Tax update

James Coleman, Barrister, Wellington, on proposed changes to non-resident withholding tax rules

In May 2015 officials released an issues paper with respect to New Zealand's non-resident withholding tax (NRWT) rules. The paper proposes changes to deal with perceived deficiencies in the rules particularly with respect to related party cross-border transactions.

To appreciate the problem it is necessary to set out some background to the NRWT rules. Whereas New Zealand taxes its residents on their worldwide income, it taxes non-residents on their New Zealand-sourced income. With respect to certain types of income known as non-resident passive income (NRPI) the New Zealand-based payer must withhold tax when making gross payments of NRPI to the non-resident recipient. NRPI comprises interest, dividends and royalties.

One of the justifications for this is that non-residents can trade in New Zealand through branches or subsidiaries and it is often more difficult for the government to collect taxes from non-residents because of the simple fact that they reside outside the jurisdiction. Given that it would be unfair not to tax them, the system of collecting the tax by way of imposing a withholding obligation on the payer is seen as a sensible compromise.

New Zealand is perceived in economic circles as a net importer of capital. Because there are various arguments to the effect that it would be detrimental to impose taxes which impede the importing of capital, the approved issuer levy (AIL) was devised. It applies to lending by non-residents to unassociated New Zealand residents. In those circumstances, a levy of 2% is imposed on the payer of the interest, which is deductible by the payer for New Zealand income tax purposes. Because it is deductible for New Zealand income tax purposes, the effective rate of the approved issuer levy is 1.44%.

Related to all this are the "thin capitalisation" rules. They too have an effect on the taxation of inbound investment into this country. These rules limit the amount of interest deductions that can be claimed by a New Zealand subsidiary of a non-resident group. These rules however have a "safe harbour" component for administrative ease which allows the New Zealand resident to deduct all interest expense as long as the debt does not exceed 60% of the subsidiaries assets. Interestingly, the officials note that the OECD BEPS project is looking at strengthening the thin capitalisation rules globally.

The concerns that officials have with respect to the NRWT rules ultimately stem from the fact that they are drafted in the older style of drafting which focuses on individual transactions and has antiquated definitions of payment. In this regard, the officials helpfully summarised the problem at [3.1] of the issues paper where they say:

> Liability to NRWT is triggered when the 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 the

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"

The language as a whole is directed more to a cash basis of accounting for receipts and is focused on individual instruments or transactions. As a consequence, transactions with associated parties are prone to being manipulated because in the absence of the normal commercial tension between the vendor and borrower the parties can insert features that are more focused on the derivation of tax benefits.

The officials note two examples of the type of structuring that can occur. Firstly, NRWT can be deferred for a non-resident lender for a long period of time in situations where the New Zealand borrower can claim deductions each year in relation to the interest owed. This is because the borrower will be accounting for the interest on an accrual basis in its financial statements and the legal obligation to pay it will be enough for it to be recognised as an expense and obtain an entitlement to deduct it. So as long as the interest is not credited to the account of the lender, that obligation to withhold the NRWT will not crystallise.

Secondly, because NRWT is imposed on essentially a cash basis the non-resident lender can derive their interest income in an economic sense by the sale of the instrument shortly before the interest payment is due.

Other examples, not contained in the issues paper, can be seen in the avoidance case law. In *Vinelight Nominees Ltd v CIR* (2013) 26 NZTC 21-055 the Court of Appeal had to consider an avoidance arrangement concerning the NRWT rules. The case involved a family that had emigrated from Hong Kong but retained investments there. The family incorporated a company in Hong Kong called Weyand Limited (WL). In New Zealand, there was a long-established company called Vinelight Investments Ltd (VIL) through which the family's New Zealand business activities were conducted via various subsidiaries and the like. Through a complicated series of loans and share issues WL ended up the lender of $3 million to VIL.

On advice from the family's accountant, the shareholding in WL was transferred from the parents to the children. Further, a trust was formed with the corporate trustee being a company called Vinelight Nominees Ltd (VNL). VNL took over the obligation to pay WL and hence there was lending from a non-resident (WL) to a resident (VNL). The trust in respect of which VNL was trustee, applied to be registered for an AIL. Steps were taken to register the particular lending for the AIL regime. Again, on advice from the family's accountants, various arrangements were put in place, which provided (in broad terms) that all the income from the subordinate activities ended up in the hands of the trust, which was offset by the interest obligation due to WL. The effect of this was that, for New Zealand domestic purposes, the trust had a nil net profit and hence no New Zealand tax to pay.

The High Court summarised the arrangement (at [115]) in the following terms:

…the arrangement included the following:

(a) The steps taken to ensure that the party liable to Weyand on the debt was not associated with Weyand for the purposes of s NG 2(1)(b)(i). To this end the Trust was settled on terms that avoided association with Weyand.

(b) The incorporation of VNL as trustee of the Trust, VNL at all material times being under the control of Mr and Mrs Chin.

(c) The Trust's registration as an approved issuer for the purposes of Part 6B SACD.

(d) VNL's assumption of liability for repayment of the debt.

(e) The registration of Weyand's advance as a registered security for the purposes of Part 6B SACD.

(f) Weyand charging and VNL paying interest on the debt.

Because the AIL regime had been triggered the net effect of the scheme was that New Zealand income tax of 1.44% was paid on the New Zealand earnings. The Commissioner challenged the scheme as a whole as constituting a tax avoidance arrangement. However she specifically focused on the abuse of the NRWT rules.

The arrangement in black letter terms was entirely compliant with the tax laws. This is because by use of the device of the trust, the relationship between WL and VNL was not within the definition of associated parties for the AIL rules and hence those rules were able to apply. If there had been association the NRWT rules applied, overriding the AIL provisions.

Because any avoidance argument requires an analysis of the scheme and purpose of the Act,the court was required to consider the scheme and purpose of the NRWT and AIL regimes. The most extensive discussion as to the policy behind the AIL regime is found in the High Court at [122] et seq. The High Court referred to the *Tax Policy – Business Tax Policy* 1991, 30 July 1991.

In summary terms, the policy behind the AIL regime is to reduce the costs of overseas borrowing to New Zealand borrowers and was aimed at lenders who would typically only lend to New Zealand businesses if they were compensated for any withholding tax it had to pay. The issues paper notes that when the issuer and the non-resident holder, that is, the borrower and the non-resident lender, are associated parties, the NRWT rules continue to apply to the payment of interest. The High Court quoted the Taxation Review Authority's decision (*V Trust v Commissioner of Inland Revenue* [2011] NZTRA 7; Case 11/2011 (2011) 25 NZTC 15,177 (1-011)) at [317] summarising the purpose of the AIL rules:

> The purpose of association rules is basically to identify common control and common ownership. Where there is that level of common control or ownership, then the concession is not intended to be available because it can be inferred, in that situation, the lending to the New Zealand borrower would have occurred in any case. There is no need to provide the same incentive sought by genuine third-party lenders.

> Parliament does not intend to extend the incentive where that arms-length aspect is missing, particularly, when the loan is already in place and, by necessary implication, was made in the knowledge that full NRWT would have to be paid.

The argument advanced on behalf of the taxpayers was that Parliament had deliberately chosen a particular associated persons rule and, therefore, if these facts fell outside of that rule one can assume that Parliament did not intend to tax that situation. Their argument was given short shrift by the High Court and the Court of Appeal, both courts considering that the taxpayer's use of s NG 2(1)(b)(i) could not have been within Parliament's contemplation and purpose when it enacted the provision.

As a further example, reference could be made to the *Alesco New Zealand Limited v Commissioner of Inland Revenue* (2013) 26 NZTC 21-033. In that case non-resident withholding tax was also avoided in circumstances where interest deductions were generated in New Zealand, ironically under the financial arrangement rules, in relation to "interest" that did not really exist as an economically real cost.

It is normally thought to be more efficient if the law is drafted in a manner pursuant to which the policy intent is obtained directly rather than by reference to the support of the general anti-avoidance provision. Hence, it is perhaps unsurprising that officials wish to address directly some of the problems seen as being inherent in the current drafting of the NRWT rules.

The proposed solution being advocated by officials is a movement to the financial arrangement rules. Those rules would apply to determine liability to income tax by reference to financial arrangements which, by virtue of the computational methodologies used, effectively taxes on a more economically substantive basis.

The proposed move would only apply to arrangements between associated persons. Chapter 4 deals with suggestions to broaden the concept of associated persons for the purpose of the AIL regime. By moving to the financial arrangement rules officials consider that there would be a broadening of the kind of arrangements which will give rise to non-resident passive income and make sure that the recognition of that income ties more closely with the recognition of the associated expenditure.

A second benefit is that determination of the amounts of non-resident passive income would be done under the financial arrangement rules, which would then prevent the deferral of payments for tax purposes.

Officials provide an example of some of the situations that will be dealt with by the proposed changes (at [3.8]). There they refer to the purchase of goods on credits with no explicit interest charge and the use of optional convertible notes which pay coupon interest below the specified rate.

Officials could also point to the fact that the proposed changes would mean that the scenarios described in *Alesco New Zealand Limited v Commissioner of Inland Revenue* at least would be ineffective in avoiding NRWT. Officials are probably correct in assuming that the rules

are largely being thwarted, because for any one avoidance case that reaches the court there are probably 100 that do not.