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[s18(c)(i)]	that the making available of the information requested would be contrary to the provisions of a specified enactment	
[40]	Not in scope	

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) and section 18 of the Official Information Act.

NRWT: RELATED PARTY AND BRANCH LENDING

Proposal

1. This paper seeks Cabinet's agreement to include changes to the Income Tax Act 2007, Tax Administration Act 1994 and Stamp and Cheque Duties Act 1971 in the March 2016 omnibus taxation bill, which strengthen the NRWT and AIL rules so they apply more consistently.
2. The Government announced in November 2014 that it would undertake consultation aimed at updating and strengthening New Zealand's NRWT rules on related party debt. Cabinet agreed to release the officials' issues paper *NRWT: related party and branch lending* in May 2015 (EGI Min (15) 8/1 refers). The issues paper suggested extending the scope of NRWT, including applying it on an accrual basis in certain cases, denying use of AIL for arrangements that are economically equivalent to related party lending, and restricting the exemptions that allow NRWT or AIL to not apply to certain lending involving onshore and offshore branches, and sought submissions on the suggested solutions. The proposals in this paper have been developed in response to the submissions received and following direct consultation with key stakeholders.

Executive summary

3. The officials' issues paper *NRWT: related party and branch lending* was released in May 2015. The issues paper presented a number of complementary options to ensure that NRWT was paid in a timely manner on interest paid to related parties or that is economically equivalent to interest paid to related parties. The issues paper also presented a number of complementary options to ensure that AIL applied consistently on interest payments to unassociated non-residents. A total of 22 submissions were received on the issues paper as well as three submissions on a second round of targeted consultation.
4. Following consideration of submissions and further consultation with submitters a package of complementary changes has been developed to ensure that the NRWT and AIL rules apply consistently and appropriately.
5. The changes recommended as part of this package are:
 - a. Widening the scope of related party arrangements that NRWT applies to by extending a number of definitions;
 - b. Applying NRWT on an accrual basis for certain related party arrangements which would otherwise result in a large degree of deferral between interest deductions and NRWT payments;

- c. Applying NRWT when a third party has been interposed into a transaction which in substance involves interest payments to a related party;
- d. Applying NRWT when a group of non-residents act together to fund a New Zealand business and when considered as a group those non-residents would be associated with the New Zealand business;
- e. Restricting AIL registration to situations where the borrower seeking registration can be presumed not to be associated with the lender, or where the interest payment is sufficiently large for this to be cost effectively confirmed;
- f. Restricting the onshore branch exemption from NRWT or AIL so it only applies when lending is by a New Zealand branch of a non-resident to a New Zealand resident or (for compliance cost reasons) where the non-resident is lending to an unassociated person and has a New Zealand branch with a banking licence;
- g. Applying AIL to a notional interest payment from a New Zealand branch to its non-resident head office if that New Zealand branch is claiming an income tax deduction for the notional interest payment but it is not currently subject to AIL;
- h. Applying AIL to an interest payment by an offshore branch of a New Zealand resident if that offshore branch borrowed the money to on-lend to a New Zealand resident; and
- i. Allowing a member of a New Zealand banking group to pay AIL on an interest payment to an associated non-resident.

Background

6. Non-residents can choose to fund their New Zealand subsidiaries using either debt or equity. But depending on the tax treatment in the residence country there may be a tax bias in favour of using debt because interest is deductible in calculating taxable income in New Zealand whereas dividends are not.
7. To reduce this bias, New Zealand has thin capitalisation rules which limit the amount of interest a non-resident owned company can deduct. NRWT is also imposed on interest paid by a non-resident owned company to its shareholders and associates. NRWT applies to cross-border payments of interest to associated non-resident lenders at a rate of 15% reduced to 10% under double tax agreements.
8. The thin capitalisation and NRWT rules help ensure that foreign-owned companies are taxed at a reasonable level. However, the NRWT rules are out of date. The NRWT rules can be circumvented in various ways which largely reflects that fact that financial transactions are much more sophisticated than they were at the time the NRWT rules were enacted in 1964.
9. Non-resident investors who circumvent the NRWT rules face a lower effective tax rate in New Zealand than other non-resident investors. This is not appropriate.

Comment

10. We are recommending changes to address holes in the current NRWT and AIL base. In broad terms, the approach we have taken to address holes in the NRWT and AIL base is to ensure that the tax applies evenly to economically similar and easily substitutable transactions. We have not attempted to expand the NRWT base beyond its target of associated party interest, or debt which is logically indistinguishable from associated party interest.

Broadening arrangements giving rise to NRPI

11. Non-resident passive income (NRPI) – on which NRWT is calculated – only arises where there is “money lent”. Although the definition of “money lent” is broad it does not apply in all situations where there is funding provided under a financial arrangement. This can result in a New Zealand borrower taking a deduction for funding costs (technically, “financial arrangement expenditure”) where the non-resident lender has no NRPI and therefore no New Zealand tax liability.
12. To resolve this asymmetry we recommend the definition of “money lent” be widened to include any amount provided to a New Zealand 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. As “money lent” is a term used in other places in the Income Tax Act 2007 we recommend this change is limited to the NRWT rules.

Avoiding timing mismatches between NRPI and financial arrangement expenditure

13. The interaction of the NRWT rules (which rely on definitions of items such as “payment”) and the financial arrangement rules (which calculate income and deductions on an economic accrual basis) creates an incentive for New Zealand borrowers from non-residents to enter into arrangements that give rise to deductions for funding costs without giving rise to a “payment” of “interest” which triggers NRWT. The ability to take advantage of these incentives is much more pronounced when the borrower and lender are associated.
14. The proposals below would only apply to certain financial arrangements between associated parties once certain criteria are met. All other financial arrangements would continue to be taxed under the current NRWT rules.
15. We recommend introducing a new concept of non-resident financial arrangement income (NRFAI) which would be a new category of NRPI. NRFAI would be calculated in a similar way to how a resident calculates financial arrangement income.
16. NRWT would be paid on NRFAI, instead of the current payments basis of NRWT, when an associated party financial arrangement has a sufficiently large degree of income deferral. Income deferral is measured by comparing cumulative payments under an arrangement (on which NRWT is ordinarily payable) with cumulative deductions.
17. A flowchart of the process a taxpayer would go through to determine whether the NRFAI rules apply is provided as an appendix.

Applying NRWT when an unrelated party has been interposed to access AIL

18. The policy intent has always been that AIL should not be available on interest payments to a related party lender. As this restriction only applies when the borrower and lender are associated as defined in the Income Tax Act 2007 it does not currently apply when the lender is in substance equivalent to an associated party or when the arrangement has been structured so the direct lender and borrower are not associated (subject to the possible application of section BG 1, the general anti-avoidance provision).
19. Two situations which currently allow AIL on what is in substance related party interest payments are back-to-back loans and multi-party arrangements.
20. A back-to-back loan involves a related party lender lending to a third party who subsequently on-lends that funding to a related party borrower. A multi-party arrangement involves a more complex structure where the principal portion of funding originally provided by a third party is subsequently sold to a person who is related to the borrower.
21. We recommend introducing specific rules applying to arrangements that have the purpose or effect of circumventing the AIL. Once these rules are triggered both the borrower and the interposed third party will have a liability to withhold NRWT on interest attributable to the associated non-resident. However, the third party should not be subject to any liability if it is not aware of the arrangement.

Acting together

22. Where two or more persons, who generally are not associated with each other or the New Zealand borrower, act together to control, and in particular to fund, that borrower (typically joint venture or private equity investment structures) AIL is currently available. Because they are acting together, they can use shareholder loans as a substitute for equity in exactly the same way as if the New Zealand borrower was owned by a single investor. Accordingly, we propose to treat interest on loans made by such shareholders as potentially subject to NRWT.
23. Similar provisions were introduced into the thin capitalisation rules in 2014. We recommend a similar test is introduced into the AIL rules so that where two or more non-resident persons act together to control and fund a New Zealand entity, any interest payments to one of those persons would be ineligible for AIL.

Eligibility for AIL

24. Since the introduction of AIL in 1991 the payment of AIL has always required the borrower to be an approved issuer and the borrowing to be a registered security. There are currently no restrictions on registering a security.
25. We propose to restrict the categories of lenders and/or borrowers for which a security can be registered. The purpose of this restriction is to prevent associated parties paying AIL instead of NRWT by incorrectly claiming that they are not associated and relying on Inland Revenue not identifying this non-compliance. Identification of non-compliance is made more difficult by virtue of the fact that lenders are inevitably non-resident and therefore more difficult to independently research. Factors which increase

the risk of incorrect claims, and often also the difficulty of audit, are where both borrower and lender are closely held entities, or of a comparatively modest financial size.

Borrowing not attributed to an onshore branch

26. NRPI does not currently include interest payments by a New Zealand resident to a non-resident if that non-resident is engaged in business in New Zealand through a fixed establishment in New Zealand. This is known as the onshore branch exemption.
27. However, the current law also applies to exclude interest payments made to such a non-resident when the non-resident's onshore branch has no involvement in the transaction. Although income tax is payable on the margin earned by the non-resident this is often much less than the NRWT or AIL that would be payable if the branch did not exist.
28. For non-bank entities this structure has been used to reduce the amount of New Zealand tax that would have otherwise been payable on income from New Zealand investment. To correct this problem, officials recommend that a payment of interest by a New Zealand resident to a non-bank non-resident will only be covered by this exemption if the money lent is used by the non-resident for the purposes of a business it carries on through its New Zealand branch.
29. There are two types of transactions currently covered by the onshore branch exemption relating to banks. When a bank borrows from an associated person (eg their non-resident parent) we recommend that a payment of interest should only be covered by this exemption if the money lent is used by the New Zealand branch bank. This will prevent the onshore branch exemption applying when a New Zealand bank borrows from an associated person that has a New Zealand branch and is consistent with the other AIL changes recommended below.
30. The majority of New Zealand borrowers who are not associated with a New Zealand bank but borrow from a non-resident bank with a New Zealand branch are borrowing to acquire foreign property (eg foreign investment properties or migrants who maintain an offshore residence). These borrowers are currently not required to withhold NRWT or pay AIL on these interest payments due to the onshore branch exemption. We recommend the continued application of the onshore branch exemption to interest payments by New Zealand resident to an unassociated non-resident bank with a New Zealand branch.

Borrowing allocated to an onshore branch

31. Our proposals in this respect generally relate to banks. A non-resident bank can borrow offshore for the purpose of funding its worldwide operations and allocate a portion of this funding to its New Zealand branch. The New Zealand branch can then use the funding to make loans and generate taxable income. When calculating its net income taxable in New Zealand, the bank can deduct from the income generated by its New Zealand activities a deemed interest amount, attributable to the borrowing raised offshore and used to fund the New Zealand business.
32. New Zealand is unable to impose NRWT or AIL on any portion of the interest paid on the offshore borrowing by the bank. Currently, we also do not impose NRWT or AIL

on the interest which the New Zealand branch is deemed (as described above) to pay to the non-New Zealand part of the bank which provides it with funding.

33. The result is that interest paid on funding allocated to a New Zealand branch, is not subject to NRWT or AIL even when interest payments on an equivalent loan by a non-resident to a New Zealand resident subsidiary company would be subject to NRWT or AIL.
34. We recommend funding costs which are deductible by a New Zealand branch of a non-resident for income tax purposes, in relation to a deemed loan to the branch by its head office, are made subject to AIL.

Offshore branch exemption

35. NRWT or AIL only apply to interest payments that have a New Zealand source. One of the exclusions from having a New Zealand source is known as the offshore branch exemption. This applies where the interest is derived from money lent outside New Zealand to a New Zealand resident that uses the money for the purposes of a business it carries on through a fixed establishment offshore.
36. This exemption is intended to apply to a New Zealand resident operating an active business through a branch in another country. If that offshore branch borrows money to fund its offshore operations the interest on this funding should not be subject to NRWT. This treatment ensures that the offshore branch of a New Zealand company does not have to pay NRWT when a foreign incorporated subsidiary borrowing for an equivalent business would not have to.
37. However, this exemption also applies where a New Zealand company sets up an offshore branch which borrows money for the purpose of providing funding to New Zealand borrowers, who may be related or unrelated to the New Zealand company.
38. Due to the practical difficulties in establishing and maintaining a commercial offshore branch this exemption is generally only used by large foreign-owned banks operating in New Zealand. By using this exemption a New Zealand bank can borrow through an offshore branch of a related New Zealand company without paying AIL on interest payments whereas it would have to pay AIL if it borrowed directly from the ultimate lender. This exemption provides a tax advantage to large foreign-owned banks that is not practically available to New Zealand-owned banks or non-banks.
39. We recommend that an interest payment to a non-resident by an offshore branch of a New Zealand resident is subject to AIL or NRWT to the extent that the money borrowed is lent to a New Zealand resident.

Replacement of NRWT with AIL on interest paid by a member of a New Zealand banking group to an associated non-resident

40. Under current rules an interest payment by a New Zealand bank to a non-resident associated party is subject to NRWT. However, due to the existence of branch structures as discussed above, in practice no NRWT is payable. If the recommendations above are enacted these branch structures will no longer be effective so that, in the absence of further changes, these interest payments would become subject to NRWT.

41. We recognise that there are commercial reasons why a foreign bank may borrow from an unrelated party and on-lend to its New Zealand bank subsidiary. As the foreign bank is a margin lender it can be considered that any related party lending will have ultimately been sourced from an unrelated party and is not a substitute for equity. This can therefore be distinguished from related party funding by a non-bank.
42. We consider that attempting to impose NRWT on bank related party lending would be inappropriate and would likely result in a New Zealand bank borrowing from unrelated parties directly even when – in the absence of tax – it would be economically efficient to borrow via a related party. To remove this tax impediment we recommend that a member of a New Zealand banking group be able to pay AIL on interest payments to an associated non-resident.

Consultation

43. The proposals were subject to public consultation in the *NRWT: related party and branch lending* officials' issues paper released in May 2015. 22 submissions were received on this issues paper. In October 2015 officials undertook targeted consultation with the banking industry on the deemed interest proposals. Three submissions were received on this second consultation including one from the New Zealand Bankers' Association on behalf of its members.
44. Most submitters accepted the proposals relating to associated party debt, on the basis that NRWT should apply evenly across economically similar transactions. A number opposed the proposal to tighten the criteria for registering for AIL, and after consultation this proposal was substantially modified. Many submitters questioned the appropriateness of broadening AIL. For example, they noted that it increases the cost of raising capital in New Zealand and may reduce investment in the country. The proposals are about correcting anomalies in the current rules to level the playing field for taxpayers to whom the NRWT and AIL rules apply (or are intended to apply). It would only have a very minor impact on the cost of capital.
45. The cost of capital argument was raised strongly in relation to the proposals relating to funding through bank branches. However, the rate of AIL is only 2%. Accordingly, any increase in interest rates resulting from the imposition of AIL will be relatively low (eg if current rates are 5%, the increase would be no more than 0.1 percentage points, to 5.1%), and may well be much smaller than that, given competitive pressures, including from (a) New Zealand owned banks who already pay AIL on interest payments to non-residents (b) non-resident lenders, who appear to be able in some cases to provide funding at sufficiently low rates that borrowers are prepared to pay the AIL.

Financial implications

46. The proposed amendments are estimated to increase tax revenue by \$57 million per annum once fully implemented. The proposals have a variety of application dates from enactment date for new arrangements through to the 2022-23 year for certain branch arrangements entered into prior to the enactment of these proposals.

47. The combined revenue impact of all proposals is estimated as:

	\$m – increase/(decrease)							
Vote Revenue	2015/	2016	2017	2018	2019	2020	2021	2022/23 &
Minister of Revenue	16	/17	/18	/19	/20	/21	/22	out years
Tax Revenue	\$0	\$7	\$21	\$37	\$51	\$53	\$55	\$57
Total Operating	\$0	\$7	\$21	\$37	\$51	\$53	\$55	\$57

Human rights

48. The proposals are not inconsistent with the Human Rights Act 1993 or the New Zealand Bill of Rights Act 1990.

Legislative implications

49. Implementing the proposals will require amendments to the Income Tax Act 2007, Tax Administration Act 1994 and Stamp and Cheque Duties Act 1971. It is recommended that the necessary amendments be included in the taxation bill scheduled for introduction in March 2016. I recommend that the amendments apply from a variety of application dates. The general rule for the application dates of these proposals is that they will apply to arrangements entered into after enactment with all arrangements entered into before enactment applying the new rules from the first day of the taxpayer's income year starting after the date of enactment.
50. None of the new rules should apply to existing arrangements retrospectively and depending on which rule applies should instead apply between the enactment date and the start of the sixth year after the enactment date.

Regulatory impact analysis

51. Two Regulatory Impact Statements (RIS) are attached.
52. The Quality Assurance panel at Inland Revenue has reviewed the *NRWT: Related party and branch lending – NRWT changes* RIS and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.
53. The Quality Assurance panel at Inland Revenue has reviewed the *NRWT: Related party and branch lending – bank and unrelated party lending* RIS and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.

Publicity

54. If Cabinet agrees to the recommendations in this paper, the Minister of Revenue will issue a press release outlining the changes agreed to by Cabinet in advance of a tax bill being introduced.

Recommendations

55. We recommend that Cabinet::

1. **Agree** that the definitions that require NRWT to be paid on related party interest payments should be extended, so that NRWT is payable if the borrower is able to claim a deduction under the financial arrangement rules.
2. **Agree** that the obligation to pay NRWT should not be able to be deferred in related party loans, subject to a de minimis.
3. **Agree** to require a New Zealand borrower to pay NRWT on interest paid to a non-resident lender who is a member of a group of non-residents who are acting together and, viewed in the aggregate are associated with the borrower.
4. **Agree** that interest paid in respect of back-to-back loans and multi-party arrangements intended to avoid the application of NRWT by interposition of a third party should be subject to NRWT.
5. **Agree** to limit the ability to register a security for AIL to situations where the risk that interest will be paid to an associated person is acceptably low, and make certain provisions for securities which are already registered.
6. **Agree** that recommendations 1 to 5 should apply to existing arrangements from the start of the income year commencing after the date of enactment and for all other arrangements from the date of enactment.
7. **Agree** that when a non-resident with a New Zealand branch which does not hold a New Zealand banking licence, or is lending to an associated party, earns New Zealand-sourced interest, that interest should be subject to NRWT (or AIL if the lender is a bank) unless the loan is made in the course of the branch business.
8. **Agree** that recommendation 7 should apply to:
 - a. existing loans from an associated non-resident which is not a bank from the date of enactment;
 - b. existing loans from an unassociated non-resident which is not a bank from the income year commencing six years after the date of enactment;
 - c. existing loans from a non-resident which is a bank from the income year commencing three years after the date of enactment; and
 - d. all other loans from the date of enactment
9. **Agree** that New Zealand resident companies which are members of a New Zealand banking group should be able to pay AIL on interest paid to non-resident associated lenders.
10. **Agree** that recommendation 9 should apply from the date of enactment.
11. **Agree** that AIL should apply to interest paid by the offshore branch of a New Zealand resident company to the extent that the branch lends the funds to New Zealand residents.

12. **Agree** that recommendation 11 should apply to existing arrangements from the start of the income year commencing six years after the date of enactment and for all other arrangements from the date of enactment.
13. **Agree** that NRWT or AIL should be imposed on amounts of notional interest which are deducted by the New Zealand branch of a non-resident with respect to funding from other parts of the entity.
14. **Agree** that recommendation 13 should apply to existing arrangements from the start of the income year commencing three years after the date of enactment and for all other arrangements from the date of enactment.
15. **Note** the following changes as a result of the decisions in recommendations 1 – 14 have the following impact on the operating balance:

	\$m – increase/(decrease)							
Vote Revenue Minister of Revenue	2015/ 16	2016 /17	2017 /18	2018 /19	2019 /20	2020 /21	2021 /22	2022/23 & out years
Tax Revenue	\$0	\$7	\$21	\$37	\$51	\$53	\$55	\$57
Total Operating	\$0	\$7	\$21	\$37	\$51	\$53	\$55	\$57

16. **Agree** that the amendments be included in the next available tax bill.
17. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on the detail of these proposals without further reference to Cabinet.

Hon Bill English
Minister of Finance

Hon Todd McClay
Minister of Revenue

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Date

____ / ____ / ____
Date