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AUSTRALIA + NEW ZEALAND

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WEEKLY COMMENT: FRIDAY 29 MAY 2015

1. This week I continue looking at *NRWT: related party and branch lending – An officials' issues paper on possible changes to the non-resident withholding tax rules* ("the NRWT issues paper") released on 7 May 2015. Submissions have been invited on a number of aspects and the closing date for submissions is 16 June 2015.
2. Last week I looked at the new concept of non-resident financial arrangement income ("NRFAI") for determining income that should be subject to NRWT, using financial arrangements rules to calculate and allocate income to separate NRWT periods (that would coincide with the payer's income years), which would apply if the payer and the recipient are associated ("the association test") and all the interest subject to NRWT up to the current year is less than 90% of NRFAI ("the deferral test").
3. This week I look at the remaining issues discussed in the NRWT issues paper:
 - (a) Adequately restricting the use of approved issuer levy ("AIL") on payments directly or indirectly to an associated non-resident; and
 - (b) Curtailing the foreign branch and NZ branch exemptions, so as to limit their scope and make them apply as originally intended.
4. Officials have suggested that the suggested reforms would apply to financial arrangements entered into on, or after the enactment of the legislation, which is expected to be in the second half of 2016. In addition, transitional arrangements have been proposed for financial arrangements entered into earlier and still existing at the date of enactment.

Restricting the use of AIL

5. When interest is paid by an "approved issuer" under a "registered security", the rate of NRWT is 0%. Approved Issuer Levy ("AIL") is payable instead at the rate of 2% of the interest under s. 86I, s. 86J and s. 86K of the *Stamp and Cheque Duties Act 1971*.
6. Officials are concerned that there is no legislative requirement that an approved issuer cannot register a security that is issued to an associated party. This means that although interest cannot legally have AIL paid on it, it is possible for some taxpayers to break the law and this can only be discovered upon investigation.
7. Officials have suggested that a security should 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) A financial institution in the business of lending money to the public; or

- (b) 10 or more persons who are not associated with each other.
8. An approved issuer that is 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 at present.
9. For the purpose of these tests, officials have proposed that:
- (a) A member of a registered banking group would be treated as in the business of lending money to the public; and
 - (b) 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.
10. Officials recognise there could be legitimate third party funding arrangements outside of these criteria. The example given is of private placements in international financial markets. Such transactions could potentially automatically qualify for AIL registration, and submission have been invited on this point.

Transitional arrangements for AIL registration

11. Officials have proposed that the new registration requirement would only apply to securities registered after the suggested application date.
12. 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 did 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.

Identifying the payee in AIL returns

13. Officials have noted that the AIL return (IR 67A) currently does not require the payee to be identified. Officials have suggested that it would be beneficial if the return identified the payee, as is currently required for the NRWT annual reconciliation (IR 67S). Apparently, Inland Revenue's current computer system prevents this from being cost-effectively instituted at present, but this will be reconsidered in future.

NZ residents with offshore branches

14. Interest derived from money lent outside New Zealand to a NZ company that uses the money for the purposes of a business they carry on outside NZ through a fixed establishment outside NZ (i.e. through a foreign branch), is not sourced in New Zealand and no NRWT will apply.
15. The exemption is supposed to equate the situation where a foreign branch borrows from a non-resident with the situation where a foreign subsidiary borrows from a non-resident. However, officials note that the foreign branch could on-lend the funds to other NZ borrowers (related or unrelated to the NZ company). This allows NZ borrowers to indirectly source funds from non-residents and avoid paying NRWT on the interest.
16. Officials have stated that this type of structure has been adopted by a number of participants in the NZ financial sector to fund their NZ operations. Inland Revenue is not aware of it currently being used by any non-financial sector entities.
17. The solution proposed is to define the interest paid by the offshore branch of a NZ resident as NZ-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 NZ residents. In addition, officials propose that if NRWT is not paid on such interest, payment of AIL will be mandatory.

18. Officials have considered the Australian approach to the problem, which is to impose NRWT on interest paid by an Australian resident to an offshore branch of an Australian resident. However, officials note that it would be difficult in such circumstances to impose net income tax on the foreign branch income, given that NRWT would have been withheld from the interest income. Moreover, if the borrower and the branch are associated, but the ultimate lender is not associated, there would be an argument that AIL should be payable instead of NRWT. For these reasons officials state they prefer imposing NRWT/AIL on the interest paid to the ultimate lender.

Transitional arrangements for offshore branches

19. For financial arrangements entered into by offshore branches of NZ banking groups before the changes are enacted, officials propose imposing AIL on interest payments made in income years beginning more than five years after enactment, which would provide an extended period of grandparenting. Officials have also suggested there may need to be a rule to deal with prepayments to avoid the new rules before they commence to apply.
20. For existing arrangements of offshore branches of non-bank groups, officials have proposed imposing NRWT or AIL on interest payments made in income years following enactment. An anti-avoidance prepayment rule may need to apply here as well.

Non-residents with onshore branches

21. The two relevant current income tax exemptions in this case are as follows:
- (a) Interest derived by a non-resident is not non-resident passive income (“NRPI”) if the non-resident is engaged in business in New Zealand through a fixed establishment in New Zealand (“the onshore branch exemption for NRPI”).
 - (b) Interest on money lent by a non-resident to another non-resident with a NZ branch, is not NZ-sourced income unless the money is used by the non-resident with the branch for the purposes of a business they carry on in New Zealand through the branch (“the non-resident’s foreign-sourced income exemption”).
22. Officials have noted that the combination of these two rules makes it possible for a non-resident with a NZ branch to borrow through its foreign head office and lend money from the head office to a NZ resident essentially free of NZ tax:
- (a) The payment of interest by the NZ resident to the head office (i.e. the “first level”) is not subject to NRWT because of the onshore branch exemption for NRPI; and
 - (b) The payment by the head office to the foreign lender (i.e. the “second level”) is not subject to NRWT either, because it is not interest sourced in NZ.
23. NRWT is avoided through borrowing and lending from the head office instead of the NZ branch. This results in no tax payable on the interest other than income tax on a very slim margin (the interest income derived by the head office less the interest expense).
24. Apparently, this exemption has been used by both the financial sector and non-financial sector groups to fund New Zealand entities without paying NRWT or AIL.

25. The proposed solution is to restrict the onshore branch exemption so that interest income of a non-resident with a NZ branch will only be exempted from being non-resident passive income ("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. Interest paid to the NZ branch itself will remain exempt from NRWT.

Transitional arrangements for onshore branches

26. Officials have proposed the same transitional treatment as for a NZ resident with an offshore branch:

- (a) NRWT or AIL will apply to interest payments on all arrangements entered into after the enactment of the legislation;
- (b) Unless the non-resident operates as a registered bank, NRWT or AIL will apply to interest payments on existing arrangements in income years following enactment. The anti-avoidance prepayment rule would apply if introduced;
- (c) If the non-resident operates in NZ as a registered bank, interest 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.

Bank borrowing from associated entities

27. Officials recognise that there will be commercial reasons why a NZ bank may borrow from its offshore parent or another associated entity offshore. Because a bank is a margin lender, officials maintain that it can reasonably be considered that funding on-lent to a NZ 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.

28. For these and other reasons such as limited control over the interest charged and the likely cost to NZ borrowers from banks, officials propose 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 NZ banking group, as currently defined for thin capitalisation purposes.

29. For the same reasons, the proposals to levy NRWT on NRFAI discussed in last week's *Weekly Comment* will also not apply to registered banks.

30. These concessions will not apply to non-banks, including other businesses operating in the financial sector.

31. The concessions will apply and banks will be able to pay AIL on interest payments made after the enactment of the proposals.



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