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Our ref 150703KPMGsubNRWT

3 July 2015

Dear Sir

KPMG submission on *NRWT: Related party and branch lending*

KPMG is pleased to make a submission on the Officials Issues Paper – *NRWT: Related party and branch lending* (the "Issues Paper").

The Issues Paper proposes extending as well as strengthening the withholding tax rules applying to offshore interest (and interest like) expenditure.

Although we accept that it is appropriate for the Government to reconsider its policy settings, the Issues Paper presents very limited justification for changing those policy settings.

This means that we are concerned that cost of capital and sovereign risk considerations have not been well thought through.

The proposals will increase the cost of capital for unrelated as well as related party debt. In some cases, this will increase New Zealand taxation by 500% for long-term previously committed investment. The Issues Paper does not coherently make the case that either concern is addressed.

We are also concerned that the Issues Paper proposals will increase the prospects for double taxation. There is no proposal to limit withholding tax for non-deductible interest. This is particularly a problem as the proposals precede the OECD BEPS interest deductibility action 4 recommendations. We are concerned that those proposals will further inappropriately limit interest deductibility. Any increase in withholding taxes will increase the double taxation that applies.

We are also unconvinced by the Issues Paper's assertions that a home country foreign tax credit will mitigate this. It is by no means clear to us that a credit will be readily and easily granted by the home jurisdiction. Further, this is clearly not beneficial where the investor is a tax exempt entity (such as a sovereign wealth fund or an exempt pension fund) in its home jurisdiction. The Issues Paper's proposed New Zealand tax increases will be final tax increases for such investors.

We are concerned about the coherence of the proposals with wider Government policy initiatives. As part of its Business Growth Agenda, Government is projecting a significant need

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for capital to fund export growth. These tax proposals will likely make that capital more expensive and potentially reduce the supply of capital as a result.

Moreover, the proposals may increase the cost of existing infrastructure projects, effectively changing the economics of long-term investment decisions, after the initiation of those projects. This increases the perceived country risks associated with New Zealand and will potentially reduce the appetite for New Zealand infrastructure projects or increase their costs. We will leave it for that industry to make detail submissions on these issues.

In our initial comments on the Issues Paper (in KPMG's taxmail issue 1 May 2015), our view was that it appeared to provide ad hoc responses and as a result the risk was that the solutions were incoherent and incomplete. On further reflection, we are reinforced in that view.

However, we have attempted to draft a coherent submission and to be constructive with our responses.

Our detailed submissions elaborate on our general and specific concerns. Our submission is in two parts and each part has a summary of our submissions and comments which we trust adequately answers the questions asked.

We would be pleased to discuss any aspect of our submissions. Please do not hesitate to contact us, Paul Dunne on 09 367 5991 or John Cantin on 04 816 4518.

Yours sincerely

Paul Dunne
Partner

John Cantin
Partner

Detailed KPMG submission on

NRWT: related party and branch lending

3 July 2015

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Part 1 – General comments on the proposals to extend the base

This part considers the Issues Paper at a broad level.

It canvases a number of topics and submissions as well as informing our specific submissions.

In large part it is a response to Chapter 2 of the Issues Paper.

We note that the proposals affect:

- FDI, where there is a choice between debt and equity funding; and
- Third party funding.

The considerations discussed in this section may not apply equally to the different scenarios.

Summary of general submissions

In our view:

- the current outcomes are not contrary to existing policy. They are expected and known outcomes. The policy in support of the changes needs to be well developed and transparent.
- the analysis and evidence to support a change of policy is not apparent from the Issues Paper.
- the current policy settings, which are based on cost of capital and hollowing out concerns, have not been shown to be incorrect. The cost of capital concerns have implications for Government goals regarding the growth of New Zealand's exports;
- double taxation (due to no change for non-deductible interest, a likelihood that foreign tax credits will not be available, and the future implementation of BEPS Action 4 recommendations) will increase the cost of capital;
- the law change risk arising from imposing extra tax on existing arrangements and of unilateral amendments to DTAs create unnecessary Sovereign risk.

These concerns are best addressed by:

- acknowledging that tax competition exists between countries;
- making any analysis, which addresses the concerns identified, available for public review and contestable; and
- at least, deferring the proposals until the full range of BEPS recommendations and the response to them has been factored into the analysis. This will enable:
  - an overall view of the proposals effect on the taxation of capital in New Zealand to be ascertained; and
  - to confirm that the proposed settings are appropriate policy.

Our detailed comments in support of this view follow.

1 Current outcomes not contrary to existing policy – the need for change is not adequately addressed

In a number of instances, the Issues Paper comments that the matter being discussed achieves "a contrary to policy" result. This is said to justify a proposal to extend the current tax base.

In our view, such statements are inherently wrong.

1.1 The international tax review

Chapter 8 of the 2006 document *New Zealand's International Tax Review: A direction for change* raised the issue of "NRWT avoidance" structures. The document did not explicitly state the structures at issue. However, in our view, the same structures were being contemplated as are contemplated by the Issues Paper.

Submissions made on that document, including KPMG's, were that any changes should not proceed. The proposals were considered contrary to New Zealand's interests as they would increase the cost of capital. (Discussed in more detail below).

The result was that no changes arose from the 2006 consultative process.

1.2 Issue of rulings

Further, Inland Revenue has issued binding rulings to support the position taken by taxpayers. As Inland Revenue is aware, its own policy is to only issue a binding ruling when it considers that the avoidance provisions of the Act do not apply. As Inland Revenue applies section BG 1, whether Parliament contemplated an outcome or not, this is equivalent to Inland Revenue agreeing that the outcome is <u>not</u> contrary to policy.

1.3 Joint Savings and Investment Review

Inland Revenue refers to the Joint Savings and Investment Review as support for the taxation of non-resident direct investment. That Review modelled a corporate income tax rate reduction to determine whether such a reduction would assist with the Government's Business Growth agenda. The Review did not consider a "no taxation of non-resident direct investment" scenario and in our view does not support the statement made.

The Review did conclude that the modelled reduction would mean that New Zealand would lose more in tax revenue than it would gain from increased investment by non-residents. However, it is by no means clear from the published report that an increase in the tax rate for non-residents would enhance New Zealand's position (i.e. have the reverse effect to that concluded for a corporate income tax reduction). This does not appear to have been modelled.

Page 14 of Annex 2 to the Cabinet Report notes that the base model was amended to allow for debt as well as equity investment so that different tax treatments could be factored into the model. Although it would be reasonable to assume that current outcomes would have been modelled (as the outcomes were known to Officials at the time), it is not clear whether the current outcomes or the proposed outcomes were assumed. We note too that the proposals extend beyond foreign direct investment as they extend to situations where third party debt funding is at issue. Accordingly, it is difficult to make an even in principle assessment of whether the modelling supports the Issues Paper policy settings.

It would be logical to use the model to test the effect of the policy settings now being asserted in the Issues Paper. However, we note that the Report itself cautions that the model may not be robust.

> *Going forward there are a number of refinements we would seek to make in the longer term alongside additional testing work to increase our confidence in the internal workings of the model further. (Para 63, Annex 2)*

1.4 Justification for a significant policy change is absent but needed

In our view, the Issues Paper assertion that a result is contrary to policy is not justified. The result is that the Issues Paper fails to make the case or provide the evidence for what is in our view a significant policy change.

There are in our view a number of factors that support the current position that should be addressed. As we note above these factors do not apply to all scenarios and all the proposals. However, we consider it important that they be explicitly considered.

We firstly address New Zealand's capital needs.

2 New Zealand's export growth objective

The Government has an export growth objective of increasing the ratio of exports to GDP by 40% by 2025. KPMG has analysed NZ's capital needs (attached as Appendix 1) to meet that target. Assuming that New Zealand can itself meet capital growth requirements, there remains a significant capital gap. This will require foreign investment to fill that gap.

The base extension proposals for foreign direct investment and foreign funding are likely to compromise those goals.

3 Two key principles

3.1 Allocating taxing rights for the supply and use of capital

The key issue that needs to be addressed is the appropriate allocation of taxing rights for business profits between the country that is the supplier of capital ("supplier country") and the country that is the user of capital ("user country").

To illustrate, assuming that dividends are not deductible, and at the extreme:

- A 100% equity funded subsidiary allocates taxing rights in full to the user country and nothing to the supplier country;
- A subsidiary which is debt funded so that its taxable income after interest deductions is zero (it is assumed that it is possible to so structure the debt funding for this discussion), allocates taxing rights to:
  - the user country to the extent of tax on the interest expense (in New Zealand's case this is typically 10%); and
  - the remainder of the taxing right is allocated to the supplier country.

The thin capitalisation and transfer pricing rules provide limits on the ability to shift taxing rights between the user country and supplier country.

In short, the ability to deduct interest provides a proxy for allocating taxing rights between the supply and use of capital. (This point was made in a slightly different way in KPMG's 2007 submission on New Zealand's International Tax Review. A copy of the framework section of that submission is attached as Appendix 2).

New Zealand's current and proposed taxing rights for business profits (before interest deductions and assuming that the transfer pricing and thin capitalisation rules are complied with) of foreign direct investment is as follows:

Source and nature of funding to the extent that the business profits before interest are paid to the funder	Current rules – rate and economic bearer of the tax	Proposed rules
Resident lender	Full New Zealand tax borne by lender	No change
Non-resident associated funder by way of financial arrangement which is not money lent	0%	10% NRWT

Non-resident non-associated lender of money lent	2% borne by borrower	2% or 10% if associated under new rules (borne by borrower)
Non-resident associated lender resident in a DTA country	10% NRWT	10% NRWT with earlier payment if interest income does not match financial arrangement interest expenditure
Non-resident with NZ Branch	28% corporate income tax on the margin	2% AIL or 10% NRWT on gross if not connected to the NZ branch. No change if connected to the NZ branch
NZ resident with offshore branch	28% corporate income tax on the margin (after foreign tax credit, if any)	28% corporate income tax on the margin 2% AIL or 10% NRWT on the offshore branch funding cost
Equity	28%	28%

(Note that this summary does not cover debt funding by way of a branch to the extent it is not a means to make foreign direct investment.)

We accept that the Government is entitled to reconsider the balance of taxing rights between users and suppliers of capital. However, the proposals significantly shift those taxing rights and in our view this requires evidence that regard has been had to the factors which support the current allocation.

We note the critical question remains the deductibility of debt returns but not equity returns.

3.2 Who bears the tax?

The Issues Paper takes different and inconsistent views of whether a borrower or lender bears the tax.

For example, paragraph 2.10 refers to AIL being an effective 1.44% cost due to it being deductible to the borrower while paragraph 3.23 assumes that the lender will bear the tax ("In many cases, the borrower might take account of the payment of NRWT on NRFAI by reducing its next interest payment to the lender.")

We consider it important to take into account gross up requirements in lending arrangements. This assists with understanding who bears the tax as well as ways in which the tax is best collected.

3.2.1 AIL assumptions

The AIL regime is aimed at reducing the cost to the borrower as this reduces the gross up required from 10% to 2%. It proceeds on the basis that the borrower is required to gross up interest for withholding taxes.

This is a reasonable assumption for a financial institution which makes a margin on its lending. Tax at 10% of the gross interest is generally greater than corporate income tax on the margin. The financial institution would therefore have excess credits which it cannot use.

Some non-resident financial institutions will not require a gross up:

- to remain competitive with a domestic lender able to offer an interest rate which is less than the non-resident's grossed up interest rate; or
- if the financial institution's domestic tax rules allow it to otherwise use the foreign tax credit.

In either scenario, the objective of a lower cost of borrowing is met.

3.2.2 Associated persons assumptions

AIL does not apply in an associated person scenario. However, the interest rate is governed by the transfer pricing rules. The related party loan is benchmarked against third party loans (of similar terms and conditions). The benchmarked interest rate is applied to the related party loan.

The benchmark interest rate is not grossed up for AIL or NRWT. This is because the benchmark information does not extend to whether the comparable loans have a gross up requirement. This means that, in effect, either:

- a domestic lender; or
- a non-resident lender who does not require a gross up so as to meet the domestic lender's rate

is assumed. (It assumes there is not an alternative non-resident lender who might be prepared to take a lower, even if grossed up, interest rate).

This suggests that the associated person lender bears the cost of the NRWT. However, this tax liability is calculated in form as on interest. To the extent that studies show that taxes on foreign direct investment fall on domestic consumers and labour, the tax is borne domestically rather than by the non-resident. If the investor is locked into contracts or is unable to increase prices to consumers or lower payments to labour, the tax will be borne by the foreign direct investor.

3.2.3 Principles

We consider the principles that should be taken into account are:

- a non-resident non-associated lender will require a gross up provided the grossed up interest rate is less than a domestic competitor's rate. In either case, the borrower bears the cost as a cost of funds.

- a non-resident associated lender may bear the tax if a foreign direct investor is unable to alter consumer prices or the cost of labour. If that is not the case, the tax will ultimately be borne by domestic consumers and labour.

4 The key concerns

There are a number of areas of concern.

4.1 Cost of capital

The submissions on the 2006 Discussion Document highlighted the cost of capital to New Zealand as the main issue that supported the current policy settings.

In brief, as Inland Revenue will be aware, the cost of tax on funding is borne by the borrower. This is readily apparent in the Government's own decision to gross up interest on Government borrowing for AIL.

The cost of capital concern was apparently accepted by Government. As well as there being no change to the tax settings, the Double Tax Agreement ("DTA") policy has been to reduce NRWT while preserving AIL. (Note however that the DTA policy creates constraints on New Zealand's response to any valid concerns. AIL needs to be maintained when that might not be the best approach).

This impact affects not just export companies but all New Zealand borrowers to the extent that wholesale funding of the finance and banking sector is sourced from offshore.

There is nothing in the Issues Paper to allay the cost of capital concerns or to suggest that the current approach is incorrect.

On these grounds alone the proposals need to be reconsidered.

4.2 "Hollowing out"

We understand that the current policy settings address concerns about the "hollowing out" of NZ's banking system as current policy supports a New Zealand presence.

KPMG's analysis of the capital required to support the export growth goals show that New Zealand needs to grow significant companies. Their funding needs are best appreciated and serviced by those who understand their business.

The Issues Paper largely (but not wholly) means that whether or not a branch exists in New Zealand the same AIL cost will arise for a New Zealand corporate borrower. To the extent that this encourages non-resident lenders to service New Zealand from offshore, this is likely to lead to New Zealand business finding it more difficult to find funding rather than less.

We can see no evidence that this thinking has been factored into the Issue Paper's analysis or proposals.

5 Double taxation and Country Risk Premium

The BEPS concern is to prevent double non-taxation and to tax income where it is appropriately determined to be earned.

5.1 Double Taxation

5.1.1 Non-deductible interest

The proposals increase the prospect of double taxation. (The after foreign tax position is considered further below). This is because the proposals do not distinguish between deductible and non-deductible interest.

New Zealand's policy settings are for 28% corporate income tax to apply to business profits earned by a company. The proposals mean that New Zealand will tax non-deductible interest at an effective rate of 38% (28% as corporate income tax and 10% withholding tax on the gross interest). This is in excess of the appropriate tax to be borne in New Zealand. (We address the fungibility of funding in our detailed submissions below.)

5.1.2 The availability of foreign tax credits

We also note that the Issues Paper's discussion of foreign tax credits is limited and unsupported. It does not take into account significant investment by tax exempt investors. For these investors, additional New Zealand tax will be a final tax with no reduction in their foreign tax position.

For other investors, the cursory analysis provided in the Issues Paper provides little comfort.

The concern is that their home jurisdiction will not allow a foreign tax credit on income which is:

- not considered to be income; or
- for which the tax is paid significantly before the income is taxable in their home jurisdiction.

We note in particular New Zealand's approach to foreign tax credits. Excess credits are unable to be carried back or forward and nor are they are refundable. This would suggest that the outcomes argued for in the Issues Paper are unlikely.

The Issues Paper (at 3.34) suggests there is no timing element to the availability of credits in section LJ 2. In a recent letter to KPMG from Inland Revenue Policy & Strategy (dated 10 June 2015) responding to concerns regarding the availability of credits in respect of FDR income (formally paid as a capital gains tax, sometime after Fair Dividend Rate income arises), Inland Revenue advised:

> *As you note, in some cases there is a mismatch between the timing of the tax paid overseas and in New Zealand. This problem is part of the inherent nature of reconciling taxation on accrual and realisation. However, I note, if New Zealand is obliged to give a tax credit under one of its DTAs, the taxpayer can use the mutual agreement procedure (MAP) in the relevant DTA to seek relief.*

This confirms our view that a non-resident lender may find it difficult to access a foreign tax credit. This is particularly so as Inland Revenue suggests that the MAP would need to be used to confirm a credit.

We also note that at 3.11, Officials appear to be concerned that domestic law changes (in relation to applying NRWT on foreign exchange movements on foreign currency loans) may not be DTA compliant. This also confirms our concerns that tax credits will not be readily available.

We would expect Officials to have confirmed the position with our major trading partners to be in a position to categorically state that the relevant DTA will provide a foreign tax credit.

5.2 Sovereign change of law risk

The change in policy creates significant Sovereign change of law risk. The Issues Paper proposes changes to the definition of related party as well as to the definitions of interest and the timing of withholding tax. These changes interact and, from the proposed transitional measures, affect existing arrangements as well as past expenditure.

These retrospective impacts require a full and reasoned analysis of why the current policy settings are no longer appropriate. We can see no evidence of such an analysis.

This is particularly the case for the change from AIL to NRWT. This is a 500% increase in the New Zealand tax rate of non-residents. (To put this in context, this is the equivalent of increasing the company tax rate from 28% to 140%.)

A change of such magnitude requires and deserves much better justification than appears in the Issues Paper. Without such support, which we consider to be a minimum requirement, foreign investors will require a premium if they are to invest in New Zealand in the future.

6 Risks of departing from international consensus

6.1 DTA avoidance by New Zealand

The proposed means of addressing some of the concerns is to redefine interest. This highlights the foreign tax credit risk.

By redefining interest, Officials are seeking to have the relevant interest article apply to allow New Zealand taxation. This assumes the domestic definition of interest applies to the interest article. This is proposed so that DTAs, which would otherwise prevent New Zealand taxing the income amount, arguably do not prevent New Zealand tax applying.

This is part of a worrying trend by Governments and Revenue Authorities to circumvent agreed DTA positions by redefining tax imposts. We note that the UK Diverted Profits Tax was established as a separate tax to which the UK argues that its DTAs do not apply. Australia's Multi-National Avoidance proposals seek to amend its anti-avoidance rules so that its DTAs do not prevent it from taxing the targeted amounts.

These are potentially "bad faith" changes to domestic legislation as they alter the "bargain" to which each country has agreed. We understand that the US has made informal comments regarding the acceptability of such changes outside the BEPS consensus.

The direct risk that this creates is that a DTA counter-party will resist the application of the DTA in the way that Officials consider it will apply.

The further risk is that domestic amendments to circumvent a DTA affect the international consensus on what and how income should be taxed. The risk is compounded by the reality that countries do and will compete over tax. This includes imposing tax as well as extending tax incentives.

In a recent letter to the US Treasury, the chairs of the Senate Finance Committee and the House Ways and Means Committee stated:

> *Many of the OECD's BEPS project objectives are sound, and international cooperation – as well as competition – in tax policies is desirable.*

New Zealand (and others) seeking to unilaterally circumvent DTAs increases the risk of a reactive competition for tax. Our concern is that New Zealand is unlikely to be a winner in such a competition.

6.2 OECD BEPS project

Action 4 of the BEPS project is focused on interest deductions. The draft Action 4 discussion document proposes further limitations (compared to current New Zealand policy settings) through amendments to thin capitalisation rules. Unfortunately, the OECD proposed that this would be implemented in conjunction with the continued application of withholding taxes so that it does not address double taxation.

Although New Zealand has stated that BEPS related policy will follow the generic tax policy process, and the Issues Paper attempts to distance the proposals from the BEPS project, (i.e. it is stated to be consistent with the BEPS concerns but not the subject of the BEPS actions), our concern is that a combined implementation of the Action 4 recommendations and the Issues Paper proposals will increase the double taxation of foreign direct investment into New Zealand..

We acknowledge that the Issues Paper itself considers that the BEPS project may require changes to the proposals. In our view, proceeding with the proposals before fully considering the changes that might arise from Action 4 runs the risk of an incoherent policy solution.

6.3 In the best interests of New Zealand?

Our consistent view has been that implementing BEPS recommendations needs to be in New Zealand's best interests.

In the same letter quoted earlier, the Congressional Chairs also stated:

> *Congress will craft the tax rules that it believes work best for U.S. companies and the U.S. economy. We expect that as we move forward on U.S. tax reform, U.S. tax policy will not be constrained by any concessions to other nations in the BEPS project to which Congress has not agreed.*

This is a clear statement that at least some in the US tax system consider that tax policy should be in the best interests of their country. It raises the prospect that the BEPS project will not be universally accepted or implemented. The interest limitation proposals, amongst other matters, are singled out in the letter.

There are, in our view, risks to New Zealand from proceeding with the proposals without having regard to the full BEPS recommendations and the response of other countries.

Part 2 – Comment on the specific proposals

In this part we consider the specific proposals in the Issues Paper. We have attached as Appendix 3 illustrations of the proposals.

It is difficult to provide an overall coherent submission as there are a number of dependencies including retrospective application. However, without repeating the concerns covered in Part 1, our detailed comments on the Issues Paper lead us to the following submissions.

Summary of submissions on the specific proposals

Chapter 3

Funding from non-resident associated persons which is in form debt or debt like can validly be taxed on an accrual basis to match the resident's financial arrangement income.

- This appears to us to be best done by way of an "as agent" regime which should apply to all associated non-resident passive income.
- Inland Revenue should confirm with our major trading partners that this will not cause concern for the availability of foreign tax credits and it should ensure that it has an acceptable and efficient means for confirming that New Zealand tax has been properly paid.
- This would remove the need for wash up and threshold rules as only one set of rules would apply.

Interest arising from a financial arrangement which is not a conventional financing instrument (for example a deferred property agreement) should not be treated as NRFAI. The risk that such income would not be treated as interest income by our treaty partners is too great.

The new rules should only apply to new financial arrangements or, if that is not accepted, they should not attempt a catch up for prior year financial arrangements interest.

Chapter 4

Back-to-back loans and multi-party arrangement changes should only proceed for new financial arrangements or, if that is not accepted, only to income arising after enactment.

The acting together proposal should not proceed or, if that is not accepted, it should only apply where there is debt in proportion to shareholding and a group of non-residents hold more than 50% of the payer.

Chapter 5

The limitation of AIL is unwarranted. The concerns can be addressed through Inland Revenue exercising the current onus of proof on the payer to show they are unrelated to the lender.

If that is not accepted, the parties who can access AIL should be expanded to include a variety of financing and also a variety of financiers.

A review of the AIL regime, which includes associated persons in the rules and clear rules for custodians, is required. Consideration should be given to making AIL an income tax.

Clarifying registration and reporting requirements would be useful but care needs to be taken with imposing reporting requirements on the Crown (for no benefit) and on others to ensure that multiple and/or inconsistent obligations are not imposed.

Chapter 6

We repeat our cost of funds to New Zealand concerns.

Apart from those concerns:

- The limitation of the offshore branch exemption will create potential double tax problems if AIL or NRWT is not attributable to the branch. It may not be effective for countries where the relevant DTA has an interest source rule which sources interest where a permanent establishment is located. We consider that applying AIL to such interest would be considered DTA avoidance.
- The limitation of the onshore branch exemption may reduce the incentive to have a New Zealand presence for foreign banks.

The branch proposals should therefore be reconsidered.

The analysis which supports a related party bank margin AIL regime, which we support, also supports a related party financing entity AIL regime. This would however require the financing entity to show that it is financed by unrelated parties.

The following sections elaborate on these key points as well as making other submissions.

7 Chapter 3 – Broadening the definition for associated persons

Chapter 3 proposes rules to address perceived concerns regarding the definition of interest and the timing of interest income for the purposes of the NRWT rules where the parties are associated.

7.1 Arrangements at issue

7.1.1 Providing funds

We understand that it is intended that only financial arrangements which provide funds will be subject to the new rules. We assume that this means that the same arrangements which are classified as debt for the thin capitalisation rules will be subject to the new rules.

7.1.2 Commercial non-loan transactions

New Zealand re-characterises a number of arrangements as the sale of goods with loan funding. This is not the case in all countries.

New Zealand will therefore be seeking to tax as interest amounts what may be seen as a receipt for the sale of goods. Despite the Issues Paper's confidence that the foreign jurisdiction will respect New Zealand's re-characterisation to allow a foreign tax credit, we consider there are technical and practical hurdles that should be taken into account before the rules are extended as proposed.

The technical hurdle is discussed above. A DTA counter-party will be motivated to argue that the amount is not in relation to a debt instrument despite the proposed deeming rule. In our view, Officials should confirm that DTA counter-parties will accept the proposed deeming rule.

Notwithstanding any agreement, our experience is that foreign jurisdictions are much more bureaucratic in testing that a foreign tax credit is available. (See also the quote on New Zealand's own position at 5.1 for timing mismatches).

Officials should be ensuring that Inland Revenue has a simple and well known process for confirming that the New Zealand tax is properly collected so that a foreign tax credit is readily available.

7.1.3 Non-deductible interest

As we have noted above, denying a deduction and imposing withholding tax will double tax the income. The thin capitalisation rules effectively treat the related party financial arrangement as equity. Equity distributions can be fully imputed with effectively no withholding tax, the same result should apply to interest which is non-deductible.

We note the view that debt and interest is fungible so that the interest which is actually denied cannot be determined. However, it is most likely that related party debt is the marginal debt as it

is most easily controlled by a foreign direct investor and would be typically sub-ordinated to third party debt. It is logical that it is this interest which is treated as the non-deductible interest which is not taxable in New Zealand and to which NRWT does not apply.

We also note that our experience is that the thin capitalisation safe harbour ratio breaches are due to the impact of commercial factors on a company's assets. This means there is more likely to be a loss than a profit to tax. In short, there should be no BEPS concerns as interest deductions will not be effective in transferring profits.

7.2 The method of collecting the tax – an income tax as agent regime

The proposal to collect NRWT from NRFAI suffers from the difficulty of requiring a deduction where there is no cashflow. Further, whether NRWT applies under the current rules or under the proposed rules, will require calculations to determine whether relevant thresholds apply or not.

We consider that an "as agent" income tax approach may assist with compliance and funding of the tax.

Our proposal is modelled on the general insurance as agent regime where a payer of an insurance premium files a tax return for the deemed income of the non-resident insurer and pays the tax accordingly. The deemed income is 10% of the premium taxed at the corporate tax rate which currently equates to a final tax of 2.8% of the premium.

In outline, NRPI and NRFAI derived by an associated person would be taxed as scheduler income through an income tax return filed by the "payer" of the income. This would assist with compliance as the payer would have to perform the financial arrangement calculations for their own income tax return. This would make it easier to ensure that the interest expense and the interest income matches.

It would also allow all NRPI to be included in the single return. This would eliminate the need for rules differentiating between withholding tax on interest and NRFAI and to prevent double taxation of income as NRFAI and NRPI.

We would expect a relevant DTA to be able to be applied so that the income tax so payable complies with the DTA limitations. In other words, the corporate income tax for an associated person resident in a country with a 10% limitation, would be able to be limited to 10% of the gross NRPI through the tax return. Inland Revenue's current systems may require either:

- a deemed income provision; or
- income tax return completion instructions which treat as taxable income the allowable DTA tax grossed up at 28%

for this to be achieved.

We acknowledge that this approach has potentially two disadvantages:

- NRWT currently collected in the month following payment of interest may be deferred; and

- The income tax rate will reduce from a potential 30% to 28% for interest paid to associated parties not resident in a DTA country.

We do not have the detail to assess these disadvantages but:

- We expect that very little tax is collected at the 30% tax rate; and
- The proposal will bring forward income and tax payments which will offset any deferral. The possibility of including the liability within the provisional tax system could also be explored so that the benefit of the reduction in tax for the payer is matched at the same time by the tax for the payee.

7.3 Transitional rule

The transitional rule, to include all NRFAI as withholding income, should not proceed. The rule, if it does proceed, should only apply to NRFAI which arises after the date of enactment.

7.4 Acting in concert

We make detailed comments in subsequent sections. However, we note that this proposed change will significantly increase the tax liability of such a counter-party.

At a minimum, the proposal to apply NRFAI to these counter-parties should only apply to financial arrangements entered into after enactment.

7.5 For the record…

We note for the record the irony of Inland Revenue using an Optional Convertible Note ("OCN") as an example of a mismatch between the financial arrangement interest expense and the NRPI rules.

Inland Revenue argued that this difference was not an outcome contemplated by Parliament to successfully argue that section BG 1 applied. The use of an OCN as an example in the Issues Paper instead confirms taxpayers' arguments that the difference was intended and contemplated.

7.6 Other comments

At 3.14 and elsewhere, there is a reference to a yield to maturity or expected value method being used to calculate NRFAI. From a compliance perspective, it would seem to make sense that the payer's method is used.

The deemed payment date is the balance date of the payer. NRWT would be payable the 20th of the following month. This may not match the timing of the calculations by the payer for financial reporting purposes. Our as agent proposal addresses this. Otherwise, consideration should be given to a later deemed payment date.

Example 2 assumes an instrument issued on the first day of the year where it appears somewhat easier to calculate whether the threshold applies or not. Treating all associated person interest as NRFAI (and not NRPI) subject to an as agent filing would eliminate the need for thresholds and for wash up calculations.

3.23 asserts that adjustments to cash payments can be readily made "since the parties will by definition be related". This does not take into account:

- the transfer pricing rules which are based on existing terms and conditions of the loan. Officials appear to be making an assumption, contrary to the transfer pricing requirements that the loan is arms-length and that the parties can simply amend the terms. However, we note that a change of law risk in an arms-length scenario would normally be assumed by the borrower and a gross up would be required.
- the extended definition proposed elsewhere in the Issues Paper. Given that this extension can apply where one shareholder but not another is a lender, the problem will need to be dealt with under the contractual arrangements rather than by way of a ready adjustment between the parties.

These factors need to be taken into account if the proposal is to proceed.

At 3.41, the Issues Paper notes that a wash up calculation will not be required for NRFAI which is not NRPI. At 3.42 it states that prepayments will need to be dealt with. It is not clear how the situation which gives Officials concern would arise. We understand that the instruments at issue would not be money lent so there are likely to be fixed contractual terms which are unlikely to allow or contemplate earlier payments. We also note that, unlike actual interest, a prepayment is unlikely to shift all of the financial arrangement income to a pre-enactment period unless the arrangement was terminated. In that case, it would be likely replaced by an actual loan giving rise to NRPI. This may obviate the need for what appears to be complex rules.

8 Chapter 4 – Related persons

8.1 Back-to-back loans

We consider the proposals are acceptable in principle. However, consideration should be given to:

- cash sweep arrangements; and
- interest "offset" arrangements

for accounts held by a wholly-owned group, which appear to be within the broad description of the proposed rule. As these reduce the effective funding, they should not be included.

We assume that the rule will rely on self-assessment but that this in turn will require some connection between the offshore funding and the New Zealand borrowing. Otherwise, it will be difficult to apply the proposed rules.

We also note that it is not clear how the proposed rule would apply if the back-to-back loan was with a New Zealand resident. The examples address the multi-party scenarios and appear to imply that a New Zealand resident (or within the tax base) party would mean that no NRWT is payable. We assume that this is because a New Zealand taxed entity would be taxed on their margin while having to deduct AIL/NRWT as appropriate.

8.2 Multi-party arrangement

The multi-party arrangements appear to have the economic effect described.

However, the proposals should only have post-enactment effect:

- Our preferred approach is an arrangement entered into after enactment date; or
- Deemed interest income which arises after enactment date. (The interaction with Chapter 3 proposals is unclear in this regard.)

8.3 Acting together

Consistent with our general comments, we consider that the proposal to extend associated persons to those that are deemed to act together creates significant Sovereign risk in its application to existing arrangements.

To the extent that a change is justified, an extended definition of associated person should be limited to:

- Where the debt is in proportion to shareholding; <u>and</u>
- Non-residents hold more than 50% of the interest in the New Zealand paying entity.

8.4 Other comments

Paragraphs 4.1 and 4.2 and 5.2 proceed on the basis that AIL cannot be deducted on interest paid to an associated person. We note that this is not technically correct. The associated person cannot benefit from the 0% NRWT rate provided by section RF 12. However, as the AIL rules are drafted, there is no apparent limitation on AIL being levied on interest paid to an associated person. (This is not the case for registered securities which qualify for the 0% rate under section 86IB of the Stamp and Cheque Duties Act 1971).

We make a further submission on the AIL rules in the following section to address this potential anomaly.

9 Chapter 5 – Eligibility for AIL

The Issues Paper proposes two types of changes to the AIL rules – to reform the compliance obligations and to further restrict access to AIL.

9.1 General review of AIL provisions required

A review of the AIL provisions (for matters which are not included in the Issues Paper) is required. We consider that AIL is not well integrated with the NRWT rules. The matters that should be considered include:

1. An associated persons prohibition should be included in the AIL provisions so that the prohibition is clear within the AIL rules. This would allow:
   - Relevant provisions of the Tax Administration Act to apply where AIL was incorrectly applied to an associated person as the self-assessment and other regimes would apply to require testing of association by an AIL payer.
   - Further rationalisation of the rules, for example, an issuer could be registered rather than registering specific securities. The current requirement can lead to confusion and omissions.
   - AIL registered persons to be able to make clear statements regarding registration and the payment (or not) of AIL on particular interest payments.
2. The ability of a borrower to rely on a custodian's representations to pay AIL and for a custodian to rely on representations by clients should be confirmed.
   - Currently, many borrowers' registered securities are held by custodians. Clear rules on the ability to treat particular holdings and investors as subject to AIL or not would be helpful. This would also allow rationalisation of agency rules across NRWT and other RWT rules to occur.
3. The treatment of AIL as a duty/levy rather than a creditable income tax.
   - AIL, as a duty, is typically treated as a deductible expense rather than a creditable tax. Where the non-resident lender bears this cost (refer our earlier analysis regarding competition with domestic lenders), the lack of a credit means that AIL directly reduces their margin.
   - To address this the AIL regime could be made part of the Income Tax Act so that it becomes an income tax.
   - However, we assume that the acceptance of AIL by our treaty partners is based on it being a non-creditable levy and we accept that such a change should not be made unilaterally (consistent with our comments above).

9.2 Reform proposals – registration and reporting

9.2.1 General comments

We agree that registration and return requirements should be reformed. This will assist taxpayers with ensuring that AIL obligations are met and are shown to be met.

9.2.2 Integration of AIL reporting with other regimes

We also consider it sensible to have reporting requirements for a payer of AIL but to delay this, presumably, until after the Business Transformation reform of Inland Revenue's systems.

However, we note that the reporting requirements are likely to overlap with Automatic Exchange of Information ("AEOI") and FATCA reporting requirements. Consideration should be given to integrating an interest payer's reporting obligations for NRWT/AIL/FATCA/AEOI so that reporting is not duplicated. In other words the AIL reporting requirement should not be separate or in addition to other reporting. The opportunity to rationalise reporting and return requirements across these regimes should also be taken.

9.2.3 Crown reporting

The Crown, as a payer of interest on Government bonds which is grossed up for AIL, is a significant payer of AIL. It would have reporting obligations in the future. The Crown will have a cost when the risk of AIL being incorrectly paid, because the parties are associated, is nil.

Further, to the extent that a non-resident's interest is held by a custodian, the Crown will not have details of the investor. These details will be held by the custodian but the custodian does not actually receive the AIL to pay to Inland Revenue. It is paid direct. This means that the custodian would be reporting a "deemed recipient" of AIL, paid on the recipient's behalf. The custodian will not have full information and will incur costs to fulfil its proposed reporting obligations.

In our view:

- Consideration could be given to excluding Crown debt from the reporting rules as the risk of an associated party lending to the Crown is nil. This would remove the cost of reporting AIL recipients. (We note that this would not remove a custodian's obligations under either FATCA or AEOI.)
- Alternatively, consideration should be given to the assumptions that a custodian is entitled to make when reporting. Those assumptions should be made explicit.

9.3 Proposals to broaden the base by restricting access to AIL

We have commented extensively on the effect of the base broadening proposals on NZ's cost of capital and country risk premium. In our view these support our view that the proposals should not proceed.

9.3.1 Inland Revenue confirming non-association

We understand that the proposals are the result of concerns regarding the ability of Inland Revenue to confirm that a lender and borrower are not associated. We consider the proposals to restrict AIL to financial institutions (banks) and to securities offered to ten or more persons is unduly blunt. The proposals will affect clearly unrelated parties.

Further, the ten or more person requirement will add to the cost of raising funds. A borrower will incur costs in order to offer the security to ten or more persons, to qualify for AIL, when an unrelated funder is prepared to fully provide the funding that is required.

9.3.2 Proving non-association

We note that the onus of proof is on the taxpayer. In scenarios where Inland Revenue might have a concern, it can simply ask taxpayers to prove non-association.

Although it may be difficult for a taxpayer to prove a negative (that they are not associated), we would expect the parties to be motivated to prove non-association to access AIL. For New Zealand borrowers this is particularly the case where there is a gross up requirement.

If there is a gross up, the non-resident may be less motivated. A borrower's response is likely to be to request representations that the lender is not associated and to provide proof where required. However, this can only be done prospectively.

We also note that the prohibition on associated persons is in our view only implied. The penalty for paying AIL to an associate is that NRWT continues to apply, not that AIL has been incorrectly applied. Our suggestion that the associated person prohibition should be included in the AIL rules would in our view assist with making it clear that AIL cannot be applied and that the onus of proof is with the payer of AIL.

9.3.3 When non-association can be presumed

In the alternative, there are a number of lenders and types of funding which can be reasonably excluded from the proposed 10 or more non-associated lenders rule for accessing AIL. This can be achieved by deeming the lenders to be financial institutions or by deeming certain arrangements not to be subject to the rule. We note especially that New Zealand's tax rules already re-characterise commercial transactions as loans and the proposals at chapter 3 propose to extend this further.

9.3.3.1 Non-bank financial institutions

Not all financing is provided by banks. Financial institutions should be widely defined to include, for example:

- Insurance companies;
- Lessors;

- Distressed asset funds;
- Corporate bond funds;
- Private Equity funds;
- Sovereign wealth and pension funds

which provide debt but not equity funding to the borrower.

This will assist with preserving AIL where the borrowing is placed privately rather than widely offered.

9.3.3.2 *Distressed debt funds*

Financing can also be provided to a distressed borrower by special purpose funds. If these borrowers do not have access to AIL, a distressed borrower will be faced with an increase in their grossed up liability as they will bear an NRWT rather than an AIL cost.

We note that it is highly unlikely that a foreign direct investor would advance funds to a company and then have the company become a distressed borrower to take advantage of an AIL rather than an NRWT rate on the interest.

9.3.3.3 *Suppliers*

A supplier (for example a construction or manufacturing company) may be prepared to provide financing to make the sale. Further, the funding can be provided through the contract for goods and services. These funders should also be treated as financial institutions.

9.3.3.4 *Listed entities and their subsidiaries*

Listed entities, and their subsidiaries, can through publicly available information be confirmed (or not) as non-associated parties. These funders should not be treated as disqualified for AIL.

9.3.3.5 *Where a lender is not a substantial security holder in a listed borrower*

Where the New Zealand borrower is a listed entity, the debt instrument should be automatically eligible for AIL, provided the lender, or an entity associated with the lender, has not disclosed a substantial product holding in the listed issuer as defined by the Financial Markets Conduct Act 2013.

A person has a substantial product holding in a listed issuer if the person has an interest of 5% or more of a class of quoted voting products in a listed issuer. The FMCA requires that a substantial product holding in a listed issuer is disclosed. Therefore, if a lender, or an entity that is associated with the lender, has not disclosed a substantial product holding in the listed entity then, by implication, they must have a voting interest in the listed entity of less than 5% and therefore will

not be associated with the borrower. On this basis it is appropriate for AIL to automatically be available in these circumstances.

10 Chapter 6 – Branches

10.1 Cost of funding for New Zealand - Bank branches

The concern regarding the cost of capital to NZ for the proposals, as they affect banks, are significant. There is no assessment of this impact (or if such work has been carried out this has not been publicly disclosed). The proposal should not proceed until that analysis is done (and/or disclosure is made) and the impact is shown to be immaterial. In particular, any analysis should not simply assume that the current low interest rate environment will persist. A sensitivity analysis is required.

10.2 New Zealand resident offshore branch exemption

The Issues Paper proposes that this exemption would be removed and AIL or NRWT applied to interest paid by the offshore branch. The Issues Paper proposes the rules will apply:

- To new financial arrangements entered into after enactment date; and
- To existing arrangements:
  - For New Zealand Banking Group branches, from five years after enactment;
  - For others, for interest paid after enactment.

In other words, the proposed rule will apply on enactment to all financial arrangements except those entered into by Bank Branches. The rule will apply to Banks from 5 years after enactment.

10.2.1 Available deductions to the offshore branch

The Issues Paper does not consider the position of the offshore branch with respect to foreign tax.

It is not clear that the foreign jurisdiction would allow the foreign branch a deduction for either AIL or NRWT paid by the foreign branch on interest paid to its or other countries' residents. This additional tax expense could be seen to be attributable to its New Zealand and not foreign branch business. This could lead to over-taxation.

10.2.2 Double Taxation Agreement impact

We have not reviewed every DTA but a standard term is that interest is sourced, for the purposes of the DTA, where a permanent establishment is located for the purposes of the interest article.

It is therefore likely that a relevant DTA would override any amendment to make interest paid by an offshore branch subject to New Zealand income tax.

10.3 Foreign company NZ branch onshore exemption

The proposal potentially has some administrative advantages as the primary liability to account for the tax will be on the borrower. However, this advantage is a contingent one for the lender and may be more theoretical than real. It relies on the borrower registering, which is more likely for a corporate borrower than an individual. A failure by the borrower to deduct and account for NRWT or AIL would mean the non-resident still has an obligation to meet the liability.

The proposal is likely to increase the tax cost (as the cost is greater than income tax on the margin) so as to increase the cost of funding.

This proposal may also increase the incentive for non-residents to provide funding from offshore rather than from a NZ branch.

These factors should be explicitly addressed before proceeding.

10.4 Foreign company offshore branch exemption

The Issues Paper does not explicitly address foreign companies with New Zealand branches which are funded from an offshore branch. Paragraph 6.30 implies a similar proposal to that which would apply for a New Zealand resident's offshore branch.

Such a proposal would suffer from the same difficulties as the proposal for New Zealand resident's offshore branches. It:

- Would increase the cost of capital;
- Potentially lead to over-taxation as a deduction is denied in the foreign jurisdiction; and
- May not be effective as DTAs would prevent New Zealand NRWT applying.

We also note that this proposal may make payers with small withholding liabilities obliged to register and pay NRWT or AIL. This is because the $500 threshold does not apply if the payer of interest has a certificate of exemption. In some cases, a New Zealand company will have funds in a current account on which interest will be received. If that account is overdrawn, interest is payable by the New Zealand company. As they will likely have a certificate of exemption, they will be required to deduct NRWT or AIL for what are usually small amounts.

10.5 Related party margin funding

10.5.1 Related party bank funding

The Issues Paper proposes that funding from a related party bank should be able to access AIL. The Issues Paper states that a related bank is a margin lender. It is in effect a conduit for third party borrowing. This supports the application of AIL to such funding. We agree.

10.5.2 Extending AIL to related treasury company funding

For commercial reasons, companies may find that third party borrowing is constrained. The lender is not prepared to enter into multiple loans with individual subsidiaries. The lender lends to a single entity within the group. That entity, operating as a treasury function for the group, lends to individual subsidiaries. Such lending is in form related party lending which does not currently qualify for AIL.

In economic substance it is third party lending except for the margin that the treasury entity is obliged to make for transfer pricing reasons.

The same analysis as outlined in the Issues Paper extends to related party financing and treasury entities.

If these entities can show third party borrowing, they should be entitled to access AIL.

We note that paragraph 6.35 asserts that the proposal should be limited to banks due to their thin capitalisation rules. This is said to engender confidence regarding the lack of substituting related party debt for equity investment.

We note that there is an equally clear boundary for all other foreign controlled companies. It is the safe harbour ratio. That Officials are questioning the adequacy of the current safe harbour ratio, in the light of the BEPS project, is not justification for preventing non-bank margin funders from accessing AIL.

10.6 Other comments

Paragraph 6.10 is confusing. It proposes that AIL is paid if NRWT is not paid. This is the reverse of the normal approach to third party borrowing, NRWT is payable if AIL is not paid. This may be an attempt to address the DTA concerns raised above. If that is the case, the Issues Paper should be explicit and we note our comments at 6.1 outlining our concerns that New Zealand is seeking to avoid the effect of DTAs through unilateral domestic amendments. We further note that this seems to put at risk New Zealand's DTA policy that it will accept nil New Zealand income tax if AIL is paid.

Appendix 1: KPMG’s analysis of NZ’s capital needs

ROLE OF CAPITAL MARKETS

WHAT GOT US HERE

WON'T GET US THERE

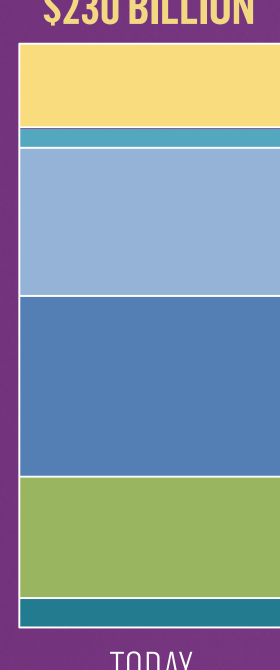
NEW ZEALAND NEEDS

OUR CAPITAL MARKETS TO ATTRACT $200bn OF NEW CAPITAL BY 2025 TO SUPPORT OUR EXPORT GROWTH TO IMPROVE OUR PROSPERITY

TODAY'S MIX OF BUSINESS CAPITAL

EXPORT SECTOR CAPITAL

TODAY



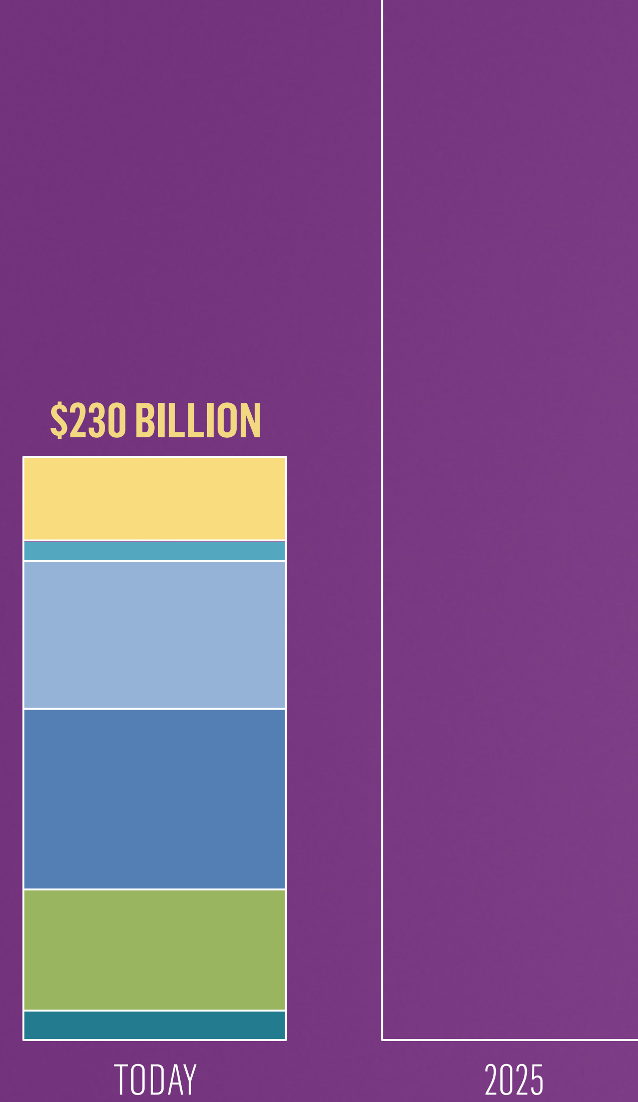
BANK FUNDING

HOUSEHOLDS

KIWISAVER

EXPORT CAPITAL

WHAT WE NEED – FILLING THE GAP



FOREIGN DIRECT INVESTMENT
NZ SUPERFUND AND ACC
BUSINESSES WORKING CAPITAL
BANK FUNDING
HOUSEHOLDS
KIWISAVER

MBIE BUSINESS GROWTH AGENDA SAYS WE'LL NEED

$420bn

BY 2025 TO SUPPORT EXPORT GROWTH

WHY DO WE NEED MORE CAPITAL?

LAND USE

INFRASTRUCTURE

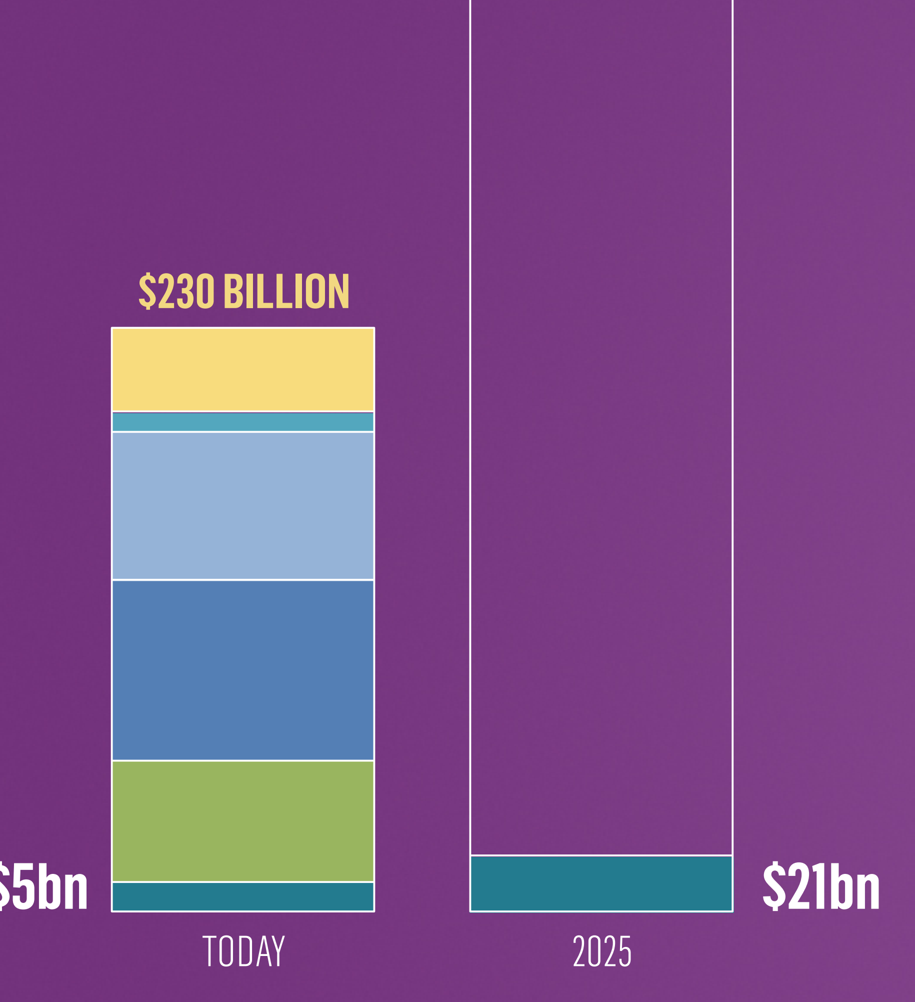
PP&E

TECHNOLOGY

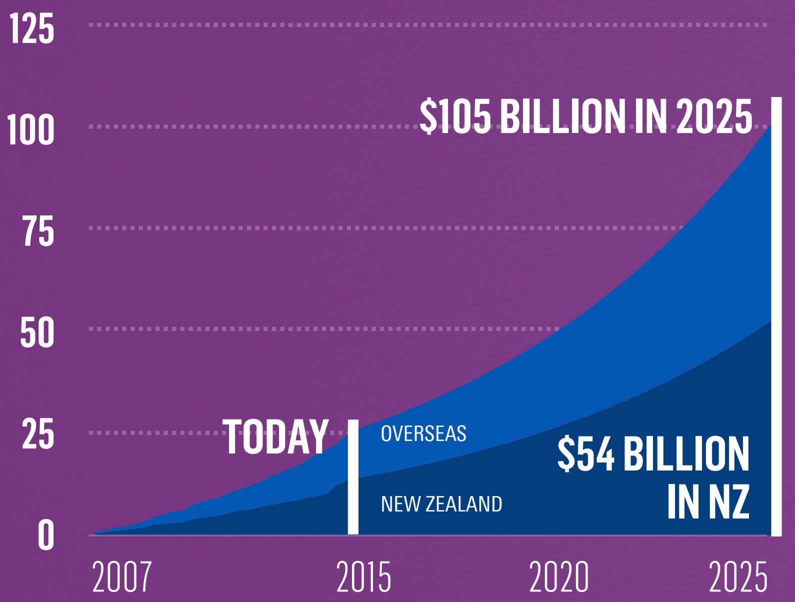
R&D

EXPORT CAPITAL

KIWISAVER

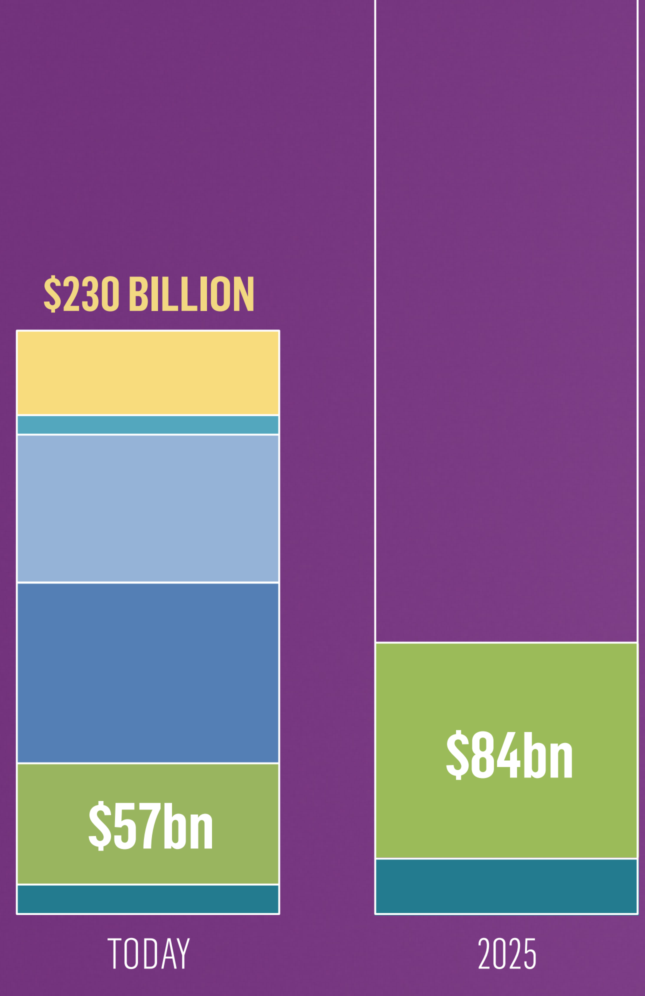


$21bn FROM KIWISAVER



EXPORT CAPITAL

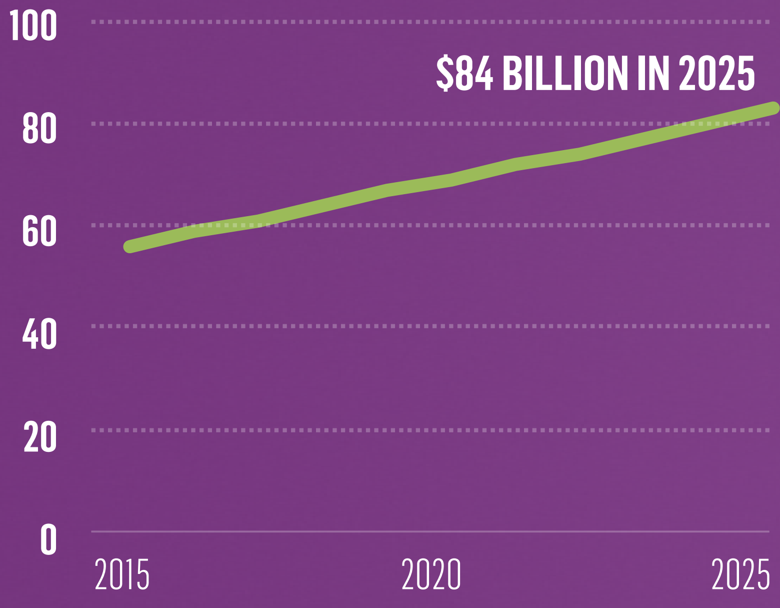
HOUSEHOLD EQUITY INVESTMENT



- FOREIGN DIRECT INVESTMENT
- NZ SUPERFUND AND ACC
- BUSINESSES WORKING CAPITAL
- BANK FUNDING
- HOUSEHOLDS
- KIWISAVER

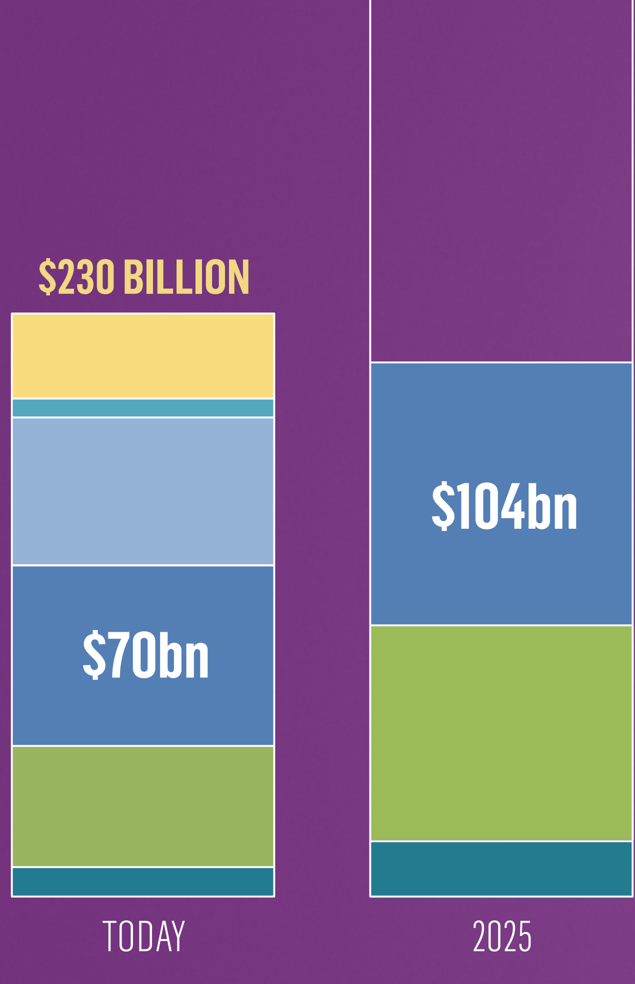
$84bn

FROM HOUSEHOLDS



EXPORT CAPITAL

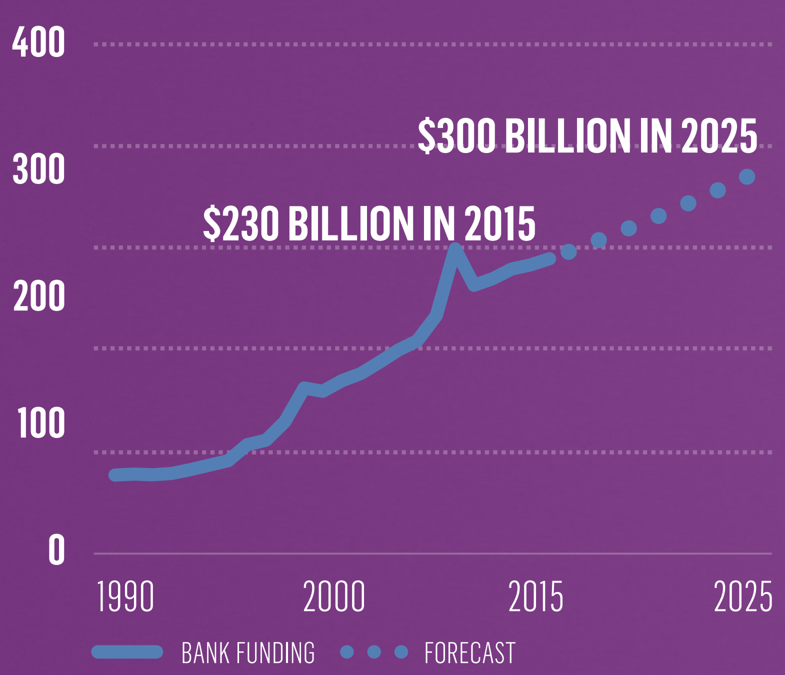
BANK FUNDING



- FOREIGN DIRECT INVESTMENT
- NZ SUPERFUND AND ACC
- BUSINESSES WORKING CAPITAL
- BANK FUNDING
- HOUSEHOLDS
- KIWISAVER

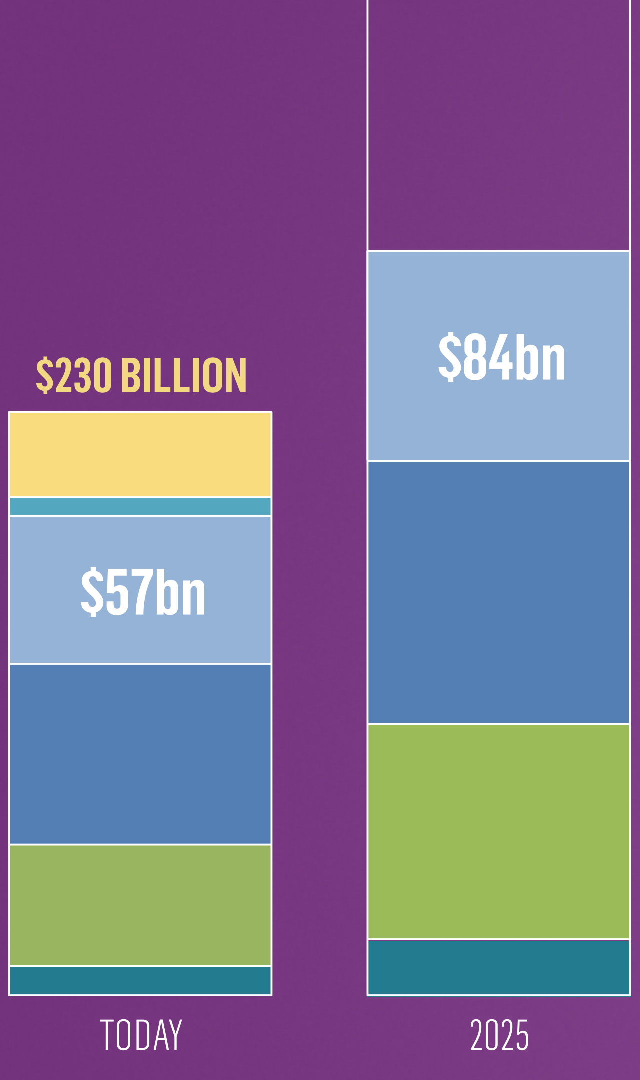
$104bn

FROM BANK FUNDING



EXPORT CAPITAL

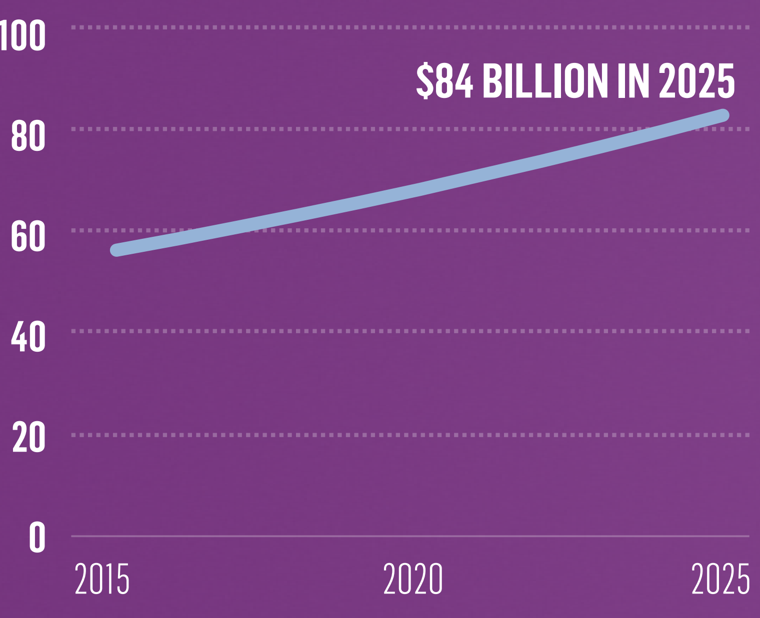
BUSINESSES WORKING CAPITAL



- FOREIGN DIRECT INVESTMENT
- NZ SUPERFUND AND ACC
- BUSINESSES WORKING CAPITAL
- BANK FUNDING
- HOUSEHOLDS
- KIWISAVER

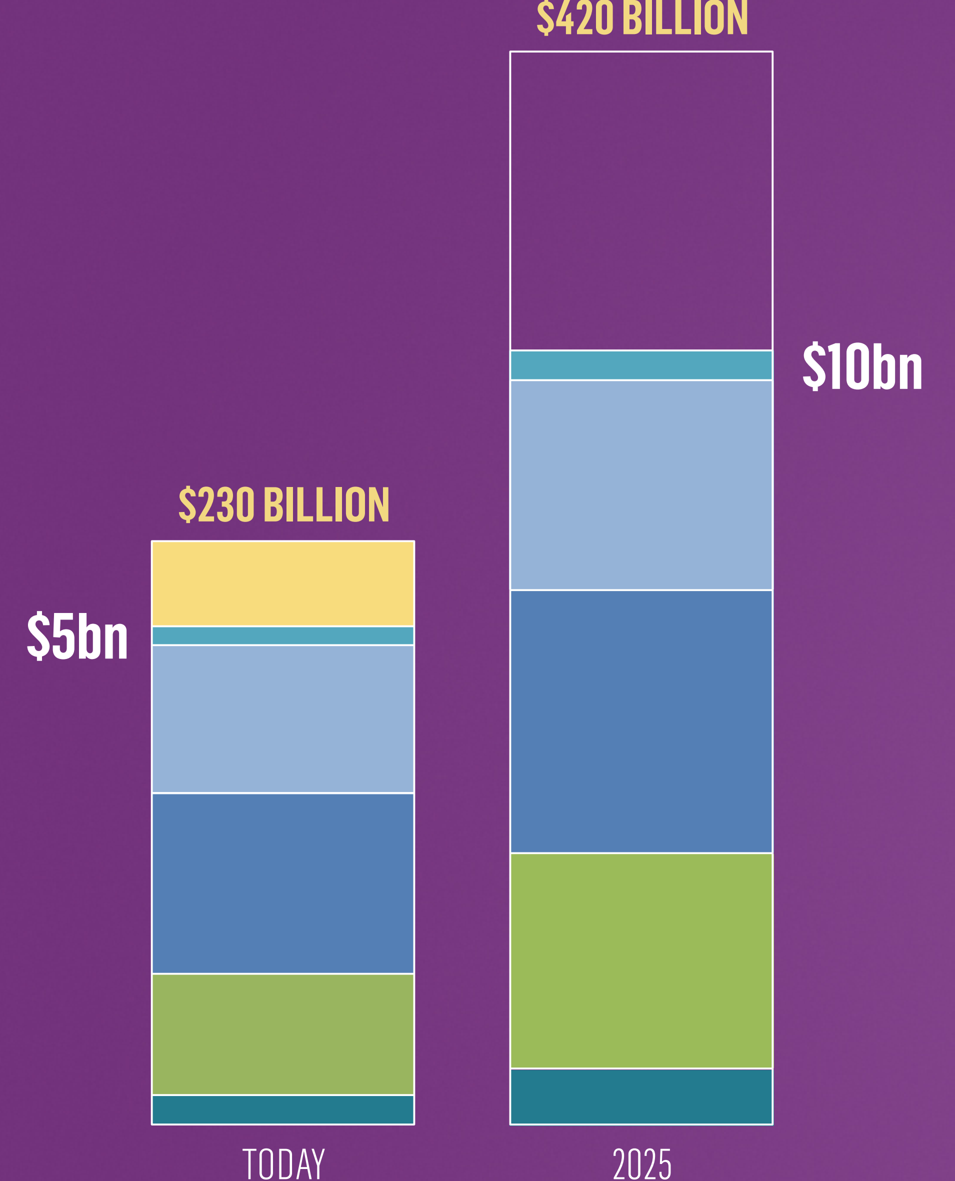
$84bn

FROM BUSINESSES WORKING CAPITAL



EXPORT CAPITAL

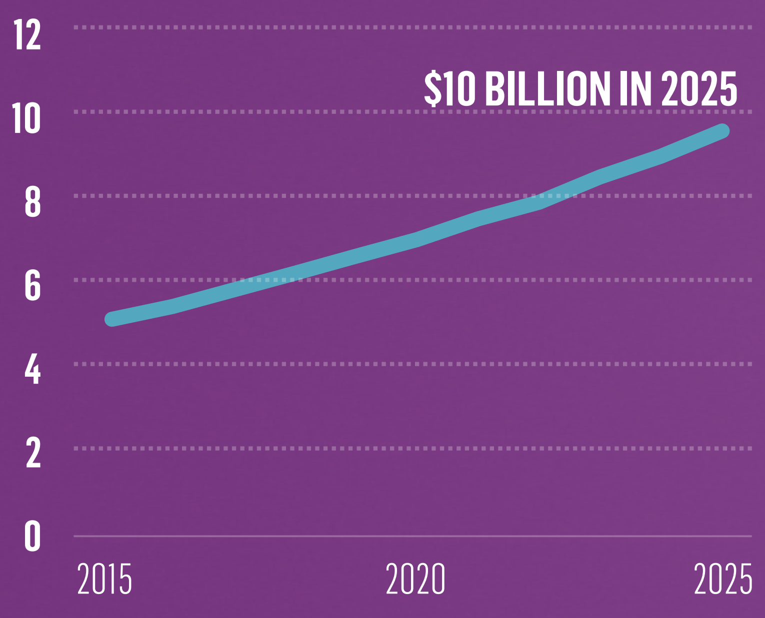
NZ SUPERFUND AND ACC



- FOREIGN DIRECT INVESTMENT
- NZ SUPERFUND AND ACC
- BUSINESSES WORKING CAPITAL
- BANK FUNDING
- HOUSEHOLDS
- KIWISAVER

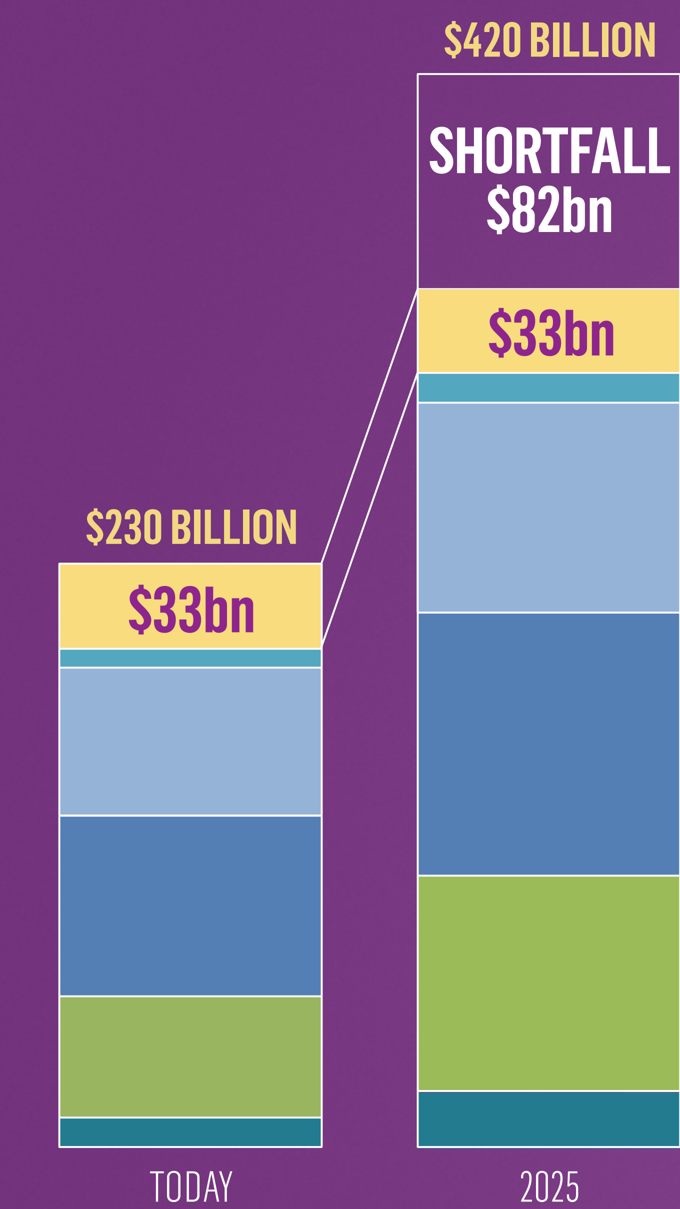
$10bn

FROM NZ SUPERFUND AND ACC



EXPORT CAPITAL

FOREIGN DIRECT INVESTMENT OR OTHER?



- FOREIGN DIRECT INVESTMENT
- NZ SUPERFUND AND ACC
- BUSINESSES WORKING CAPITAL
- BANK FUNDING
- HOUSEHOLDS
- KIWISAVER

EXPORT CAPITAL

FOREIGN DIRECT INVESTMENT OR OTHER?

- FOREIGN DIRECT INVESTMENT
- NZ SUPERFUND AND ACC
- BUSINESSES WORKING CAPITAL
- BANK FUNDING
- HOUSEHOLDS
- KIWISAVER

$230 BILLION

$33bn

TODAY

$420 BILLION

$115bn

2025

NZ WILL NEED OVER

$115bn

OF FOREIGN DIRECT INVESTMENT BY 2025

OVER $82bn WILL BE NEW FDI CAPITAL

HOW WILL WE ATTRACT OVER $80bn NEW FOREIGN DIRECT INVESTMENT?

- GET SCALE
- EASY PLACE TO DO BUSINESS
- BE TRANSPARENT AND OPEN
- APPROPRIATE BUSINESS RULES / COMPLIANCE
- LEVERAGE OUR BRAND 'NZ INC'
- WELCOMING FOREIGN PEOPLE AND THEIR FAMILIES
- COLLABORATION

Appendix 2: Extract from KPMG's 2007 submission on the International Tax Review

1 Framework

We consider there are two issues not included in the discussion document that need to be addressed in order to establish a framework for the international tax review. Such a framework would make it easier to determine the appropriate trade-offs.

The first issue is the role of New Zealand's imputation regime and the drivers that imposes, and the second is that the discussion document equates the tax base of a taxpayer with the New Zealand tax base.

1.1 Imputation regime

Considering the imputation regime means acknowledging the following propositions:

- New Zealand businesses will be motivated to pay tax in New Zealand.
- This will be unlikely to change with an active exemption.
- For owner-operated businesses particularly, the after New Zealand tax cost is important so they will be focused on the effect of foreign taxes.

Focusing on these issues means foreign tax paid should qualify for imputation credits. (Compare, for example, an individual who operates through a foreign branch with an individual who operates through a New Zealand company with a foreign branch). We understand that such a change is likely to be fiscally costly, but having the right policy framework makes it easier to measure the necessary trade-offs.

Explicit consideration of the imputation regime, and therefore of the effect of deferral and the timing of taxing points for foreign direct investment, is critical to developing good tax policy for outbound investment.

1.2 New Zealand source and tax base

Underlying the base protection measures is the view that New Zealand sourced income must be taxed. That is consistent with the general approach. However, the critical issue is how New Zealand sourced income should be measured; both in terms of the base and at what level.

The discussion document focuses on measuring the base at the taxpayer level. This means that the New Zealand tax base may be overtaxed as a result of the proposals.

For example, if a company borrows from its trust shareholder and the proposed thin capitalisation rules apply, the company will have non-deductible interest while the trust will have assessable interest. This clearly overtaxes the New Zealand tax base.

The focus should be on protecting the New Zealand tax base not on protecting the tax base of a single taxpayer.

This means it is critical to have a clear view of what is New Zealand sourced income.

The assumption is that interest paid to a non-resident is New Zealand sourced and the gross interest should be subject to tax. That assumption does not always hold.

For a foreign direct investor, debt is used because equity investments do not generate a deduction against the New Zealand tax base. Traditionally, this is taken as a signal the income is New Zealand sourced as New Zealand business profits.

Equally, the interest expense could be taken as a signal that the capital and equity risk is taken not in New Zealand but offshore. This means that denying an interest deduction overtaxes the New Zealand tax base because New Zealand profits are overstated. (Compare, for example the approach taken to branch profits of a bank where the intra-branch lending is not treated as New Zealand sourced because the risk is offshore).

The problem then is not that New Zealand's tax base is understated but that it is overstated. This is due to the lack of a deduction for equity risk taken offshore by an FDI investor.

Consideration of what is New Zealand's tax base and its measurement is required to properly direct the policy choice and trade off.

1.2.1 Underlying assumption

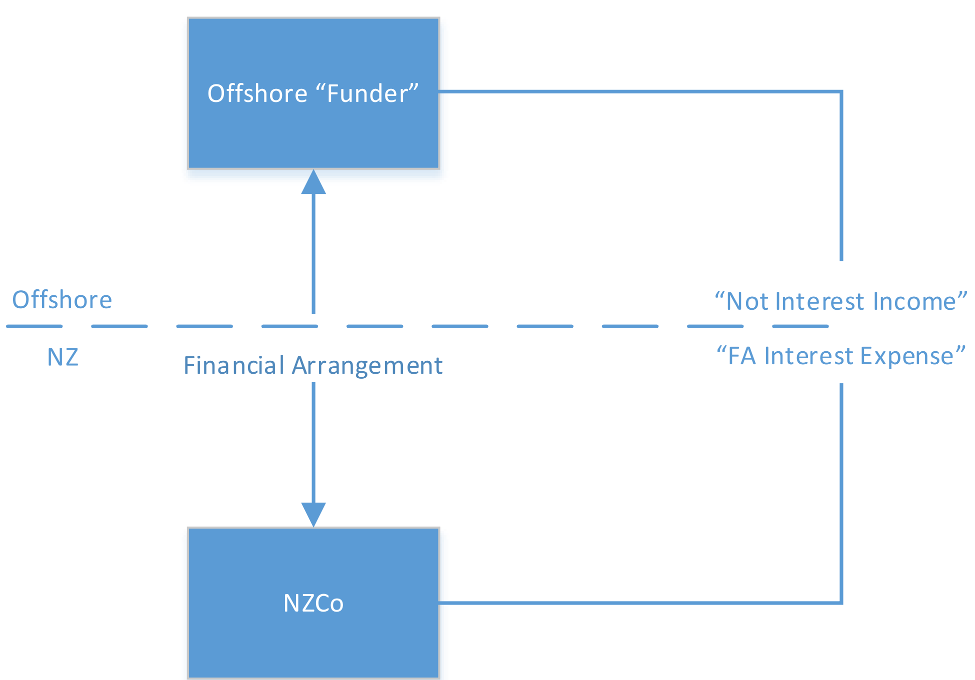
The discussion document assumes that it is easy to gear the New Zealand tax base to eliminate the base. ($100 of profit can be eliminated by making an FDI investment which produces $100 of profit to match the $100 of interest expense). The reality is quite different.

An investment in an active business will bring with it risks. There is no simple equation which predictably shows that a certain level of gearing and interest expense will produce a certain level of profit in an active business.

We consider the comments in the 2001 McLeod Tax Review on the effective tax rate for non-residents are potentially misleading. Although we accept there are lessons to be learnt from Inland Revenue's banking project, the policy solutions generated do not apply widely.

Appendix 3: Illustrations of the NRWT and AIL proposals

Chapter 3 – Redefining Interest



Financial Arrangements

- Zero-coupon bond
- OCN/MCN
- Deferred property
- Leases

Current	Proposed
No NRWT/AIL or "delayed" NRWT /AIL	NRWT/AIL on "Not Interest Income" as interest expense incurred

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Chapter 4 – Back-to-back and split funding

- NRWT payable rather than AIL

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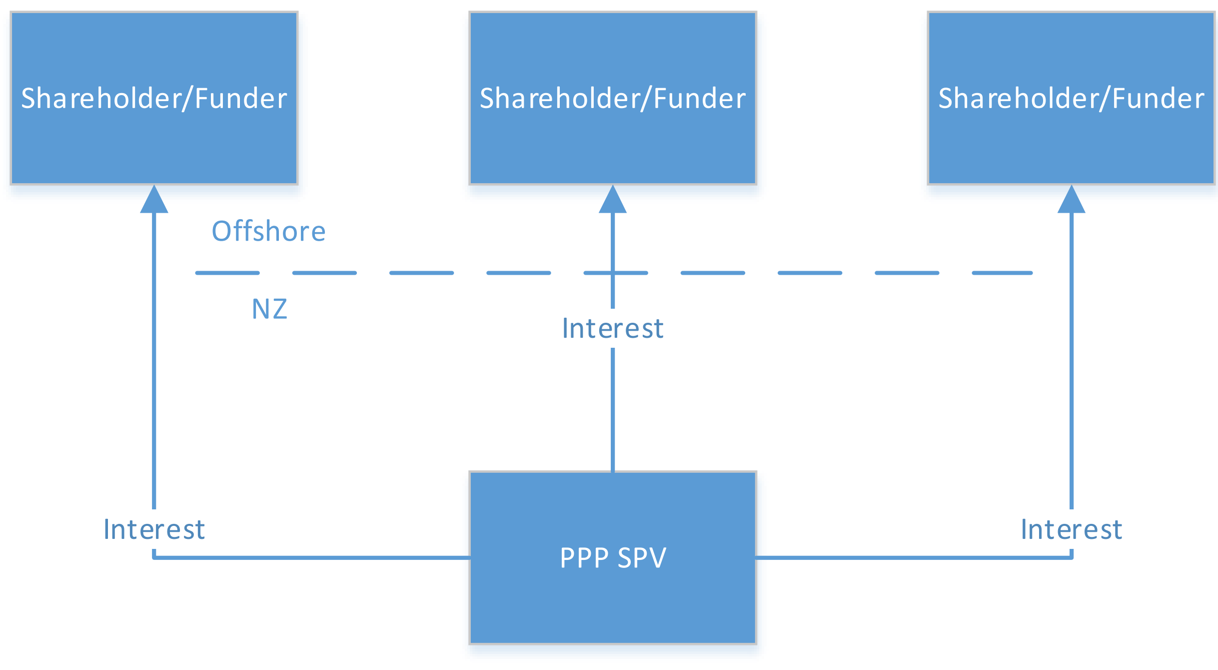
Chapter 4 – Acting together



	Current	Proposed
Interest	AIL	NRWT

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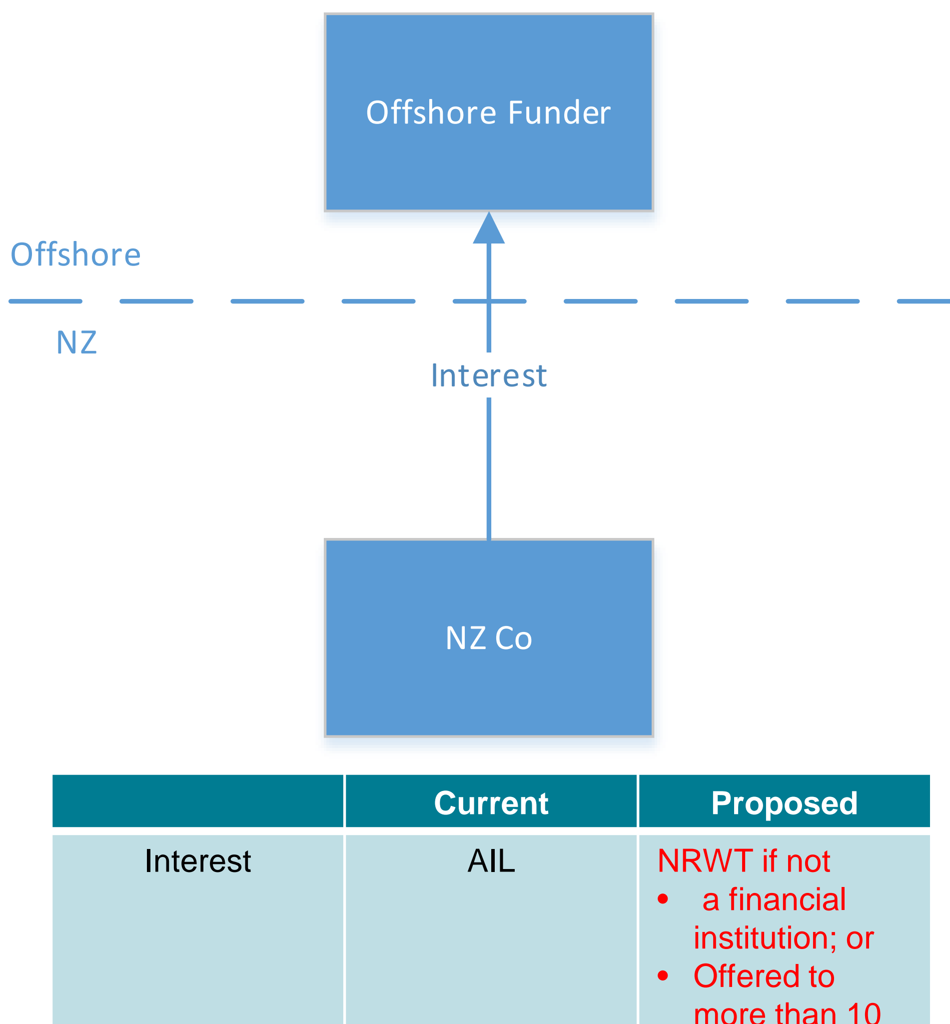
Chapter 5 – Financial institution and more than 10 person funding



	Current	Proposed
Interest	AIL	NRWT if not • a financial institution; or • Offered to more than 10

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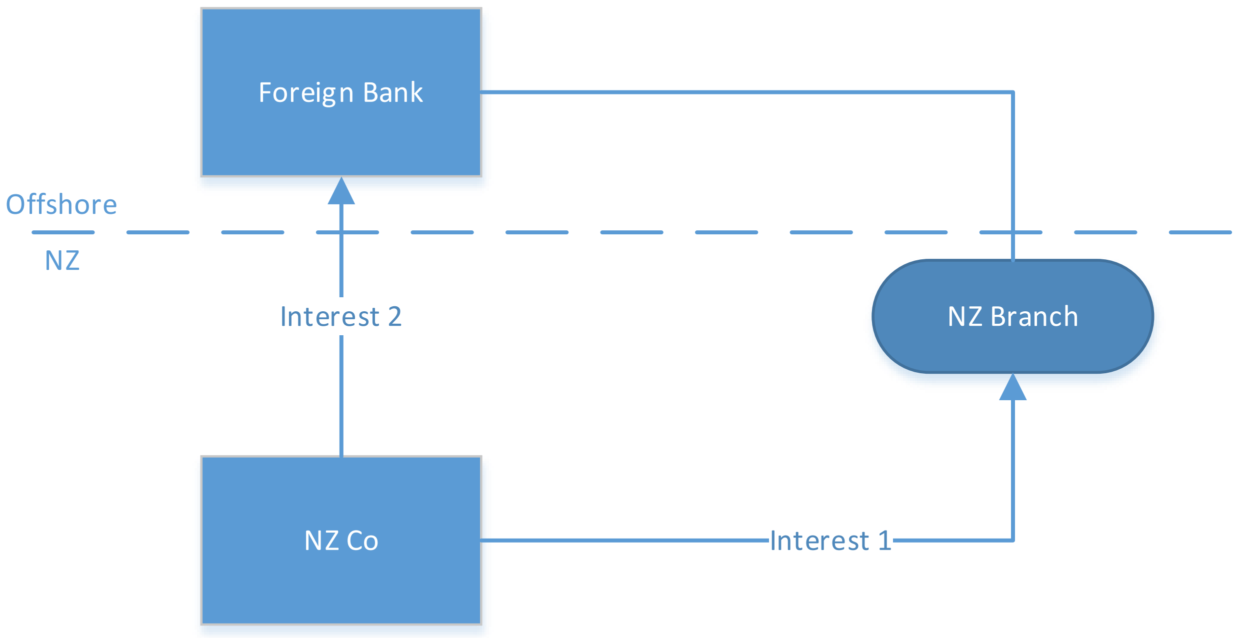
Chapter 6 – Onshore exemption NZ Fixed Establishment Connection required



	Current	Proposed
Interest 1	No NRWT	No NRWT
Interest 2	No NRWT	NRWT/AIL

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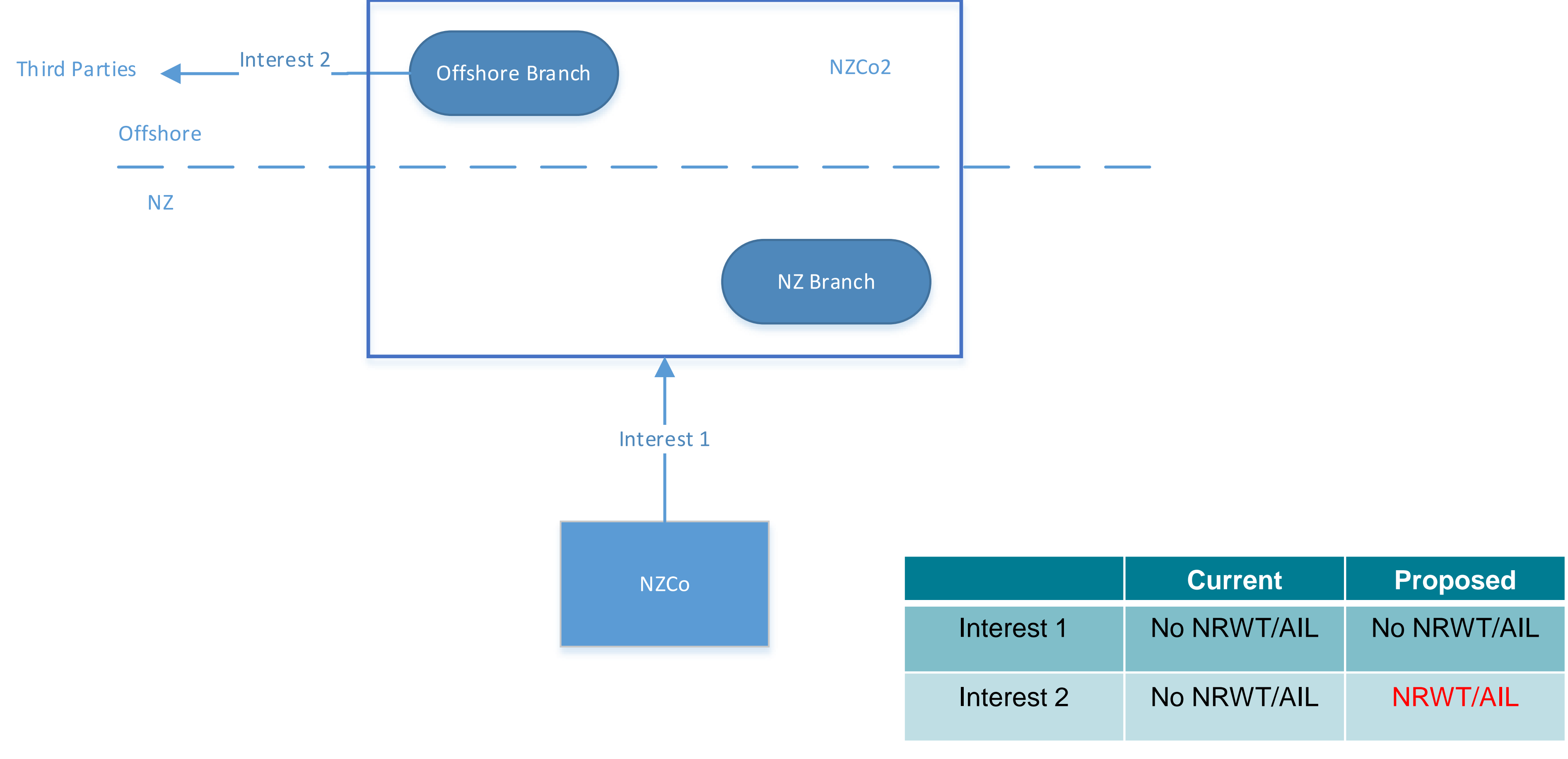
Chapter 6 – NZ resident offshore branch exemption



	Current	Proposed
Interest 1	No NRWT/AIL	No NRWT/AIL
Interest 2	No NRWT/AIL	NRWT/AIL

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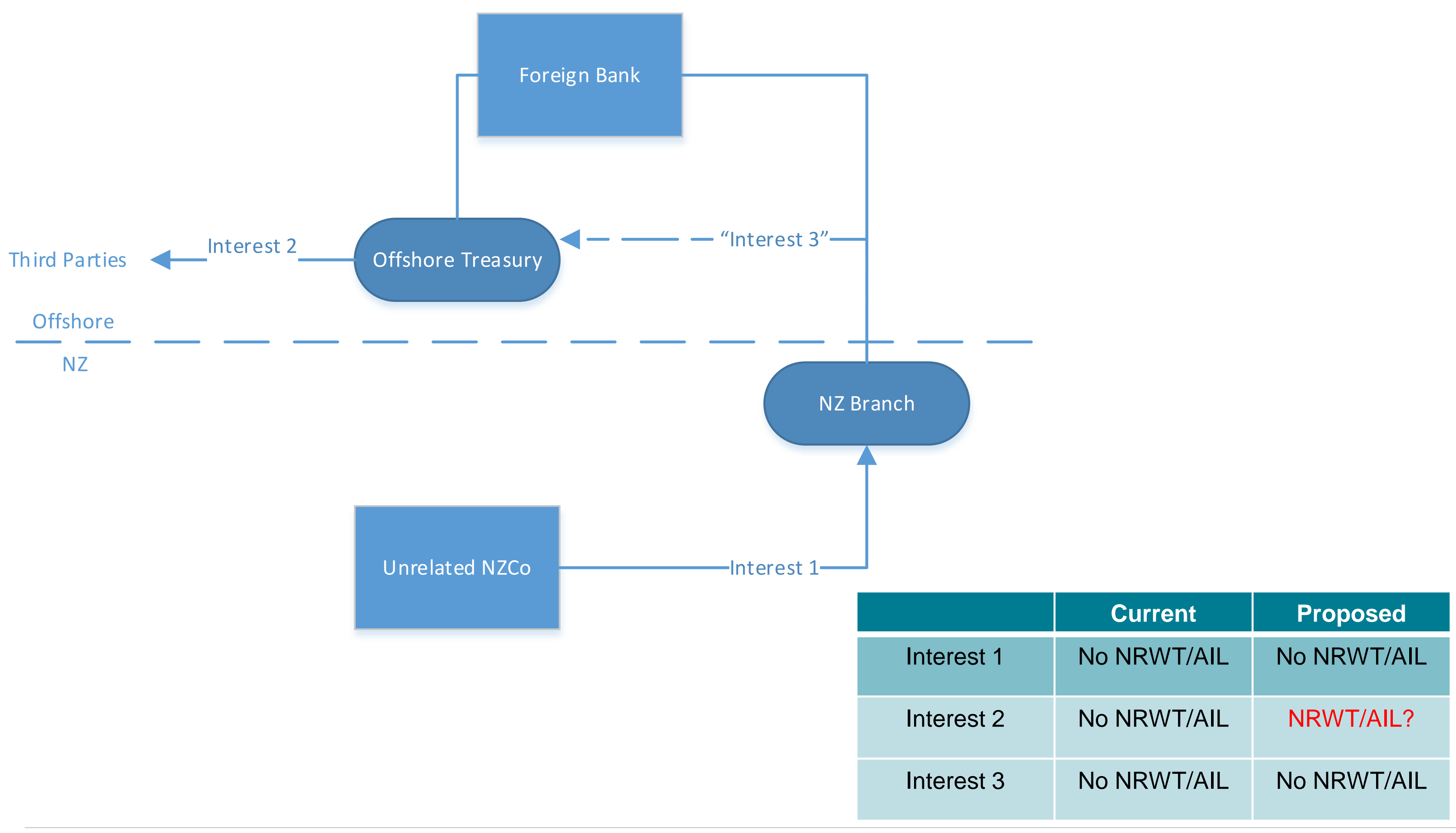
Chapter 6 – Foreign Bank Funding (proposed implied by 6.30)



	Current	Proposed
Interest 1	No NRWT/AIL	No NRWT/AIL
Interest 2	No NRWT/AIL	NRWT/AIL?
Interest 3	No NRWT/AIL	No NRWT/AIL

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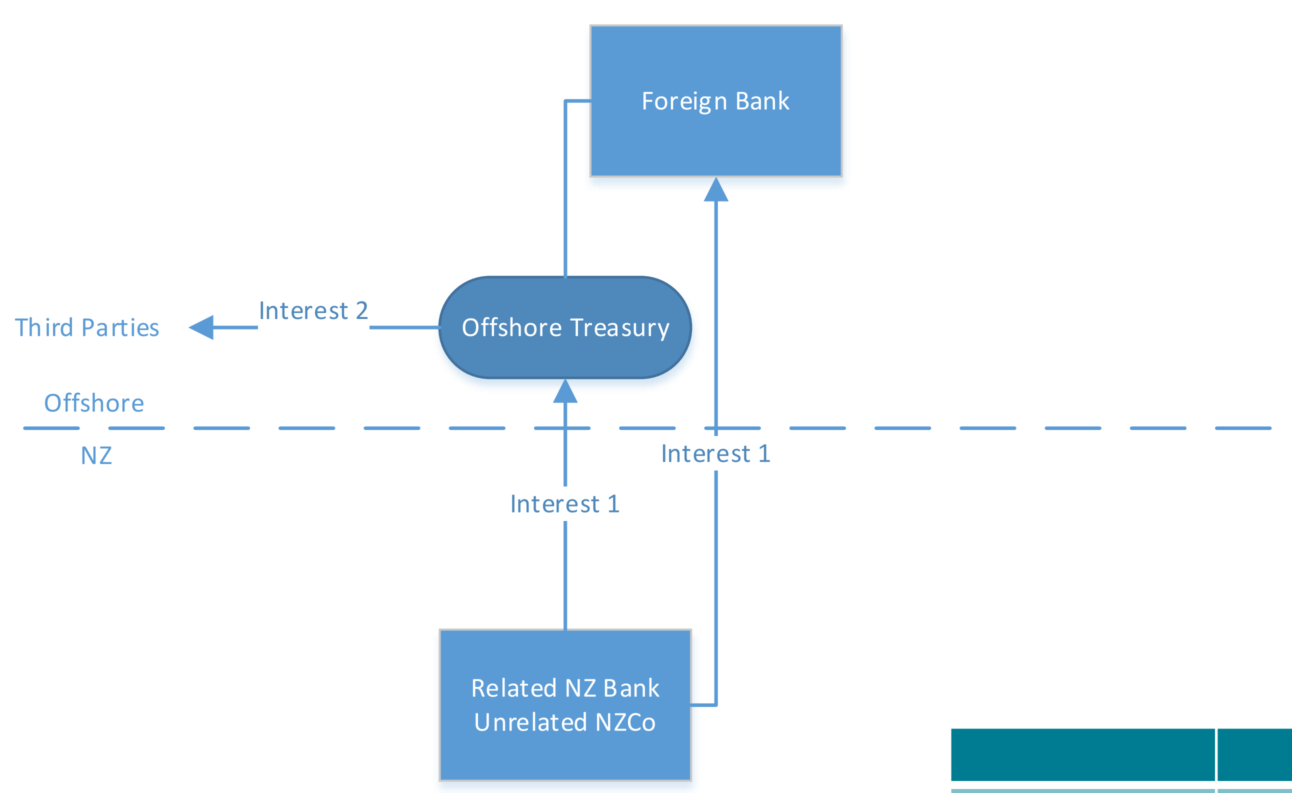
Chapter 6 – Related Bank Funding



	Current	Proposed
Interest 1	NRWT	AIL
Interest 2	No NRWT/AIL	No NRWT/AIL

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