsidiary debt and the ownership interest held in the subsidiary:

(b) the company is not a widely-held company and the company is funded for the income year under an arrangement between the members of the group concerning debt (the member-linked funding) under financial arrangements meeting the requirements of section FE 18(3B)(b)(i) to (iii) for the members:

(c) the company has member-linked funding provided in a way recommended to, or implemented for, the members as a group by a person