NEW ZEALAND LAW SOCIETY
NZLS EST 1869

Law Society Building, 26 Waring Taylor Street, Wellington,
DX SP20202, Wellington or PO Box 5041, Lambton Quay,
Wellington 6145, New Zealand

TEL +64 4 472 7837 • FAX +64 4 473 7909
E inquiries@lawsociety.org.nz
www.lawsociety.org.nz • my.lawsociety.org.nz

3 July 2015

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

By email: public.consultation@ird.govt.nz

Non-resident Withholding Tax (NRWT): Related Party and Branch Lending, Officials' Issues Paper

Introduction

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the *Non-resident Withholding Tax (NRWT): Related Party and Branch Lending, Officials' Issues Paper* (Issues Paper).

2. The Law Society generally supports officials' intention to address anomalies in how the NRWT system applies to related party debt. However, some of the changes proposed seem to reflect significant changes in established government policy on the taxation of international inbound investment. Further public consultation is required before those changes are adopted, to ensure that the effects of the changes are fully evaluated.

3. We set out below a summary of our submissions and our detailed analysis on the proposals in the Issues Paper. Words not defined in this letter bear the meaning they have in the Issues Paper.

Summary of submissions

4. The Issues Paper refers to likely future significant changes in New Zealand's tax system as a result of the OECD BEPS (Base Erosion and Profit Shifting) Action Plan, and states that a comprehensive and cohesive review of the taxation of inbound investment could be needed in future. Given the significance of a number of the proposals in the Issues Paper regarding the way tax is calculated and who is required to pay it, it would be preferable if substantial changes to the NRWT regime were deferred until the outcome of the OECD BEPS Action Plan is known.

5. Given the proposals in the Issues Paper are targeted towards complicated and sophisticated transactions designed to avoid or defer NRWT or approved issuer levy (AIL), it may be more appropriate to consider an anti-avoidance rule targeted towards related party transactions rather than a range of amendments of general application.

6. Applying an accruals-based approach to the taxation of non-residents seems to be a fundamental change in established government policy. This policy change has not been identified or discussed in the Issues Paper. Furthermore, the proposed approach is not a full accruals approach but rather seems to be a hybrid approach given that there is no wash-up mechanism.

7. Narrowing eligibility for AIL to exclude non-resident owning bodies from AIL treatment requires further thought, owing to the broad and somewhat uncertain nature of paragraphs (b) and (c) of the "non-resident owning body" definition.

8. Narrowing eligibility for AIL to registered banking groups or other financial institutions with outstanding loans to at least 100 persons seems too restrictive when the policy concern is undisclosed association between parties to a transaction, and will exclude a number of genuine third party financing arrangements from the AIL regime.

9. Changing the law relating to offshore and onshore branches would fundamentally affect the cost of capital for New Zealand businesses, either directly or indirectly. The proposals seem to amount to a new imposition of AIL (or possibly NRWT) on certain transactions entered into within international banking groups and between banks and third party borrowers. Again, this seems to be a change in established government policy. There should be a greater degree of public consultation accompanied by detailed analysis of the impacts on the New Zealand economy before the proposed changes are adopted.

Analysis of Proposals

Timing of change to the NRWT rules

10. Changing the taxation of inbound investment requires a comprehensive and cohesive approach. As the Issues Paper recognises, other current initiatives such as the OECD BEPS Action Plan may lead to substantial changes to tax systems in a number of countries, including New Zealand, in this area.

11. The proposals in the Issues Paper could also have a fundamental impact on relevant taxpayers, and the New Zealand economy more broadly, if adopted. The proposals would affect the basis upon which non-residents investing in New Zealand are taxed, the scope of the regimes and the amount of NRWT or AIL payable. There would also be an increased number of borrowers unrelated to banking groups who would need to comply with the AIL regime. Whilst implementation of the proposals would be most obviously relevant to those in the financial sector, all participants in New Zealand's capital markets are likely to be affected.

12. Given the potential cumulative effect of all of these legislative changes on the cost of capital in New Zealand and the way New Zealand business is structured, it would be preferable for aspects of the Issues Paper that propose significant changes to the NRWT system to be considered as part of the future wider review, and/or to be subject to more detailed consideration and consultation before being introduced. The aspects of the Issues Paper that propose law changes to address non-compliance with the current regime (such as back-to-back loan arrangements and borrowers paying AIL rather than NRWT in respect of interest paid to associates) could be progressed separately.

Definition and recognition of income under the NRWT rules

13. Non-residents have consistently been excluded from the scope of the financial arrangements regime applicable to New Zealand residents. The introduction of the concept of non-resident financial arrangement income (NRFAI) seems to be a fundamental shift from taxing non-residents on a payment basis to an accruals basis which is similar to the financial arrangements regime.

14. The NRWT and AIL regimes were designed to ensure that New Zealand's capital markets remained competitive on an international scale. If that intention has been outweighed by other concerns it would be helpful if taxpayers were made aware of the other factors and given an opportunity to comment.

15. If the concept of NRFAI is adopted to determine whether a person obtaining financing is required to deduct NRWT (or AIL), the Law Society makes the following observations:

    15.1 There is no equivalent to the "base price adjustment" under the financial arrangements rules. Without such a provision, there seems to be a risk that NRWT payable is either too much or too little compared with the actual economic income of the person providing financing.

    15.2 To make tax compliance simpler for taxpayers, income for NRFAI purposes should be calculated using the same methods as under the financial arrangement rules.

    15.3 Paragraphs 3.6 and 3.7 of the Issues Paper suggest expanding the scope of NRPI (non-resident passive income) by extending the definition of "money lent" by reference to what falls within the definition of "financial arrangements". It is not clear how this concept would then apply to require withholding from payments made under financial arrangements such as collateralised derivatives or sharia-compliant lending.

    15.4 Imposing NRWT on an accruals basis rather than a payments basis means that a person obtaining financing may have to fund NRWT at a time when they may not have cash available, even though the overall NRWT liability for a transaction may remain unchanged. The Issues Paper assumes this is acceptable on the basis that the parties to the transaction will be related. However, this approach could, for example, have a significant impact on a New Zealand resident start-up business funded by its non-resident parent. Under the proposals, the start-up would have to pay NRWT at the time the interest is accrued. This could be much sooner than if NRWT is due under the payments basis and well before the taxpayer has the cash resources to meet the liability. The arrangements entered into between the parent and the start-up to delay the payment of interest in this situation are likely to be commercially driven arrangements with no mischief associated with the deferral of NRWT. To combat this undesirable outcome, there could be an exemption for companies accruing interest expenses which are genuinely loss-making at the time of the accrual. It would be helpful to seek views from New Zealand businesses on the proposed change to the imposition of NRWT on an accruals basis, as there may be other situations where a deferral of interest (and therefore NRWT) is commercially justifiable.

    15.5 The transitional rules seem complex and, where a wash-up calculation is required, would result in the new NRWT rules applying to the entirety of the financial arrangement. Officials may wish to consider whether grandparenting all existing financial arrangements would be simpler and more appropriate.

15.6 There is no discussion surrounding sections RF 2(3)(d), RF 2(4) and RF 2(5) of the Income Tax Act 2007, which specifically deal with tax liabilities of non-residents where interest is paid between associated persons. Officials seem to recognise implicitly that these provisions are not effective in ensuring that non-residents pay the correct amount of income tax (either through the application of double tax agreements or due to difficulties in enforcing the rules). Officials should consider whether these provisions need to be retained.

"Acting together" criteria

16. The proposed approach in paragraphs 4.15 to 4.23 of the Issues Paper reduces the availability of AIL to non-resident owning bodies who lend to New Zealand resident borrowers. Paragraphs (b) and (c) of the definition of "non-resident owning body" in YA 1 of the Income Tax Act 2007 are broad and somewhat uncertain. Removing eligibility for the AIL regime for those lenders that fall within the definition of "non-resident body" may add further confusion to this area. Alternatively, lenders who fall within (b) or (c) should not be excluded from the AIL regime on the basis that if the lender's debt is not proportionate to its equity in the borrower then there is less risk that the lending is a substitute for equity investment.

Eligibility for AIL

17. The proposed approach in paragraphs 5.4 and following of the Issues Paper for registration for AIL seems unnecessarily restrictive given the stated policy intention. It would be preferable if there was a specific and targeted exclusion from the registration requirements, or for there simply to be more scrutiny of applications and AIL returns.

18. Having a list of specific criteria which must be met for registration to be permissible, which is not based on the relationship between the parties, means that there is a risk that genuine third party financing arrangements will be excluded from the AIL regime. For example, under the proposed criteria, borrowing from off balance sheet special purpose capital markets lenders seems to be excluded from the AIL regime, which is presumably not officials' intention. Finance leases and other financing arrangements with offshore parties that are not traditional financial institutions would also appear to no longer qualify for AIL under the proposals.

How branches interact with the NRWT rules

19. The Law Society understands the rationale for the suggested changes to the onshore and offshore branch rules, and acknowledges that the way these rules have been drafted raises different tax outcomes depending on whether an entity has a branch, which taxpayers have been able to use to their advantage. In saying that, these rules are now well-established and also reflect current New Zealand tax policy in relation to international inbound investment. The proposals would result in significant changes to the relevant tax rules and could potentially disrupt New Zealand's capital markets. There needs to be further public consultation on the policy behind the proposals and the effect the proposals would have before they are adopted. Inland Revenue's proposals should also be accompanied by analysis by Treasury of the expected wider economic impacts, in order for meaningful consultation to occur. The tax consequences of these proposals cannot be considered in isolation.

20. As officials recognise, the changes would be of most direct relevance to the banking sector as they are the major users of offshore/onshore branch structures. The effect of the proposed changes would be as follows:

20.1 In relation to the offshore branch exemption, a new class of transactions between New Zealand companies (namely banks or members of banking groups) with offshore branches and non-residents would give rise to New Zealand sourced income, which would be subject to NRWT or AIL. It seems likely that banks will pass such costs onto borrowers.

20.2 In relation to the onshore branch exemption, a new class of transactions between third party New Zealand borrowers and banks with New Zealand branches would become subject to NRWT or AIL. In any particular transaction the borrower would need to register for AIL and, ultimately, to bear the cost of such AIL (or NRWT if the borrower fails to register for AIL) through contractual provisions entered into with the bank.

21. Both of these changes would significantly expand the scope of the NRWT/AIL regime and, ultimately, increase the cost of capital to New Zealand borrowers. Increased costs of capital are also likely to result in an impediment to investment by non-residents in New Zealand. Officials' suggestions therefore are unlikely to have the intended effect of collecting the right amount of tax from non-residents and could instead risk reducing the desirability of New Zealand as an investment option.

22. The New Zealand government has previously recognised that the imposition of AIL (or NRWT) may give rise to an impediment to non-residents investing in New Zealand. To remove this impediment, the 0% AIL rate for widely-held or listed corporate bonds was introduced in 2012. It was recognised at the time that AIL liability of 0% on corporate debt could effectively have been achieved through using offshore or onshore branch structures for financing and that this may have discouraged the issue of corporate bonds on the domestic market.

23. Changing the offshore and onshore branch rules to increase the amount of AIL and NRWT collected seems therefore to be a change in government policy on how international inbound investment should be taxed. Such a fundamental change in policy should be the subject of wider public consultation and more in-depth economic analysis before being adopted. The rationale for the change should be properly explained, and the costs and benefits of the change in policy fully considered.

24. An option which could be considered is the extension of the 0% AIL regime to the transactions that would become in scope for NRWT/AIL under the proposed changes. This would preserve the current policy position. However, a disadvantage of this approach would be that third party borrowers may be required to comply with the AIL regime in providing information to Inland Revenue, perhaps unnecessarily increasing the compliance burdens of taxpayers.

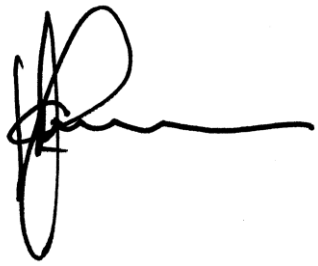
25. From a conceptual perspective, the approach suggested in paragraph 6.11 of the Issues Paper seems preferable to changing the rules related to New Zealand sourced income, which would have consequences beyond the NRWT regime. However, adopting the approach in paragraph 6.11 would mean that third party borrowers in transactions would need to register for AIL to reduce the NRWT cost that would otherwise be imposed. This does not seem to be a desirable result and may be the basis for the approach proposed by officials.

26. Officials may also wish to consider whether market disruption could be minimised by changing their proposals for transitional rules so that the new rules only apply to new financial arrangements.

Conclusion

27. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely



Chris Moore
President