KPMG

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Regular commentary from our experts on topical tax issues

Issue 1

The NRWT proposals will increase funding costs for New Zealand businesses.

Business needs to determine how their existing funding arrangements will be affected and submit accordingly.

Proposals will increase tax on related-party debt

Snapshot

Inland Revenue and Treasury have released an issues paper with proposals to address what they see as *"potential weaknesses in the tax treatment of interest earned by non-residents"*. This will increase the cost of related-party debt funding for New Zealand business.

What's the problem?

Officials' main concern is the incentive and ability for non-residents to shift profits out of New Zealand with no or minimal tax paid under the Non-Resident Withholding Tax ("NRWT") rules. Officials consider that:

1. There are problems with the definition and recognition of income under the NRWT regime. The concern here is that mismatches can arise between New Zealand resident borrowers and non-resident lenders as:
    - NRWT is only imposed on interest on "money lent". Returns on financing transactions that do not involve money lent are not subject to NRWT.

Contact us

John Cantin
Partner, Tax
T: +64 (0) 4 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
T: +64 (0) 9 367 5940
E: delwela@kpmg.co.nz

- NRWT is deferred while the New Zealand borrower can still deduct the interest expense.

2. Related parties can access the Approved Issuer Levy ("AIL") as the regime is not considered robust enough for certain back-to-back loans and where the lender is a group of controlling non-residents that are "acting together".
3. The registration requirements for AIL are insufficient. There are limited requirements for a New Zealand borrower to become an approved issuer or to register a security for AIL.
4. The offshore branch exemption from NRWT can be "misused" where funding is on-lent to finance New Zealand business activities. The onshore branch exemption can be misused as a foreign parent can avoid NRWT on funding to its NZ subsidiary by lending to a head office of a non-NZ group company that has a NZ branch, which then on-lends the funds to the subsidiary. (In contrast, NRWT applies if the foreign parent lends directly to the NZ subsidiary.)

What's proposed?

The issues paper proposes to change the way the NRWT and AIL regimes operate for related-party cross-border debt by:

- Extending NRWT to income arising under the financial arrangements rules, rather than simply "interest paid". The liability to pay NRWT will also be triggered under those rules.
- Applying NRWT, rather than AIL, to:
  - back-to-back loans involving third party lenders if a non-resident associate of the New Zealand borrower provides funds to the third party lender.
  - loans made by a group owning more than 50% of the New Zealand resident borrower and "acting together". This mirrors recent thin capitalisation changes.
- Limiting AIL to loans which are either to or from a financial intermediary, such as a bank, or raised from a group of 10 or more non-associated persons.
- Restricting the application of the offshore branch exemption if interest is paid on money which is lent to a New Zealand resident.
- Restricting the onshore branch exemption so that it only applies to interest received by a non-resident in connection with a NZ branch.
- Allowing New Zealand banks to make use of the AIL regime on interest payments to non-resident associates, as banks are margin lenders.

Importantly, the issues paper proposes "catch up" payments for existing arrangements.

Who should take note?

The proposals will impact all New Zealand businesses that have offshore debt funding from group entities. This may have a material impact on NZ subsidiary funding costs.

The proposals will also further restrict the use of the AIL regime, including in cases where there is no direct association between the New Zealand borrower and foreign lender or lenders.

Contact us

John Cantin
Partner, Tax
T: +64 (0) 4 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
T: +64 (0) 9 367 5940
E: delwela@kpmg.co.nz

Our view

Potential changes to the NRWT regime have previously been signalled by Government and Officials. The accompanying press statement states that the proposals are… *"a domestic law issue and is consistent with the aims of the OECD's action plan to tackle base erosion and profit shifting. Acting to remedy this deficiency in our tax laws is part of New Zealand's response to the issue of multinational tax avoidance."*

While it is appropriate for the Government to review these settings, our main policy concern is that there is no clear statement of the underlying policy of the NRWT rules. Rather, these appear to be ad hoc solutions to a set of disparate problems. This runs the risk of incoherent and incomplete solutions and makes it difficult to determine whether there are better and more coherent alternatives.

For example, in some cases, the solution is a "gross" tax which assumes no deductions should be allowed (such as with the proposed application of NRWT to non-associated lenders where less than 10 persons lend to the company), while in other cases, the solution acknowledges that the lender makes only a margin (the proposed application of AIL for related-party bank borrowings). The margin lending argument in support of applying AIL to banks also applies where group treasury/finance companies borrow from third parties and on-lend to other group companies. A principled solution would extend the AIL solution to these situations.

Changes to the offshore and onshore branch exemptions from NRWT are justified by Officials on the basis that they are not consistent with the policy intention for the taxation of New Zealand sourced income earned by non-residents. These exemptions were highlighted as part of the review of the thin capitalisation rules but no law change was implemented, suggesting the policy settings were considered appropriate. This is therefore an explicit change rather than a clarification.

At a practical level, there is the real issue of how to fund withholding tax when there is no cash (or other equivalent) flow and with applying complicated rules to determine the calculation and timing of withholding tax. The application of the financial arrangements rules to determine how and when NRWT applies is more suited to a tax return and subsequent payment than to a withholding tax regime. It is difficult to see how these rules can be implemented simply in either Inland Revenue's or business' systems.

Further, the issues paper assumes that any additional tax can simply be deducted from payments to the lender. Most lending agreements will require a borrower to gross up for the tax cost so that it is the borrower which bears the tax cost. A gross up clause will increase funding costs for New Zealand subsidiaries.

Despite these concerns, it seems clear that some changes to the NRWT rules will proceed.

Submissions and actions

Submissions are due by 16 June 2015. If you would like to participate in a KPMG roundtable or to discuss how the proposals affect your business, please contact your regular KPMG advisor, or:

John Cantin
Partner, Tax
Wellington
Phone: +64 4 816 4518
Email: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
Auckland
Phone: +64 9 367 5940
Email: delwela@kpmg.co.nz

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