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## **WEEKLY COMMENT: FRIDAY 22 MAY 2015**

1. This week and next week I look 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. Officials have implied that it may not be necessary to continue to impose NRWT if the worldwide group test in the thin capitalisation rules becomes mandatory as part of the OECD’s BEPS Action Plan. Under the worldwide group test, interest on a related party loan would only be deductible if that loan could be viewed as having been borrowed from a third party and on-lent to the NZ subsidiary. However, the worldwide group test is rarely used in practice because most taxpayers aim to fall within the “safe harbour” debt/assets threshold.
3. In the meanwhile, the NRWT issues paper “sets out suggestions intended to cover a wide range of transactions which currently avoid, or significantly defer, the imposition of NRWT”. Cross-border hybrid issues are not dealt with, as consultation on those issues is likely to commence by early 2016. The potential application of the general anti-avoidance provision, s. BG 1, is also not considered.
4. The discussion in the NRWT issues paper is divided into three main areas:
  - (a) Adequately defining and recognising income that should be subject to NRWT (but note that these proposals will not apply to registered banks);
  - (b) Adequately restricting the use of approved issuer levy (“AIL”) on payments directly or indirectly to an associated non-resident;
  - (c) Curtailing the foreign branch and NZ branch exemptions, so as to limit their scope and make them apply as originally intended.
5. I will look at the proposals on defining and recognising income this week. Officials have suggested that the suggested reforms in this area 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.

### **Present rules on NRWT on interest**

6. NRWT means non-resident withholding tax and refers to an amount payable under the NRWT rules. The NRWT rules are mainly set out in subpart RF.

7. A person who makes a payment of non-resident passive income (“NRPI”) is required to withhold and pay NRWT by s. RA 6. NRPI means income derived by a non-resident and sourced in New Zealand consisting essentially of dividends, royalties and interest (but importantly, in the case of interest, only if the non-resident is not engaged in business in NZ through a fixed establishment in NZ).
8. Under NZ law, NRWT is a minimum tax, but it is also a final tax on dividends, copyright royalties, and interest if the payer and the recipient are not associated. Despite this, in nearly all cases where there is an applicable double tax agreement, NRWT is a final tax at a rate determined under the terms of the double tax agreement.
9. When interest is paid by an “approved issuer” under a “registered security”, the rate of NRWT is 0%. In this case, “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*.
10. Interest is regarded as sourced in NZ, under s. YD 4(11), if it is:
  - (a) Interest or a redemption payment derived from money lent in New Zealand; or
  - (b) Interest or a redemption payment derived from money lent outside New Zealand to:
    - (i) A New Zealand resident, unless the money is used by them for the purposes of a business they carry on outside NZ through a fixed establishment outside NZ; or
    - (ii) 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.
11. “Interest” in the NRWT rules means a payment for “money lent” (as defined in s. YA 1) to any person, whether periodical or not, however it is described or calculated, and includes a redemption payment, but does not include a repayment of money lent. “Pay” includes to distribute to the recipient, to credit to the recipient’s account, or deal with in the recipient’s interest or on their behalf in some other way.
12. Notably, the financial arrangements rules do not apply to the calculation of an amount of NRPI.

### **Suggestions to reform income definition and recognition under the NRWT rules**

13. The existing rules give rise to the following anomalies, which officials aim to address:
  - (a) The fact that “interest” is linked to “money lent” for NRWT purposes means that expenditure on some financial arrangements may not be subject to NRWT;
  - (b) The definition of “interest” may not be wide enough to capture all amounts of expenditure on some financial arrangements even where the expenditure is subject to NRWT; and
  - (c) The fact that the requirement to withhold NRWT only arises upon “payment” can result in significant mismatches between the timing of deductions under the financial arrangements rules and the time when NRWT is deducted from interest income derived by a non-resident.
14. However, the suggested changes would only apply to arrangements between associated persons:
  - (a) The definition of “money lent” is to be widened so as to include any amount provided to a NZ 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;

- (b) The definition of “interest” is to be widened to include a payment (whether of money or money’s worth) received by a non-resident from an associated NZ resident, to the extent that the payment gives rise to expenditure to the NZ resident under the financial arrangements rules;
- (c) For a financial arrangement between a NZ resident and an associated non-resident which provides funding to the resident and involves a deferral of cash payments, 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 arrangements rules, except that in the case of a foreign currency loan income would be calculated in the foreign currency to maintain the current non-taxation of foreign currency gains and losses under the NRWT regime.

15. In order to give effect to the above suggestions, officials have proposed expanding the definition of interest to include “non-resident financial arrangement income” (“NRFAI”), which would be a subset of NRPI. The definition of “pay” would also be expanded to include the accrual of amounts of income calculated as NRFAI.

#### **When NRFAI would arise**

16. NRFAI would arise only in relation to financial arrangements involving deferral of income where a non-resident person provides funding to an associated NZ resident (“the association test”). This could be in situations where:
- (a) Payments under the arrangement are such that they lag behind the economic accrual of income (for example, a zero coupon note issued at a discount); or
  - (b) Payments under the arrangement do not lag behind the economic accrual of income, but the interest is not in fact paid when due.
17. The suggestion is that NRFAI would not arise in relation to an arrangement if, in all years up to and including the year in question, 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 (“the deferral test”). Allowance would be made for arrangements entered into during the year, to recognise that interest is usually paid in arrears.

#### **When NRWT would be payable on NRFAI and other issues**

18. The liability for NRWT on NRFAI would arise in the NRWT return period that includes the New Zealand taxpayer’s balance date.
19. “New Zealand taxpayer” in this context means a New Zealand resident or a non-resident engaged in business through a fixed establishment in New Zealand.
20. Since NRWT would be paid on NRFAI:
- (a) It will be necessary to have a general rule that a taxpayer making a payment (of interest) under an arrangement that generates NRFAI will not be required to withhold NRWT from the payment, so as to avoid NRWT being paid twice on the same interest.
  - (b) It will be necessary for the borrower to adjust payments to the lender to compensate for the NRWT paid on NRFAI, and officials maintain that because the parties will be associated they should be able to work this out.

- (c) The foreign currency translation date for determining the NRFAI will be the taxpayer's balance date, and not the date of the actual interest payments, resulting in some foreign exchange differences which officials prefer to ignore, rather than have a separate "wash-up" rule that reconciles the NRFAI in NZ\$ to the actual interest translated on the payment dates.
- (d) It will be necessary for the foreign lender to claim a foreign tax credit in their home jurisdiction based on the NRWT on the NRFAI, and not on the actual interest, which may be received in a later year, however, officials do not view this as a problem because in the reverse situation NZ would allow a credit for foreign tax paid in an earlier year than when the income is derived.
21. Officials have suggested that there should be no exemption from paying NRWT just because an amount of interest is not deductible, as in the existing NRWT rules. (Under the current NRWT rules, a NZ borrower deriving an amount of income under the thin capitalisation rules is still required to withhold NRWT on the interest payment.)
22. Officials have implied that their suggestions are superior to the Australian rules that require a tax deduction to be deferred to match the timing of the NRWT obligation. Officials' understanding is that where a deduction arises under the Australian Taxation of Financial Arrangements rules ("TOFA") but there is no payment, the deduction is claimed, with the possibility of being reversed in a later year if NRWT is not paid when the payment is made.

### **Tests of association**

23. As noted in paragraph 16, NRFAI would only arise in relation to funding arrangements between associated persons. Officials have proposed using the existing association test for accessing the AIL regime in s. RF 12(1)(a)(ii) – i.e. a person not associated, under subpart YB, 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.
24. However, officials have raised a couple of avoidance concerns, and have proposed some additional measures to deal with them:
- (a) Back-to-back loans and other multi-party arrangements (the example given is of a loan from a NZ resident bank to a NZ borrower, where the right to receive the loan repayment is assigned to the non-resident parent of the NZ borrower); and
  - (b) A group of apparently non-associated non-residents acting together (officials say they are aware of a number of transactions where two or more non-associated persons, each with a less than 50% ownership interest in the NZ borrower, together provide debt funding to that borrower under an arrangement, make decisions about the borrower collectively, and in economic substance operate in a similar manner as if they were a single owner).
25. In order to deal with back-to-back loans and other multi-party arrangements, officials suggest that payments by a NZ 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) A NZ resident ("the borrower") is provided with funds by a lender ("the direct lender") under a financial arrangement; and
  - (b) A non-resident ("the indirect lender"), who is an associate of the borrower, provides funds, directly or indirectly, to the direct lender in order for those funds to be passed on to the borrower; and

- (c) An arrangement was entered into between any two of the borrower, the direct lender and the indirect lender or anyone else associated with 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.
26. For the purpose of determining the amount to be deemed NRPI:
- (a) The amount provided by the indirect lender would be treated as borrowed by the borrower (except to the extent not provided directly or indirectly to the borrower); and
  - (b) The amount paid to the indirect lender would be treated as paid by the borrower (except to the extent not provided directly or indirectly to the borrower); and
  - (c) Any excess of the amount paid over the amount borrowed would be NRPI, and the deferral test, discussed in paragraph 17, will apply to calculate and allocate NRPI to income years.
27. Officials have suggested this would also cover funding chains where there are multiple non-associated parties.
28. In order to deal with non-associated non-residents acting together, officials have suggested using the concept of the “non-resident owning body” to determine whether interest paid by a NZ resident is paid to an associated person. The concept was introduced by amendments to the thin capitalisation regime enacted in 2014.
29. The non-resident owning body definition applies to a group of non-residents. Officials are concerned that the definition could be avoided for NRWT purposes by inserting some NZ residents into the mix. Therefore, officials have proposed changing the concept, so that where a group of investors with a more than 50% aggregate ownership interest act together to fund a NZ 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 NZ resident.

#### **Transitional rules for existing financial arrangements**

30. The new rules are to apply following enactment to existing financial arrangements entered into before the date of enactment as follows:
- (a) The NRWT liability for the first year is to be calculated as if the new rules had applied in previous years;
  - (b) A “wash-up” calculation would apply for arrangements that gave rise to NRPI under the old rules to ensure the NRWT actually paid is the same as the NRWT on NRFAI if the arrangement had always been subject to the new rules, when:
    - (i) The financial arrangement matures; or
    - (ii) The lender ceased to be associated or was replaced by an unassociated lender; or
    - (iii) Immediately prior to the migration of the NZ borrower;
  - (c) The wash-up calculation formula will be:  
$$(\text{NRWT if the new rules had always applied}) - (\text{NRWT actually paid})$$
31. Officials are of the view the wash-up should not apply if the financial arrangement did not give rise to NRPI under the old rules. In that case, NRWT would not be imposed on income arising before the income year following enactment. However, prepayments that relate to funding

costs incurred after enactment will have to be apportioned and the portion relating to the income year after enactment will be treated as paid on the first day of that income year, giving rise to a corresponding NRWT obligation.

### **Registered banks**

32. The proposals discussed in this week's *Weekly Comment* will not apply to registered banks. This is discussed further in next week's *Weekly Comment*.

### **Examples**

33. A number of examples are provided, which may be summarised as follows:

- (a) **Example 1:** Demonstrates the calculation of interest using the YTM method, and the resulting NRWT obligations (10% of the interest calculated using the YTM method is payable as NRWT);
- (b) **Example 2:** Demonstrates the difference between interest calculated under NRFAI rules and cash interest, and also shows that no NRWT is paid on cash interest, NRWT is paid only on NRFAI;
- (c) **Example 3:** Demonstrates that NRWT on NRFAI is a cash outlay by the borrower, resulting in either reduced payments to the lender, or an increased cost to the borrower;
- (d) **Example 4:** Demonstrates the exchange difference which could arise because the exchange rate used under the new rules is the rate on the taxpayer's balance date, whereas under the existing rules the exchange rate used is the rate on the payment date;
- (e) **Example 5:** Demonstrates the transitional rules including the calculation of NRFAI from the year after enactment and the wash-up rule ensuring NRWT paid equates to NRWT payable on total interest and redemption payments;
- (f) **Example 6:** Demonstrates the determination of deemed NRFAI in a multi-party arrangement where the indirect lender is assigned at a discount, by a NZ direct lender, the principal repayable on maturity;
- (g) **Example 7:** Demonstrates the split between the determination of NRFAI and payments subject to AIL in in a multi-party arrangement where the indirect lender is assigned at a discount, by a non-resident direct lender who is eligible for AIL, the principal repayable on maturity.



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