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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **www.ird.govt.nz/public-consultation**

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe at **www.ird.govt.nz/public-consultation** to receive regular email updates when we publish new draft items for comment.

Ref	Draft type	Title	Comment deadline
IRRUIP 13	Issues paper	Consequences of GST group registration	5 April 2019

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The High Court had to consider whether the "standard amount" payments qualified as "gifts" under s LD 1 of the Income Tax Act 2007 and therefore whether tax credits could be claimed for such payments. The Court held that payments made to the Trust by a missionary, their parents, and/or grandparents were not "gifts", while payments by other relatives and friends were.

High Court clarifies the meaning of "year" for calculating "ongoing daily care" for the Child Support Act 1991 176

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Taxation Review Authority considers whether it has the power to approve publication of a taxpayer's affairs on application by the taxpayer 178

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NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Life reinsurance

Section DR 3 of the Income Tax Act 2007

There is an amendment to section DR 3 of the Income Tax Act 2007 to ensure that no deduction for the reinsurance of a life insurer's policies is available if the life reinsurer's premium income on that policy is not taxable in New Zealand. The amendment is to ensure that the New Zealand resident insurer is denied a deduction for the premium under section DR 3 when the life reinsurer's business operates out of Canada, Japan, Russia, or Singapore. The life insurer will no longer benefit from the more favourable tax treatment received by the life reinsurer compared with those life reinsurers operating in New Zealand or other countries.

Background

Section DR 3 of the Income Tax Act 2007 is intended to deny a deduction for life reinsurance premiums when the corresponding premium income is not taxable in New Zealand. It seeks to achieve this result by providing that no deduction is available for the reinsurance of a policy unless the policy is offered or entered into in New Zealand.

However, some life reinsurance premiums incurred under policies offered or entered into in New Zealand can be relieved from tax in New Zealand under our double tax agreements (DTAs). This means that section DR 3 is not as wide as intended.

Under Article 7 of our DTAs, New Zealand is prevented from taxing business profits earned by a non-resident unless they are attributable to a permanent establishment (PE) of the non-resident in New Zealand. To ensure that the life insurance rules can continue to operate for non-resident life insurers without a New Zealand PE, New Zealand typically excludes insurance income from the scope of the business profits exemption in Article 7 of our DTAs. However, New Zealand's DTAs with Canada, Japan, Russia and Singapore include life insurance income in Article 7. Under these DTAs, New Zealand is unable to tax a non-resident life reinsurer on its New Zealand sourced premium income unless that premium income is attributable to a PE of the non-resident in New Zealand.

Key features

The amendment to section DR 3 denies a deduction for a life reinsurance premium incurred under a life reinsurance policy with a non-resident life reinsurer if the premium is excluded from taxation by New Zealand under a DTA between New Zealand and the other country or territory.

Section DR 3 would not apply in respect of a life insurance premium that is attributable to a deemed PE under section GB 54. This is because New Zealand would not be prevented from taxing such a premium under the applicable DTA.

Application date

The application date for this amendment for new life reinsurance policies is income years starting on or after 1 July 2018. There is a deferred application date for this amendment for existing life reinsurance policies of 1 July 2019.

Example 1

Primary Life is a New Zealand life insurance company that entered into a life reinsurance policy in New Zealand with Rainy Day Reinsurance on 1 July 2017. Rainy Day Reinsurance is a Singaporean company that does not have a PE in New Zealand under the New Zealand-Singapore DTA.

How will section DR 3 apply to the premiums incurred by Primary Life from 1 July 2017?

Since Primary Life entered into the life reinsurance policy with Rainy Day Reinsurance before 1 July 2018, the premiums incurred under that policy will remain deductible until 30 June 2019. This means that the claims received under the policy will remain assessable until 30 June 2019 as well. The premiums incurred from 1 July 2019 onwards will not be deductible. This means that the claims received under the policy from 1 July 2019 will not be assessable.

BEPS - Administrative measures

DEFINITION OF LARGE MULTINATIONAL GROUP

Section YA 1

The new legislation introduces the term "large multinational group", which is relevant as Inland Revenue's increased powers to assess tax or collect information only apply to members of large multinational groups.

Background

The rules in the new legislation that increase Inland Revenue's powers to assess tax or collect information are limited so they only apply to members of large multinational groups. These rules are:

- The permanent establishment anti-avoidance rule in new section GB 54 of the Income Tax Act 2007 which can only be applied to members of large multinational groups.
- New section HD 30 which allows the Commissioner of Inland Revenue to collect tax that is owed by a non-resident member of a large multinational group from a wholly-owned group member who is a New Zealand resident or that has a permanent establishment in New Zealand.
- New section 17(1CB) of the Tax Administration Act 1994 extends the Commissioner of Inland Revenue's powers to request information so they also apply to information or documents relevant to the taxation of the large multinational group and that is held by any member of that large multinational group, including group members who are outside New Zealand.
- New section 21BA of the Tax Administration Act 1994 can be used to apply consequences to a member of a large multinational group that fails to provide an adequate response to a section 17 request for information or documents within a reasonable timeframe. These consequences enable the Commissioner of Inland Revenue to make a tax assessment based on the information she has available and to prevent information that was requested, but not provided to the Commissioner, from being admitted as evidence in a dispute or court proceeding.
- New section 139AB of the Tax Administration Act 1994 provides the ability for the Commissioner of Inland Revenue to apply a civil penalty of up to $100,000 on a member of a large multinational group that does not co-operate with requests for information.
- Large multinational groups whose ultimate owner is a New Zealand resident parent entity are required to file a country-by-country report with Inland Revenue under new section 78G of the Tax Administration Act 1994.

Key features

A large multinational group is defined in section YA 1 as a consolidated accounting group that has annual consolidated group revenue for the preceding income year or period prior to the relevant income year of more than EUR €750m (which is the exemption threshold described in paragraph 5.52 of the OECD Transfer Pricing Guidelines).

This EUR €750m revenue threshold was agreed by the OECD as a way to define the large multinational groups that are required to file Country-by-Country reports with relevant tax authorities.

Example

M is a multinational group which has a member which is resident in New Zealand. M's consolidated accounts reported revenues of US $1.8b for the year ending 31 December 2018. Because these revenues are more than EUR €750m on 31 December 2018, for M's next income year beginning 1 January 2019, M will satisfy the definition of a large multinational group.

To qualify as a large multinational group, the group must also have a member resident in New Zealand or income with a source in New Zealand and a member who is resident in a country or territory other than New Zealand.

There is no requirement that the group members be companies, so the revenues for consolidated group could include revenues that are earned through partnerships or trusts.

REQUESTING INFORMATION FROM LARGE MULTINATIONAL GROUPS

Sections 17(1CB), 21BA, 139AB and 142GB of the Tax Administration Act 1994

The new legislation amends the Tax Administration Act 1994 to provide the Commissioner of Inland Revenue with additional powers to request information from large multinational groups in order to assist a tax investigation of the relevant multinational.

Background

To combat BEPS, Inland Revenue needs to be able to properly investigate complex tax positions taken by multinationals. One of the main practical difficulties that Inland Revenue has encountered in conducting these investigations is a lack of willingness by some multinationals to provide information.

The information required in an investigation can include legal contracts and evidence about commercial and economic activities carried on by offshore entities. This information is often held by an offshore group member of the multinational, rather than in a New Zealand company or office. For example, it is common for multinationals to prepare and retain transfer pricing documentation within a specialist transfer pricing unit in their head office in another jurisdiction.

As the OECD notes in paragraph 5.15 of chapter V of their Transfer Pricing Guidelines:

"It may often be the case that the documents and other information required for a transfer pricing audit will be in the possession of members of the MNE group other than the local affiliate under examination. Often the necessary documents will be located outside the country whose tax administration is conducting the audit. It is therefore important that the tax administration is able to obtain directly or through information sharing, such as exchange of information mechanisms, information that extends beyond the country's borders."

In addition to transfer pricing, Inland Revenue needs to access offshore information to apply other international tax rules. These include the permanent establishment rules which determine whether New Zealand can tax the business profits of a non-resident company (and if so, how much of that profit New Zealand can tax), and the general anti-avoidance rule, which may be used to challenge cross-border tax avoidance.

Key features

The new rules in relation to requesting information only apply to members of large multinational groups. A large multinational group is defined in section YA 1 as a consolidated accounting group that has annual consolidated group revenue exceeding EUR €750m for the preceding income year or period prior to the relevant income year. The group must also have a member resident in New Zealand or income with a source in New Zealand and a member who is resident in a country or territory other than New Zealand.

The Commissioner of Inland Revenue has a power under section 17 of the Tax Administration Act 1994 to request specific information or documents from a person as part of a tax investigation. This person would typically be resident of New Zealand or have a physical presence such as an office in New Zealand.

New section 17(1CB) expands the scope of the existing section 17 power by allowing it to also be used to request information or documents that are held by any member of a large multinational group. This includes members that are non-residents, such as a parent or a sister company.

The information must be relevant to the taxation of the large multinational group, as opposed to an investigation concerning the tax position of someone who is outside the group such as a customer. For multinational tax investigations the relevant information sought will typically be about companies rather than natural persons.

In some cases customer information may be relevant to the taxation of the large multinational group. For example a contract with a customer may be relevant to applying the transfer pricing rules to determine whether a related party arrangement has arm's length conditions and an arm's length amount of consideration.

New section 21BA is designed to bolster Inland Revenue's ability to require multinationals to comply with a request for information under section 17 by setting out some specific consequences that can be applied if the multinational fails to provide an adequate response within a reasonable timeframe. These consequences enable the Commissioner to make a tax assessment based on the information she has available and to prevent information that was requested, but not provided to the Commissioner, from being admitted as evidence in a dispute or court proceeding.

New section 139AB provides the ability for Inland Revenue to apply a civil penalty of up to $100,000 on large multinational groups which do not co-operate with requests for information.

Application date

The amendments to insert new sections 17(1CB), 21BA, 139AB and 142GB into the Tax Administration Act 1994 apply from 27 June 2018, which is the date that the Taxation (Neutralising Base Erosion and Profit Shifting) Act received Royal assent. This means that these new administrative powers and penalties can be used by Inland Revenue after 27 June 2018 when pursuing current or new investigations, even if those investigations include income years prior to the date of enactment.

Detailed analysis

Section 17(1CB): Allowing Inland Revenue to request information held by non-resident members of large multinational groups

New section 17(1CB) allows the Commissioner to apply section 17(1) to request information or documents that are in the knowledge, possession, or control of a member of a large multinational group, including members that are non-resident.

The requested information must be relevant to the taxation of the large multinational group, as opposed to an investigation concerning the tax position of someone who is outside the group such as a customer. For multinational tax investigations the relevant information sought will typically be about companies rather than natural persons.

In some cases customer information may be relevant to the taxation of the large multinational group. For example a contract with a customer may be relevant to applying the transfer pricing rules to determine whether a related party arrangement has arm's length conditions and an arm's length amount of consideration.

Although section 17(1CB) can be used to request information from any member of the large multinational group, in practice, it is anticipated that the Commissioner would request the information from the group member who is resident or potentially subject to tax in New Zealand. In some cases, that group member may already hold or be able to access (e.g. through a shared internal document system) the information themselves. If the group member does not hold or have access to the information themselves, they will need to source the required information from other members of their group and then pass on the requested information to the Commissioner of Inland Revenue.

For example, the Commissioner could ask a New Zealand subsidiary of a multinational corporation to provide transfer pricing documentation that was held by their offshore parent. The New Zealand subsidiary would ask their parent to provide this documentation to them, and they would then supply it to the Commissioner.

Inland Revenue understands that large multinational groups typically have processes whereby information requests from tax authorities are escalated and approved by their head office (this can include cases where the relevant information is already held in New Zealand). The head office will have the authority to require the other group members to provide the information.

Further information about Inland Revenue's operational procedures for issuing notices under section 17 is available in Operational Statement OS 13/02[1] which outlines the procedures. Although this Operational Statement has not been updated to reflect the new section 17(1CB) the intention of section 17(1CB) is simply to expand the scope of Inland Revenue's existing section 17 power so it also applies to information held by any member of a large multinational group. The existing operational procedures include:

- *Where information is to be demanded under section 17, a notice will be issued in writing. Generally a section 17 notice will only be issued following a failure to provide information previously requested or where specific issues have been identified and attempts to resolve these issues have failed.*
- *The Commissioner will only require disclosure of information considered necessary or relevant and that is reasonably required in the circumstances of the case. The Commissioner will be reasonable in relation to the quantity of information sought and the timeframe for providing that information. Reasonable time will be allowed where there is genuine difficulty in obtaining and/or providing the information requested.*

Section 21BA: Consequences from failure to provide information

New section 21BA is designed to bolster Inland Revenue's ability to require multinationals to comply with a request for information under section 17 by setting out some specific consequences that can be applied if the multinational fails to provide an adequate response within a reasonable timeframe. These consequences enable the Commissioner to make a tax assessment based on the information she has available and to prevent information that was requested, but not provided to the Commissioner, from being admitted as evidence in a dispute or court proceeding.

[1] http://www.ird.govt.nz/technical-tax/op-statements/os-1302-sec-17-notices.html

It is similar to section 21 of the Tax Administration Act 1994 which can be applied in relation to requests for information from a person claiming a deduction for a payment that the person has made to an offshore person.

New section 21BA applies when all of the following requirements are met:

- The Commissioner has requested, under section 17, information or documents from a large multinational group member and the information relates to the large multinational group or to a member of the large multinational group; and
- That group member has failed to provide a response within three months, or has provided a misleading, incomplete or otherwise inadequate response; and
- The Commissioner has provided a further notice to the group member and the member has still failed to provide a sufficient response within 1 month of the further notice.

If these requirements are met section 21BA allows the Commissioner to impose the following consequences on the large multinational group:

- the Commissioner may rely on information that she holds to make a tax assessment of the group member or another member of the large multinational group and to apply any relevant criminal or civil penalties to the large multinational group. Any resulting assessment should be soundly based on the law and the information that is available to the Commissioner.
- If the large multinational group disputes the assessment or penalties the requested information will not be allowed as evidence in the dispute in a court proceeding (unless a court or authority determines that the information request was unreasonable and admitting the evidence is necessary to avoid manifest injustice).

Subsection 21BA(1) outlines the scenarios where section 21BA can be applied. Subparagraph (a) deals with the case where no response is provided within three months.

Subparagraph (b) deals with cases where a response is provided but the Commissioner considers the response to be misleading, including where relevant information has been omitted from the response.

Subparagraph (c) deals with cases where the response omits the information that the Commissioner requires to check compliance with the transfer pricing rules or attributing income to a permanent establishment. Subparagraph (c) can apply regardless of whether or not the relevant information is in the knowledge, possession, or control of the member. This ensures the consequences under section 21 can still be applied where the information does not exist because the multinational group has not prepared transfer pricing documentation or has not attempted to calculate the profits attributable to a permanent establishment. In the absence of this subparagraph, multinationals would be incentivised not to prepare or retain this information.

Subparagraph (d) deals with any other case where a response has been provided but the Commissioner does not consider the response fulfils the requirement of the section 17 request.

Civil penalty for failure to provide the requested information

New section 139AB provides the Commissioner of Inland Revenue with the ability to impose a civil penalty of up to $100,000 on large multinational groups which fail to comply with a section 17(1CB) request for information or documents.

Section 17(1CB) is explained above, but for this section to apply the information or document must be relevant to the taxation of the large multinational group and be in the knowledge, possession, or control of the member or another member of the large multinational group.

Like other civil penalties, the civil penalty in section 139AB is treated as an additional tax liability for the purpose of late payment penalties and the use of money interest rules.

Section 142GB provides that the due date for the civil penalty is the date specified by the Commissioner in the notice of the assessment of the penalty but which must be at least 30 days after the date the notice is issued.

Criminal penalties cannot typically be applied in relation to a request made in relation to information held by another member of the large multinational group under section 17(1CB). The criminal penalties in section 143 and 143A of the Tax Administration Act 1994 are not modified by the new legislation. There are some existing defences which mean the criminal penalties in section 143(2) and 143A(2) of the Tax Administration Act 1994 do not apply when the information is not in the knowledge, possession or control of the person or a non-resident who is controlled by the person.

Example

As part of an investigation of transfer pricing positions taken by S Co, a New Zealand subsidiary of a large multinational group, the Commissioner of Inland Revenue asks the New Zealand subsidiary to provide certain transfer pricing documentation including the local file of S Co and certain information from the local file of H Co, a group member in Singapore which has entered into transfer pricing arrangements with S Co.

S Co provides their local file but does not provide any of the requested information from the local file of H Co.

On 1 August, the Commissioner provides in writing a section 17 notice to S Co to formally request certain information from the local file of H Co. S Co does not respond to the request.

On 1 November (3 months after the issue of the section 17 notice), the Commissioner provides a second notice to notify that if S Co does not provide the further information by 1 December (30 days after the second notice was issued) that section 21BA may be applied. S Co responds indicating it is not able to provide the requested information.

The Commissioner makes an assessment of S Co based on the information available in S Co's local file as well as other information on comparable arrangements from databases and issues a notice of proposed assessment to S Co stating that she has applied section 21BA(2) when making this assessment as she does not have access to the information requested from H Co's local file.

The assessment is for additional tax of $4m as well as a civil penalty of $100,000 under section 139G from failing to comply with the section 17 request.

Due to section 21BA(3), S Co will typically be unable to use the transfer pricing documentation from H Co's local file that was previously requested and not provided to the Commissioner to dispute the Commissioner's assessment of S Co's tax positions.

COLLECTING UNPAID TAX FROM LARGE MULTINATIONAL GROUPS

Section HD 30

Background

Inland Revenue has strong powers to collect revenue from persons who are residents of New Zealand or who have a physical presence here. However, it can be difficult for Inland Revenue to collect tax from non-resident companies that have no physical presence in New Zealand, including in cases where they are a member of a large multinational group which does have a subsidiary or permanent establishment in New Zealand.

Key features

New section HD 30 will allow Inland Revenue to collect tax owed by a non-resident member of a large multinational group from another wholly-owned group member who is a New Zealand resident or that has a permanent establishment in New Zealand.

The rule does this by treating the other group member as an agent for the unpaid tax of the principal member (the non-resident) that owes the tax.

The rule will only apply if the principal member (the non-resident) fails to pay the unpaid tax and if the Commissioner notifies the wholly-owned group member that they will be treated as an agent for the unpaid tax.

The agent can be a non-resident who is treated as having a permanent establishment in New Zealand under the new section GB 54 (Arrangements involving establishments and non-resident businesses).

The agent will have the same dispute rights as the principal member. The rights of an agent are given by section 44 of the Tax Administration Act and include rights of objection under section 44(3) to an assessment under section 44(2).

Application date

New section HD 30 applies from 27 June 2018, which is the date that the Act received the Royal assent. This means that these new powers can be used by Inland Revenue after 27 June 2018 when pursuing current or new investigations, even if those investigations cover income years prior to the date of enactment.

COUNTRY-BY-COUNTRY REPORTS

Section 78G of the Tax Administration Act 1994

Background

One of the OECD's BEPS recommendations was to require large multinational groups (those with annual consolidated group revenue of EUR €750m or more in the previous financial year) to provide a Country-by-Country report which contains certain high-level information on the groups' global activities to tax authorities who would then exchange this information with each other.

The following aggregate information will need to be collected for 2016 and subsequent years for **each jurisdiction** in which the impacted groups operate:

- gross revenues (broken down into related party and unrelated party categories);
- profit (loss) before income tax;
- income tax paid (on cash basis);
- income tax accrued (current year);
- stated capital;
- accumulated earnings;
- number of employees; and
- tangible assets other than cash and cash equivalents.

In addition, impacted groups will need to list all of their entities that are resident in each jurisdiction, noting also the main business activity of each entity.

This information will assist tax authorities in providing them with a starting point for assessing risk and potentially requesting more detailed information that could be used to investigate a multinational's tax position.

Inland Revenue requires New Zealand headquartered multinational groups with annual consolidated group revenue of EUR €750m or more in the previous financial year to file a Country-by-Country report for all income years beginning on or after 1 January 2016.

This requirement currently applies to about 20 multinational groups, who have been notified by Inland Revenue.

A specific legislative provision to require multinationals to file Country-by-Country reports is not strictly necessary as Inland Revenue is already able to use section 17 of the Tax Administration Act 1994 to enforce these requirements. A specific provision is useful because it will provide a more explicit signal to the affected multinationals and other countries of New Zealand's commitment to Country-by-Country reporting. For example, accounting firms produce information about each country's relevant reporting requirements and they may not realise New Zealand is requiring Country-by-Country reports to be prepared and filed if they are not mentioned in our relevant tax legislation.

Section 17 allows the Commissioner to request a taxpayer to provide specific information.

Application date

Section 78G applies from 27 June 2018, which is the date that the Taxation (Neutralising Base Erosion and Profit Shifting) Act entered into force.

For the periods from 1 January 2016 to 27 June 2018, Inland Revenue will continue to use the existing requirement in section 17 of the Tax Administration Act 1994 to require the affected New Zealand headquartered multinational groups to provide Country-by-Country reports.

Detailed analysis

New section 78G applies to large multinational groups with an ultimate owner who is a resident of New Zealand.

A large multinational group is defined in section YA 1 as a consolidated accounting group that has annual consolidated group revenue of more than EUR €750m (which is the exemption threshold described in paragraph 5.52 of the OECD Transfer Pricing Guidelines). This EUR €750m revenue threshold was agreed by the OECD as a way to define the large multinational groups that are required to file Country-by-Country reports with relevant tax authorities.

NEW LEGISLATION

The revenue threshold is measured using the consolidated accounts for the preceding income year or period prior to the relevant income year.

Example

X Co is a resident of New Zealand and is the parent company of a multinational group. X Co's consolidated accounts reported revenues of NZ $1.2b, which exceeds EUR €750m for the year ending July 2018. For their next income year ending July 2019, X Co will be required to file a Country-by-Country report with Inland Revenue.

In the income year ending July 2019 X Co's consolidated accounts has reported revenues of NZ $1.1b, which for that year is less than EUR €750m. For their next income year ending July 2020, X Co will not be required to file a Country-by-Country report.

To be a "large multinational group" under section YA 1 of New Zealand's legislation, the group must also have a member resident in New Zealand or income with a source in New Zealand and a member who is resident in a country or territory other than New Zealand.

Unlike some other provisions in Taxation (Neutralising Base Erosion and Profit Shifting Act 2018) which apply to all large multinational groups (as defined in section YA 1), the Country-by-Country reporting requirement in section 78G of the Tax Administration Act 1994 only applies to large multinational groups whose ultimate owner is a resident of New Zealand (approximately 20 groups).

The "ultimate owner" is the parent entity that is required to prepare consolidated accounts that includes their subsidiaries (these consolidated accounts will include consolidated amounts from the other group members) and for which there is no other entity that owns directly or indirectly a controlling interest in the parent whereby that other entity would be required to prepare consolidated accounts that include the parent entity.

New Zealand's financial reporting requirements currently require large entities (including companies, partnerships and limited partnerships) to prepare accounts regardless of whether the entity is listed on a stock exchange. For these preparation requirements "large" is defined in the Financial Reporting Act 2013 as entities that earn over NZ$30m of consolidated revenues (which is smaller than EUR 750m) or that have over NZ$60m of consolidated assets in the previous two years.

New Zealand is a relatively small jurisdiction which allows Inland Revenue to readily identify any large organisation headquartered here that should be subject to Country-by-Country reporting requirements. In the very unlikely event that such an organisation did not prepare consolidated financial statements, Inland Revenue would use section 17 of the Tax Administration Act 1994 to specifically request this information.

Example

Y Co is a resident of New Zealand and is a member of a large multinational group. However, Y Co is a subsidiary of Z Co which is a resident of Australia. Z Co is the parent company of the multinational group. Y Co will not be required to file a country-by-country report in New Zealand, but Z Co is required to file a Country-by-Country report with the Australian Tax Office in Australia. Inland Revenue will receive Z Co's Country-by-Country report information when these reports are exchanged under the Multilateral Competent Authority Agreement on the exchange of Country-by-Country Reports.

Large multinational groups with an ultimate owner that is a resident of New Zealand are required to disclose a Country-by-Country report to the Commissioner that includes:

- The information described in Annex III of Chapter V of the OECD transfer pricing guidelines. This annex includes the OECD template for the Country-by-Country report.
- Other information as may be required by the Commissioner. This provides flexibility for future changes to the Country-by-Country report or any additional information that the Commissioner may require.

The OECD transfer pricing guidelines include a template for the Country-by-Country report and instructions and definitions for the compiling the information in the template in Annex III of Chapter V of the guidelines.

The deadline for filing a Country-by-Country report is within the 12 months after the 12 month period to which the information in the report relates.

For example a Country-by-Country report relating to 1 January 2019 to 31 December 2019 would need to be filed with Inland Revenue on or before 31 December 2020. Inland Revenue would then exchange this report with other countries by July 2021.

BEPS - Transfer pricing rules

Sections GC 6 to GC 13 of the Income Tax Act 2007

Summary of amendments

Transfer pricing rules guard against multinationals using related-party arrangements to shift profits offshore by requiring the profits from these arrangements to be determined using the arm's length conditions, including price, which unrelated parties would agree to use.

Sections GC 6 and GC 13 have been amended to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules.

Application date

The amendments to the transfer pricing rules generally apply from income years beginning on or after 1 July 2018.

Arrangements that comply with an Advance Pricing Agreement issued by the Commissioner of Inland Revenue before 1 July 2018 will be grand-parented so they remain subject to the old transfer pricing rules until the Advance Pricing Agreement expires.

Key features

The Act makes the following amendments to New Zealand's transfer pricing legislation:

- In addition to applying to transactions between associated persons, the transfer pricing rules will also apply when there are transactions between members of non-resident owning bodies and companies, and to cross-border related borrowings. *(Section GC 6(2)(b))*
- Including a reference to using the 2017 OECD transfer pricing guidelines as guidance for how the transfer pricing rules are applied. *(Section GC 6(1B))*
- The economic substance and actual conduct of the parties, along with the legal contract, will inform the transfer pricing analysis. In certain circumstances, the economic substance and actual conduct will have priority over the terms of the legal contract. This is achieved by requiring the transfer pricing transaction to be "accurately delineated" using the approach in section D.1 of chapter I of the 2017 OECD transfer pricing guidelines. *(Section GC 13(1B))*
- Where a transfer pricing arrangement is not commercially rational because it includes unrealistic terms that unrelated parties would not be willing to agree to, the approach described in section D.2 of chapter I of the new OECD guidelines may apply to disregard and, if appropriate, replace the transaction. *(Section GC 13(1C))*
- Requiring the arm's length amount of consideration to be determined using arm's length conditions. This clarifies that it may be necessary to adjust some conditions of the arrangement other than the price, in order to determine the arm's length price. *(Section GC 13(1)(b))*
- Placing the onus of proof onto the taxpayer for providing evidence (such as transfer pricing documentation) that their transfer pricing positions are correct (that is, they are determined using arm's length conditions). The general onus of proof in section 149A(2)(b) of the Tax Administration Act 1994 will now apply to transfer pricing as well as other tax matters.
- The time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position can be increased to seven years, in those cases where the Commissioner of Inland Revenue has notified the taxpayer that a tax audit or investigation has commenced within the usual four-year time bar. *(Section GC 13(6))*

Background

The OECD's transfer pricing guidelines were substantially updated in 2017 as part of the OECD's BEPS project. The updates to chapter I of the guidelines were designed to align transfer pricing outcomes with value creation (BEPS Actions 8–10). The OECD has noted that the new guidance ensures that:

- actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;
- contractual allocations of risk are respected only when they are supported by actual decision-making;
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance; and
- tax administrations may disregard transactions which are commercially irrational.

The Act amends New Zealand's transfer pricing legislation to ensure New Zealand's legislation aligns with the new OECD transfer pricing guidelines and that our rules remain effective at combatting BEPS.

Other changes have been made to strengthen Inland Revenue's ability to monitor and enforce the new transfer pricing rules. These changes include:

- Putting the onus of proof onto the taxpayer for providing evidence (such as documentation) that their transfer pricing positions are correct (that is, they are determined using arm's length conditions).
- Allowing Inland Revenue to extend the time bar for assessing transfer pricing issues to seven years, in those cases where Inland Revenue has notified the taxpayer that a tax audit or investigation has commenced within the usual four-year time bar.
- Amendments to the Tax Administration Act 1994 to provide Inland Revenue with additional powers to request information from large multinational groups in order to assist a tax investigation of the relevant multinational. These information changes are explained in the special report on administrative measures (see the section on *"Requesting information from large multinational groups"*).

Detailed analysis

GC 6(1): Purpose of the transfer pricing rules

The purpose of the transfer pricing rules is to substitute an arm's length amount of consideration if a person's net income has been reduced by the conditions of a cross-border arrangement with a related party.

The purpose statement in section GC 6(1) has been updated so it refers to the special rules for pricing cross-border related borrowing as well as the general transfer pricing rules for pricing the acquisition or supply of goods, services, or anything else.

This reflects the fact that the transfer pricing rules now include some special rules for determining how cross-border related borrowing is priced. These rules are in sections GC 6(3B) and GC 15 to 19 and require certain adjustments to be made to the credit rating of the borrower and conditions of the financial arrangement, prior to the general transfer pricing rules in sections GC 6 to GC 14 being used to price the adjusted financial arrangement.

The special rules for cross-border related borrowing are explained in the special report on interest limitation (see the section on *"Cross-border related borrowing"*).

GC 6(1B): Applying the OECD transfer pricing guidelines

New Zealand has contributed to and applied the OECD's transfer pricing guidelines since they were first published in 1995. As transfer pricing practices have become more sophisticated, the OECD through its BEPS work has updated its guidelines to represent the agreed international best practice.

Subsection GC 6(1B) has been added so that New Zealand's transfer pricing legislation explicitly refers to the OECD transfer pricing guidelines by requiring the transfer pricing rules in sections GC 6 to GC 14 to be applied consistently with these guidelines.

The OECD transfer pricing guidelines are defined in section YA 1 as the guidelines published by the Organisation for Economic Co-operation and Development as *OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris. This definition refers to the July 2017 edition of the guidelines available on the OECD's website at **www.oecd.org/tax/transfer-pricing**

The general policy intention is that when a taxpayer has correctly applied the OECD transfer pricing guidelines to perform a transfer pricing analysis that demonstrates that their transfer pricing positions satisfy the arm's length principle, they should have a reasonable degree of certainty that these tax positions will also meet the requirements of New Zealand's transfer pricing rules.

However, the guidelines still need to be applied in conjunction with New Zealand's legislation as there are some specific rules in New Zealand's legislation which are additional to the guidance material in the OECD transfer guidelines.

For example, the OECD transfer pricing guidelines were developed to provide guidance for how to apply Article 9 of the OECD model double tax agreement to "associated enterprises" as defined in that Article. New Zealand's transfer pricing legislation applies to a wider range of cross-border related party arrangements (as is further explained in section GC 6(2)(b) below).

Another area where New Zealand's transfer pricing rules are more prescriptive is that New Zealand's legislation has special rules that must be used for determining how cross-border related borrowing is priced. These rules are in sections GC 6(3B) and GC 15 to 19 and can require certain adjustments to be made to the credit rating of the borrower and conditions of the financial arrangement, prior to the general transfer pricing rules in sections GC 6 to GC 14 (and the OECD transfer pricing guidelines) being used to price the adjusted financial arrangement.

The application date for new section GC 6(1B) is income years beginning on or after 1 July 2018. This means transfer pricing positions taken on or after 1 July 2018 must be analysed in a way that is consistent with the July 2017 version of the OECD transfer pricing guidelines.

The July 2017 version of OECD guidelines, or later updates to the guidelines may also be relevant for analysing tax positions taken before 1 July 2018 to the extent that they are not inconsistent with New Zealand's domestic law at that time (in sections GC 6 to GC 14).

The OECD transfer pricing guidelines are periodically updated by the OECD and New Zealand participates in developing the updated guidelines. When these updates occur, New Zealand will consider the revisions to the guidelines with a view to updating the definition of the OECD transfer pricing guidelines in section YA 1 so it refers to the latest version of the guidelines. Future taxation bills would be used to include these updates to the definition in section YA 1.

If a future taxation Act updates the definition of the OECD transfer pricing guidelines to refer to a newer version of the guidelines, the rules must be applied in a way that is consistent with the new version of the guidelines from the date that the new Act applies.

However, when the relevant updates to the OECD guidelines are not inconsistent with New Zealand's domestic law, the latest version of the guidelines may also be relevant in analysing tax positions from a period prior to the guidelines being updated.

This is because in most cases updates to the guidelines will clarify or provide further guidance on existing concepts, rather than introducing significant new concepts or practices. In this regard applying the latest version of the OECD's transfer pricing guidelines can aid with the application and interpretation of transfer pricing legislation that was enacted earlier. Inland Revenue and many taxpayers routinely apply the latest versions of the guidelines to assist in analysing cases from earlier years, as the latest guidelines are generally consistent with our existing law.

GC 6(2)(b): Defining the related party arrangements to which the transfer pricing rules apply

Section GC 6(2) defines the transfer pricing arrangements that the transfer pricing rules apply to. A transfer pricing arrangement is a cross-border arrangement between related parties.

The meaning of "arrangement" (which is described in section GC 6(2)(a)) and "cross-border arrangement" (which is defined in section GC 6(3)), are unchanged under the new legislation.

However, the concept of "related party" has been expanded under the new legislation.

Prior to July 2018, the transfer pricing rules only applied to arrangements between "associated persons" as defined in section YA 1. For example, two companies are associated persons if they have fifty percent or more common ownership.

The new rules apply to cross-border arrangements between:

- associated persons (as defined in section YA 1);
- a company and a member of a non-resident owning body where the members of the non-resident owning body collectively have voting or market value interests in the company of fifty percent or more; and
- a non-resident (lender) and another person (borrower) that includes a financial arrangement that is a cross-border related borrowing (as defined in GC 6(3)).

Associated persons

Associated persons are defined in section YA 1 of the Income Tax Act 2007.

The definition of "associated persons" is unchanged by the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. This means the set of "associated persons" who were required to apply the transfer pricing rules prior to 1 July 2018, will continue to be subject to the transfer pricing rules after 1 July 2018 (assuming they continue to meet the definition of "associated persons" in section YA 1).

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Some typical cases where persons are associated include:

- Two companies, where the same group of persons own fifty percent or more of the voting interests, market value interests or control by other means in both of the companies.
- When a person who is not a company owns twenty five percent or more of the voting interests or market value interests of the company.
- A limited partnership and a partner when the partner owns twenty five percent or more in a right, obligation, or other property, status or thing of the limited partnership.
- A non-limited partnership and a partner in the partnership.
- Natural persons who are close relatives.

Many of these tests also include aggregation rules whereby if two persons are associated under another rule their interests are aggregated for determining whether the relevant voting, market value or control thresholds are met. So, for example if a mother owns more than fifty percent of one company and her daughter owns more than fifty percent of another, the companies would be associated with each other.

Non-resident owning bodies

Section GC 6(2)(b) extends the application of the transfer pricing rules so they also apply when the transfer pricing arrangement is between a company and a person who is a member of a non-resident owning body that has at least fifty percent of the ownership interests in the company.

This rule is intended to capture private equity structures where it is common for a group of shareholders to co-ordinate on how to debt fund the New Zealand company. In addition to using debt funding such private equity structures can also use other arrangements such as service fees or royalties to shift profits out of New Zealand in order to reduce the overall tax paid on their investments. The extension of the application of the transfer pricing rules to non-resident owning bodies means that the transfer pricing rules will apply to both debt and non-debt transactions that members of these non-resident owning bodies have with companies in New Zealand.

The concept of a "non-resident owning body" is defined in section YA 1. It is used in the non-resident withholding tax (NRWT) rules as an interest payment to a member of a non-resident owning body is not eligible for a 0% rate of NRWT (when the approved issuer levy has been paid by the borrower). The concept is also used for determining whether the thin capitalisation rules apply as companies which are controlled by a non-resident owing body are subject to thin capitalisation rules.

This means that the transfer pricing rules will generally apply to the same set of companies and non-resident investors as the thin capitalisation rules and the NRWT rules for related party interest payments.

A non-resident owning body is a group of non-residents or entities (such as trusts settled by non-residents), that have one or more characteristics indicating they are acting together to debt-fund a New Zealand company. These characteristics include:

- having proportionate levels of debt and equity among the group. Proportionality is a characteristic of acting together as it generally requires a degree of coordination to achieve;
- having an agreement that sets out how the company should be funded with an arrangement between the members of the group concerning debt if the company is not widely held. Widely held is defined in section YA 1 and means a company has at least 25 shareholders (counting any associated shareholders as one shareholder) and is not controlled by five or fewer of these shareholders; and
- having an arrangement between the members of the group concerning debt in the company in a way recommended by a person (such as a private equity manager), or implemented on behalf of the members.

Because the definition of a non-resident owning body requires the shareholders to hold debt in the company in proportion to their shareholding or for the relevant agreement or arrangement to be a co-ordinated debt funding arrangement, the transfer pricing rules should not apply simply because a company has a typical shareholder's agreement setting out how shareholders agree to exercise their individual shareholder rights.

Ownership interest is defined in YA 1 to mean voting or market value interests. Therefore if the group of members in the non-resident owning body collectively own fifty percent or more of the voting or market value interests of the company, the transfer pricing rules will apply to all debt and non-debt arrangements between the company and a member of the non-resident owning body.

Cross-border related borrowings

The application of the rules also specifically includes cross-border related borrowings subject to the new transfer pricing rules for debt arrangements.

A cross-border related borrowing is defined in section GC 6(3B). This definition is further explained in the special report on interest limitation (see the section on *"Cross-border related borrowing"*).

GC 7 to GC 12

Sections GC 7 to GC 12 are unchanged under the new legislation. These sections go through the various cases where the amount of consideration is substituted with an arm's length amount of consideration because a person's net income has been reduced by the conditions of a cross-border arrangement with a related party.

GC 13(1): Determining arm's length amounts

Section GC 13(1) outlines the process for determining an arm's length amount of consideration.

This is the amount of consideration that independent parties after real and independent bargaining would have agreed upon as the price for the identified transaction if the identified transaction had occurred under arm's length conditions.

Identifying the related party transaction

The first step is to take the transfer pricing arrangement (between the related parties) and apply section D.1 of chapter I of the OECD transfer pricing guidelines to accurately delineate the transaction.

If the accurately delineated transaction is not commercially rational so that there is no price which would be acceptable to independent parties in exchange for the relevant goods or services being supplied, the approach described in section D.2 of chapter I of the guidelines will apply, and can be used to disregard or replace the transaction.

Section GC 13(1)(a) defines the term "the identified transaction". In most cases this will be the accurately delineated transaction found by applying section D.1 of chapter I. However, in cases where section D.2 of chapter I applies to replace the transaction, the "identified transaction" will instead be the replacement transaction.

Comparability analysis

In order to determine the arm's length conditions, including the arm's length price, the identified transaction is benchmarked against comparable transactions between independent parties. This involves the use of a comparability analysis whereby the taxpayer:

- identifies the arm's length conditions which might be expected to be agreed between independent parties operating at arm's length for comparable arrangements to the identified transaction; and
- uses one or more of the approved transfer pricing methods to produce the most reliable measure of the arm's length amount of consideration that would be agreed upon as part of the arm's length conditions.

One of the five approved transfer pricing methods (or a combination of these methods) described in chapter III of the OECD transfer pricing guidelines must be used to perform the comparability analysis.

The references in GC 13(1) to the "identified transaction" are not intended to limit the methods that taxpayers may use to perform a comparability analysis – any of the five methods listed in GC 13(2) can be used to perform this analysis.

The meaning of "identified transaction", arm's length conditions and "arm's length amount of consideration" are further explained below.

GC 13(1)(b): Arm's length conditions

"Arm's length conditions" are defined in section GC 13(b) as the conditions independent parties after real and independent bargaining might be expected to agree upon for the identified transaction.

In the phrase "arm's length conditions", "conditions" is not a defined term in the Act but is intended to include financial values such as the price, gross margin, net profit, and the division of profit between the acquirer and supplier as well as other conditions. This is consistent with paragraph 1.7 of the 2017 OECD transfer pricing guidelines which refers to *"…conditions (including prices, but not only prices)."*

Conditions may also include features going beyond the financial indicators relevant in applying transfer pricing methods.

The insertion of "conditions" is intended to clarify that a wider set of features, other than the price may be relevant when considering if the conditions of the transfer pricing arrangement need to be substituted with the conditions that would apply under comparable arm's length arrangements.

The relevant arm's length conditions for a transfer pricing arrangement will depend on the specific facts of the arrangement. The conditions will be relevant to the extent to which independent parties would take those conditions into account when evaluating the terms of a similar arrangement. The process of accurately delineating the arrangement using section D.1. of chapter I of the OECD transfer pricing guidelines will assist in establishing which conditions are relevant.

New Zealand's transfer pricing legislation also refers to the concept of an "arm's length amount of consideration" (and has done so since the rules were first introduced in 1995). The Federal Court in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2015] FCA 1092 found that the term "consideration", which was used in Australia's transfer pricing rules at the time the disputed transaction took place, had a broader meaning than just the price (interest rate). The Federal Court agreed that the Commissioner could make adjustments to other conditions (security and loan covenants in the Chevron case), that could have an impact on the price.

This decision illustrates that the term "consideration" should also be interpreted more widely than price. The insertion of the new term "conditions" helps to clarify the existing policy of considering features in addition to price, rather than creating a different policy for pre-July 2018 and post-July 2018 tax positions.

GC 13(1B): Determination of identified transaction

The transfer pricing rules require the overall economic substance of the arrangement to be considered. The analysis is not limited to the legal contracts and takes into account the wider economic arrangement and commercial environment. In particular, if the legal contracts do not reflect the actual conduct of the parties, the actual conduct of the parties will be used to apply the transfer pricing rules.

New section GC 13(1B) achieves these outcomes by requiring the transfer pricing arrangement to be "accurately delineated using the approach described in section D.1 of chapter I of the OECD transfer pricing guidelines."

Section D.1 of the OECD transfer pricing guidelines describes the process for accurately delineating the transaction. This process involves identifying the economically relevant characteristics. Some broad categories of the economically relevant characteristics are listed in paragraph 1.36 of the guidelines as:

- The contractual terms of the transaction (as described in section D.1.1).
- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including:
  - how those functions relate to the wider generation of value by the multinational enterprise group to which the parties belong;
  - the circumstances surrounding the transaction; and
  - industry practices (D.1.2).
- The characteristics of property transferred or services provided (D.1.3).
- The economic circumstances of the parties and of the market in which the parties operate (D.1.4).
- The business strategies pursued by the parties (D.1.5).

As part of accurately delineating the controlled transaction, the terms of the legal agreement may be disregarded to the extent that they are inconsistent with the actual conduct of the parties. This is explained in paragraphs 1.45 and 1.46 of the OECD transfer pricing guidelines.

The OECD transfer pricing guidelines provide several examples that illustrate particular aspects of how to accurately delineate transactions. This includes examples of:

- how the terms of the written contract may be clarified or supplemented by examining the actual conduct of the parties (see paragraph 1.44);
- how to deal with differences between written contractual terms and conduct of the parties, with the result being that the actual conduct of the parties is used to accurately delineate the transaction (paragraph 1.48);
- using the conduct of the parties to identify a transaction where one has not been identified by the multinational (paragraph 1.50); and
- how risks should be assumed according to how the parties actually manage and control these risks (see paragraphs 1.83–1.85 and 1.89).

GC 13(1C): No transaction or differing transaction

Where the transfer pricing arrangements entered into are not commercially rational there is consequently no price which would be acceptable to independent parties in exchange for the relevant goods or services being supplied and acquired.

In such cases it is not possible to apply a transfer pricing analysis as transfer pricing relies on being able to identify the arm's length price which would be agreed between independent parties.

To address this problem, section D.2 of chapter I of the OECD transfer pricing guidelines provides guidance about the circumstances where a transaction can be disregarded, and if appropriate replaced with an alternative transaction that allows for a transfer pricing analysis to be performed. These circumstances are described in paragraphs 1.122-1.125 of the OECD transfer pricing guidelines.

Accordingly, section GC 13(1C) applies when the requirements of paragraph 1.122 of the OECD transfer pricing guidelines are met. In summary, this paragraph states that the accurately delineated transaction can be disregarded and potentially replaced, if it would not be commercially rational for independent enterprises to enter into the transaction, because it would not be possible to determine a price which would be acceptable to both of the independent parties at the time that the transaction was entered into.

The full text of paragraph 1.122 of the OECD transfer pricing guidelines:

> *"1.122 This section sets out circumstances in which the transaction between the parties as accurately delineated can be disregarded for transfer pricing purposes. Because nonrecognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult. Where the same transaction can be seen between independent parties in comparable circumstances (i.e. where all economically relevant characteristics are the same as those under which the tested transaction occurs other than that the parties are associated enterprises) non-recognition would not apply. Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons. The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties."*

In cases where the accurately delineated transaction is replaced it should be replaced with a new transaction that enables a price that would be commercially rational for independent enterprises to agree to. As noted in paragraph 1.124 of the OECD transfer pricing guidelines, the replacement transaction should closely adhere to the facts (as accurately delineated) of the original transfer pricing transaction and only diverge from those facts to the extent that it is necessary to achieve a commercially rational outcome:

> *"1.124 The structure that for transfer pricing purposes, replaces that actually adopted by the taxpayers should comport as closely as possible with the facts of the actual transaction undertaken whilst achieving a commercially rational expected result that would have enabled the parties to come to a price acceptable to both of them at the time the arrangement was entered into."*

Paragraph 1.128 of the OECD transfer pricing guidelines provides an example where an arrangement is replaced. The example involves a lump sum payment for all future intangibles developed by an associated company over the next 20 years. This arrangement would not be commercially rational for independent parties to agree on as it is not possible to value these future intangibles. In this example, a number of potential replacement transactions could be considered including a financing arrangement, a contract for research services or a licencing agreement for some specific identified intangibles.

The transaction will be disregarded and not replaced if the commercially rational deal that independent parties would accept in comparable circumstances is one that involves no supply or acquisition. This is provided for by new section GC (13)(1C)(a). If the transaction is disregarded under section GC 13(1C)(a) of the transfer pricing rules it will be null and void for determining the person's New Zealand income tax liability. Note that there may still be NRWT on the payments as existing section GC 12 means that transfer pricing adjustments do not affect NRWT obligations.

Paragraphs 1.126 and 1.127 of the OECD transfer pricing guidelines provide an example of a transaction which is disregarded and not replaced. This example involves a property prone to flooding which an independent insurer would not agree to insure as evidenced by there being no active insurance market for properties in that area.

GC 13(2): Approved transfer pricing methods

Section GC 13(2) requires the taxpayer to determine the arm's length amount of consideration under arm's length conditions by performing a comparability analysis as required by the OECD transfer pricing guidelines, chapter III, using any one or a combination of the five transfer pricing methods that are described in chapter II of the OECD transfer pricing guidelines.

The choice of method that should be used is the method (or combination of methods) which produces the most reliable measure of the arm's length amount of consideration (see section GC 13(1)(c)). Chapter II of the OECD transfer pricing guidelines includes some further guidance on what transfer pricing method should be used, depending on the relevant circumstances of the arrangement and data availability.

The requirements under the updated section GC 13(2) are very similar to requirements under the previous section GC 13(2) of the Income Tax Act 2007. The main differences are that the names of the transfer pricing methods have been updated to the modern terminology and the updated provision now refers to using the OECD guidelines as guidance for how to perform a comparability analysis using the methods described in those guidelines.

In addition to the guidance in chapter III of the OECD transfer pricing guidelines, there is some relevant guidance on the factors that a comparability analysis should take into account in section D.1 of chapter I of the OECD guidelines.

In particular, paragraph 1.39 of the OECD guidelines notes that "*differences in economically relevant characteristics between the controlled and uncontrolled arrangements need to be taken into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability*."

The economically relevant characteristics are the same characteristics that were considered when accurately delineating the identified transaction. Some broad categories of what these economically relevant characteristics could include are listed in paragraph 1.36 of the OECD guidelines.

Onus of proof shifted to the taxpayer

When New Zealand's transfer pricing rules were introduced in 1995 they placed the onus of proof on the Commissioner. That is, the arm's length amount of consideration has generally been determined by the taxpayer under section GC 13 of the Income Tax Act 2007.

This position has changed with the repeal of sections GC 13(4) and (5). This means that the general onus of proof in section 149A(2)(b) of the Tax Administration Act 1994 will place the onus of proof for transfer pricing issues onto the taxpayer. New Zealand's tax system operates on a self-assessment basis, where the taxpayer is expected to keep sufficient records to support its tax position. This change is therefore consistent with the fact that the onus of proof is already on the taxpayer for other tax matters.

It also reflects the practical reality of a transfer pricing analysis. As transfer pricing is driven by specific facts and circumstances and involves comparisons with similar arm's length transactions, the taxpayer is far more likely to hold the relevant information to support its pricing than Inland Revenue.

At the time of publication, the onus of proof was on the taxpayer for transfer pricing matters in Australia, the United States, Canada, China, Hong Kong, Singapore, the United Kingdom, Ireland, France and Germany. This means most multinationals already prepare transfer pricing documentation that satisfies the onus of proof for other countries.

Putting the onus of the proof onto the taxpayer increases the importance of transfer pricing documentation. A lack of adequate documentation may make it difficult for the company to rebut alternative arm's length conditions proposed by Inland Revenue.

Documentation

The revised chapter V of the OECD's transfer pricing guidelines recommends a three-tiered approach to transfer pricing documentation:

- a master file providing an overview of the multinational's global business operations, transfer pricing policies and global allocation of income and economic activity;
- a local file providing detailed information regarding material related party transactions; and

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- a Country-by-Country report which must be prepared and filed by large multinational groups. New Zealand's Country-by-Country reporting requirements apply to New Zealand-headquartered multinational groups with EUR €750m of consolidated revenue in the preceding income year. These requirements are further described in the special report on administrative measures (see the section on "Country-by-Country reports" covering the new section 78G of the Tax Administration Act 1994).

New Zealand endorses this approach to transfer pricing documentation. Further guidance on transfer pricing documentation is available in chapter V of the OECD guidelines and the annexes I and II to chapter V which outline the information which should be included in the master file and the local file.

To supplement the OECD guidelines, Inland Revenue publishes some short guidance on certain transfer pricing topics on its website at **www.ird.govt.nz/international/business/transfer-pricing/**

This supplementary guidance includes a topic on Inland Revenue's view on best practices for preparing useful and suitably focused transfer pricing documentation at **www.ird.govt.nz/international/business/transfer-pricing/transfer-pricing/practice/transfer-pricing-practice-documentation.html**

Seven year time bar for transfer pricing issues in some circumstances

Inland Revenue generally has four years from the end of the tax year in which a taxpayer files an income tax return to investigate and amend the tax position taken by the taxpayer in their return. This four year limit is known as the time bar.

The general four year time bar has been extended to seven years for the purposes of the transfer pricing rules in limited circumstances. New section GC 13(6) extends the time bar by allowing the Commissioner to amend an assessment of tax, under the transfer pricing rules, within a seven year period after the tax year in which the relevant tax return was originally filed, if the Commissioner notifies the taxpayer that a tax audit or investigation has commenced within the usual four year time bar.

The notification that a tax audit or investigation has commenced and that the Commissioner is applying GC 13(6) will be provided in writing.

If the Commissioner of Inland Revenue (or an officer of Inland Revenue who has been delegated this authority) has not provided the relevant taxpayer with a written notification within four years of the tax return being filed, the general time bar in section 108 of the Tax Administration Act 1994 will apply.

The notification requirement means the majority of taxpayers will have the same level of certainty as the general four year time bar as they will know after four years that since Inland Revenue has not provided written notification that the time bar for their transfer pricing positions is being extended that these positions are final.

Example

In May 2020, Company B files a tax return for their income year from 1 April 2019 to 31 March 2020 which includes some transfer pricing positions.

In May 2024, four years have passed since the tax return was filed. As Inland Revenue has not notified the taxpayer that their transfer pricing positions are being investigated, the taxpayer will have certainty that their transfer pricing positions (and any other tax positions) taken in their May 2020 tax return can be considered final under the general time bar in section 108 of the Tax Administration Act 1994.

In other cases, where Inland Revenue identified a tax risk and notifies the taxpayer within four years of the relevant tax return being filed, Inland Revenue will have seven years from the date the tax return was filed to make a transfer pricing adjustment.

The use of the words "despite the time bar…" in section GC 13(6) means the that in those cases where 13(6) applies, the seven year time bar overrides the general time bar in section 108 of the Tax Administration Act 1994.

The seven year time bar can be applied for all transfer pricing issues that are subject to sections GC 6 to GC 19, including "cross-border related loans" that are subject to sections GC 15 to 19.

The ability to extend the time bar for transfer pricing issues to seven years under section GC 13(6) applies from income years beginning on or after 1 July 2018. This means that tax positions taken in returns relating to income years that began before 1 July 2018 will continue to be subject to the existing four year time bar.

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NEW LEGISLATION

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The seven year time bar can be applied for all transfer pricing issues that are subject to sections GC 6 to GC 19, including "cross-border related loans" that are subject to sections GC 15 to 19.

The ability to extend the time bar for transfer pricing issues to seven years under section GC 13(6) applies from income years beginning on or after 1 July 2018. This means that tax positions taken in returns relating to income years that began before 1 July 2018 will continue to be subject to the existing four year time bar.

Example

In June 2020, Company C files a tax return for their income year from 1 April 2019 to 31 March 2020.

In 2021, Inland Revenue begins an investigation of Company C's tax return for their 2019/20 tax year. The investigation involves a series of meetings, site visits, interviews, and requests for information held by Company C and other members of their group as well as procuring expert views on certain issues from independent international specialists.

In January 2024 Inland Revenue provides written notification to Company C that they are being investigated for the transfer pricing positions that they have taken in their June 2020 tax return and that the Commissioner is applying section GC 13(6) to extend the time bar for the transfer pricing issues so adjustments can potentially be made up until June 2027.

In March 2024, Inland Revenue issues a Notice of Proposed Adjustment to Company C regarding their transfer pricing position in their June 2020 tax return. In this case, the extension of the time bar was not actually required, as an assessment was made within four years of the relevant tax return being filed.

BEPS - Permanent establishment anti-avoidance rules

Sections BH 1(4), GB 54, YD 4(17C), YD 4B, YD 5(1BA), YD 5B and schedule 23 of the Income Tax Act 2007

The Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 inserts a new anti-avoidance rule into the Income Tax Act for large multinationals (with over €750m of consolidated global turnover) with a structure intended to avoid having a permanent establishment (PE) in New Zealand.

The rule deems a non-resident to have a PE in New Zealand if a related entity carries out sales-related activities for it here under an arrangement with a more than merely incidental purpose of tax avoidance (and the other requirements of the rule are met). This PE is deemed to exist for the purpose of any applicable double tax agreement (DTA), effectively overriding the DTA's definition of a PE, unless the DTA incorporates the OECD's latest PE article.[1]

In addition, the Act inserts further provisions under which an amount of income will be deemed to have a source in New Zealand if that income can be attributed to a PE in New Zealand. If a New Zealand DTA applies to the non-resident, the definition of a PE in that DTA will apply for this purpose. If no New Zealand DTA applies to the non-resident, then a new domestic law definition of a PE will apply.

Background

PE anti-avoidance rule

New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules in conjunction with our DTAs. Under our DTAs, like those for most other countries, New Zealand is generally prevented from taxing a non-resident's business income unless the non-resident has a PE in New Zealand. This is the case even if that income has a source in New Zealand under our domestic legislation.

A PE is basically a fixed place of business of the non-resident, but it also includes a dependent agent that habitually concludes contracts on behalf of the non-resident. If a PE exists, then under the DTA New Zealand may tax only the income attributable to that PE (unless that income is also subject to another DTA provision).

The non-resident must also have a PE in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax (NRWT) on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

The problem the new rule is trying to address is the ability of some multinationals to structure their affairs so they do not have a PE in New Zealand, despite having significant economic activity carried on for them here. This usually involves the non-resident entity establishing a New Zealand subsidiary to carry out local sales related activities (the transfer pricing rules discussed elsewhere in this special report will apply to transactions between the non-resident and the subsidiary in this case).

The OECD and the G20 are also concerned about PE avoidance, and have recommended measures to address it as part of their 15 point base erosion and profit shifting (BEPS) Action Plan. This includes a new, broader definition of a PE for DTAs. Under this new PE definition, a representative of the non-resident will only need to habitually play a principal role leading to the conclusion of contracts that are routinely concluded without material modification in order to give rise to a PE for the non-resident. This contrasts with the current PE definition in most DTAs, where the representative must habitually conclude contracts on behalf of the non-resident in order to give rise to a PE.

The OECD has prepared the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) to rapidly implement the treaty changes recommended as part of its BEPS Action Plan. New Zealand signed the MLI on 7 June 2017. Under the MLI, the OECD's new widened PE definition will be included in New Zealand's DTAs, but only if the other country signs the MLI and elects to adopt that new PE definition.

This new, widened definition should be effective in addressing the kinds of PE avoidance we have seen in New Zealand. However a majority of New Zealand's trading partners have not elected to adopt the widened PE definition, including some countries from which significant investment into New Zealand is made. Therefore, the practical effectiveness of the OECD's widened PE definition is curtailed by its failure to be incorporated into many DTAs, and so it will not be sufficient to address the issue of PE avoidance in New Zealand.

Source rules

Under the current rules, there is a possibility that New Zealand may be entitled to tax a non-resident on its sales income under the PE article of a DTA, but cannot do so under our domestic source rules.

There is general international consensus that if income is derived through a PE in a country, then it is sufficiently connected with that country to be taxed there. Accordingly, any income that is attributable to a PE should also have a New Zealand source under our domestic rules.

In addition, in order to tax a non-resident on its New Zealand sales income, it is currently necessary to show that the income both has a New Zealand source and is attributable to a PE under a DTA. This increases the compliance and administrative burden of determining a non-resident's tax liability for its sales to New Zealand customers.

Key features

PE anti-avoidance rule

The Act introduces a new PE anti-avoidance rule in section GB 54 of the Income Tax Act. The rule deems a PE to exist in New Zealand for a non-resident if all the following criteria are met:

- The non-resident is part of a large multinational group. The OECD has defined a "large multinational group" as a group with at least EUR €750m of consolidated global turnover for the purpose of filing Country-by-Country reports. The same revenue threshold is used for section GB 54.
- The non-resident makes a supply of goods or services to a person in New Zealand.
- A person (the "facilitator") carries out an activity in New Zealand for the purpose of bringing about that particular supply.
- The facilitator is associated with the non-resident, is an employee of the non-resident, or is commercially dependent on the non-resident.
- The facilitator's activities are more than preparatory or auxiliary to the non-resident's supply.
- The non-resident's income from the supply is subject to a DTA that does not include the OECD's latest PE article.
- A more than merely incidental purpose or effect of the arrangement is to avoid New Zealand tax, or a combination of New Zealand tax and foreign tax.

Where a supply is subject to the rule, the non-resident is deemed to make that supply through the deemed PE. The activities of the facilitator in relation to the supply are also attributed to the PE. The deemed PE exists for all the purposes of both the Act and the applicable DTA, notwithstanding anything in that DTA.

The tax consequences of the deemed PE are determined by the other provisions of the Act and the DTA. For example, New Zealand will have a right to tax the profits attributable to the PE under the business profits article of an applicable DTA (unless that business profits article provides otherwise).

Section GB 54 may also apply in the context of a third-party channel provider arrangement. This is a single arrangement under which the non-resident supplies goods or services to a non-associated New Zealand resident and the New Zealand resident on-supplies the goods or services to identified New Zealand customers with the assistance of the facilitator. If the new rule applies in these circumstances, then the facilitator's activities will give rise to a PE for the non-resident in respect of its supplies to the third-party channel provider.

Source rule

The Act also introduces a new source rule for PEs. This rule provides that any income attributable to a PE in New Zealand has a source in New Zealand. The Act introduces the following definitions for a PE:

- Where a taxpayer is resident in a jurisdiction that has a DTA with New Zealand, the definition will be the same as the definition of a PE in that DTA. Any PE deemed to arise under section GB 54 will also be a PE under the definition (but only if the DTA does not include the OECD's new PE definition).
- Where a taxpayer is resident in a jurisdiction that does not have a DTA with New Zealand, the definition of a PE will be that set out in the new schedule 23 to the Act (domestic PE definition). This definition is based on New Zealand's model DTA article 5, which includes the OECD's new PE definition.

[1] This is contained in Article 12(1) of the Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting (MLI)

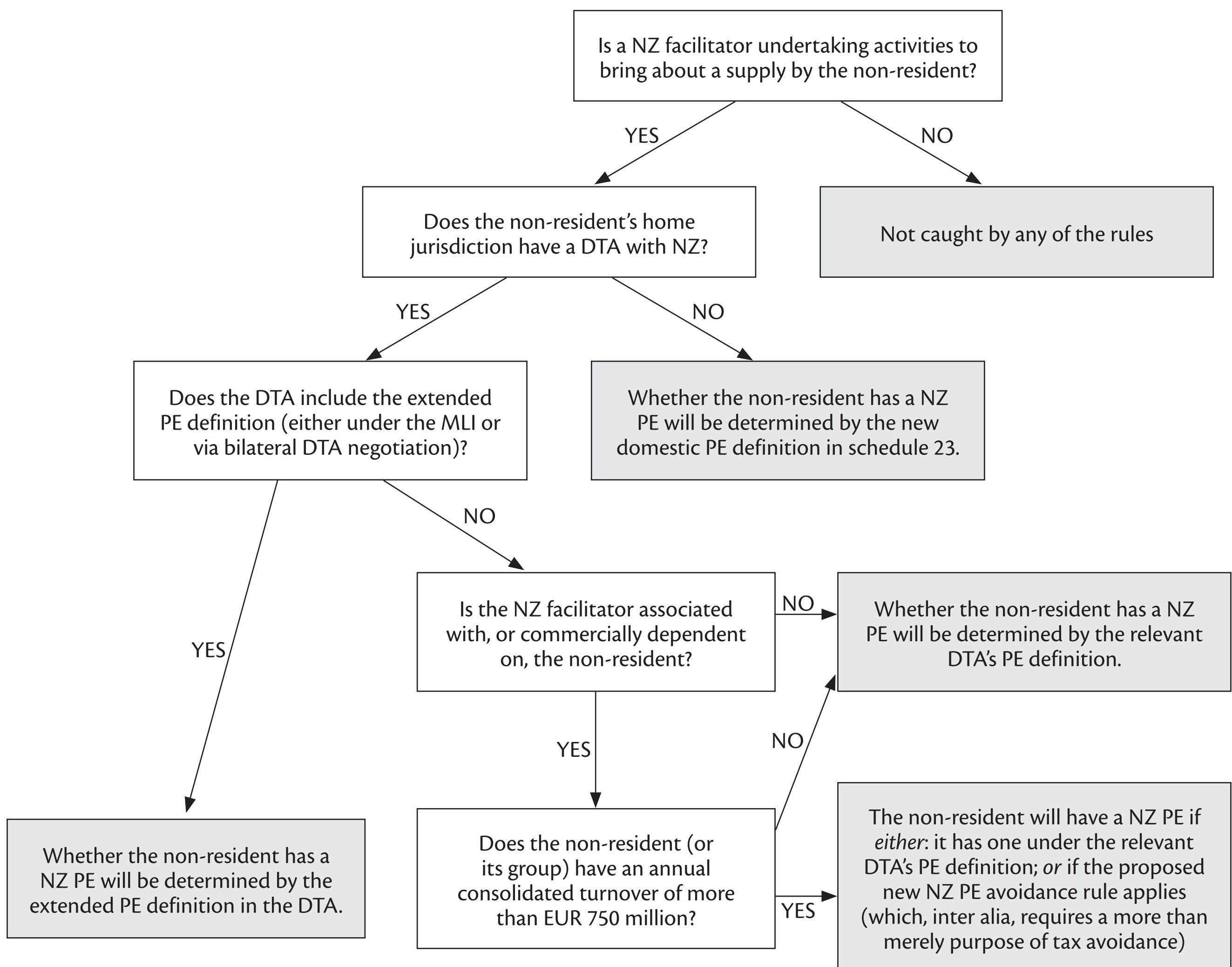
The high-level application of all these new rules can be summarised as follows. In determining whether the non-resident has a deemed PE in New Zealand, the new PE anti-avoidance rule:

- **Applies** if the jurisdiction where the non-resident is resident has a DTA with New Zealand, but that DTA does *not* incorporate the OECD's new PE definition.
- Does **not** apply if the non-resident's jurisdiction has a DTA with New Zealand, and that DTA *does* incorporate the OECD's new PE definition. Instead the OECD's new PE definition in the DTA applies.
- Does **not** apply if the non-resident's jurisdiction does *not* have a DTA with New Zealand. Instead the new domestic PE definition (which incorporates the OECD's new PE definition) applies.

In all the above circumstances, if the non-resident has a PE in New Zealand then any income attributable to that PE will have a New Zealand source. Whether income is attributable to the PE will be determined under the standard PE profit attribution methodology applied by New Zealand.

The application of these rules is illustrated in the flowchart below (which assumes there is not already a PE in New Zealand in relation to the supplies).

Flow chart for application of new rules



Application date(s)

The new rules apply for income years starting on or after 1 July 2018.

Detailed analysis

PE anti-avoidance rule

New section GB 54 deems a PE to exist in New Zealand for a non-resident if all the listed criteria in section GB 54(1) are met. These criteria are discussed below.

NEW LEGISLATION

The non-resident is, or is part of, a large multinational group - paragraph (j)

A large multinational group is defined in section YA 1 of the Act to require a consolidated accounting group turnover of at least EUR €750m (being the threshold described in paragraph 5.53 of the OECD transfer pricing guidelines) for the previous period. This revenue threshold was agreed by the OECD as a way to define large multinational groups for the purpose of filing Country-by-Country reports. The multinational must also have a member in New Zealand (or income with a source in New Zealand) and a member overseas to be a "large multinational group" under the definition.

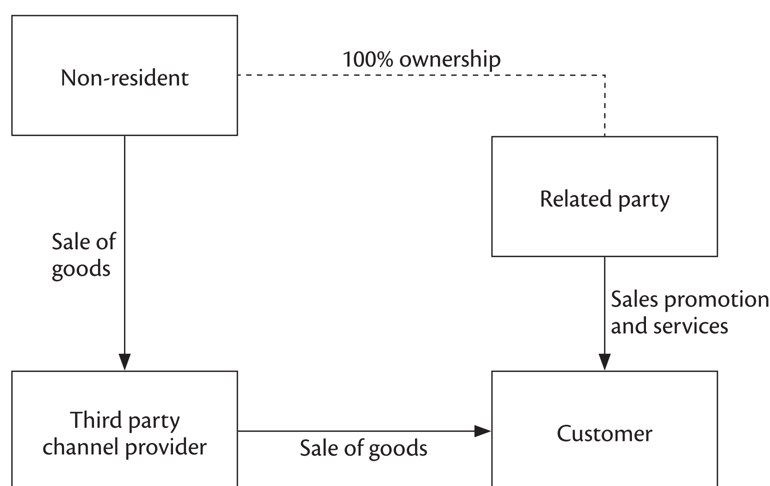
The non-resident makes a supply of goods or services to a person in New Zealand - paragraph (a)

The definition of "supply" from the Goods and Services Tax Act 1985 (GST Act) will apply for this purpose. The time of the supply should also be determined under the GST Act for the purposes of section GB 54. In addition the relevant supply may be made by the non-resident either:

- directly to a person in New Zealand; or
- to another person in New Zealand (the intermediary) under an arrangement that includes the intermediary on-supplying the goods to another person in New Zealand. The intermediary does not need to be associated or otherwise related to the non-resident.

The provision for intermediaries is intended to include third-party channel provider arrangements within the scope of the rule. Specifically, the provision is intended to ensure the rule can cover the supply by a non-resident to a third party where that supply is part of an arrangement under which those same goods or services are to be on-sold by the third party to an identified customer, and the non-resident's facilitator deals with the end-customers to bring about the supply by the intermediary to the third party. Figure 4 illustrates this kind of arrangement (with the "Related party" in figure 4 being the facilitator).

Figure 4



The customer must be known to the facilitator at the time the non-resident makes its supply to the recipient for this rule to apply. This is to ensure that only arrangements involving an identifiable customer are caught by the rule.

Third-party channel provider arrangements should be within the potential scope of section GB 54. This is because under such an arrangement, the non-resident, the facilitator, and the third party are working together to sell the particular goods or services to the end customer. Further, the non-resident's supply to the third party is wholly dependent on the customer agreeing to purchase the goods. This means that the facilitator's activities are made in relation to the non-resident's supply to the third party as well as the third party's on-supply to the end customer (which makes sense given that the facilitator acts for the non-resident, not the third party). Therefore, the activities of the non-resident's facilitator should still be able to give rise to a PE for the non-resident (provided the other requirements of section GB 54 are met).

Where section GB 54 does apply to deem a PE to exist in respect of a third-party channel provider arrangement, only the supply by the non-resident to the intermediary, and the facilitator's activities, will be attributed to the deemed PE for the purposes of determining the profit attributable to that PE. The supply by the third-party channel provider to the customer, and the activities of the third-party channel provider, will not be attributed to the deemed PE.

A person (the "facilitator") in New Zealand carries out in New Zealand an activity for the purposes of bringing about the supply - paragraph (b)

The facilitator must carry on an activity for the purpose of bringing about the supply to the recipient. Where there is an intermediary, the section will also apply if the facilitator carries on an activity for the purpose of bringing about the supply by the intermediary to the recipient. It is intended that only activities designed to bring about a particular supply to an identifiable person should potentially result in a deemed PE. Therefore activities that do not relate to a particular supply, such as advertising and marketing, would not be sufficient to trigger a possible PE under this requirement. After-sales activities, such as technical support, would also not be sufficient to meet this requirement, as they occur after the supply has been made.

The kinds of activities that are within the intended scope of this provision primarily include activities designed to convince a particular customer to acquire the supply (as opposed to general marketing and advertising, which are not carried on in relation to particular, identifiable, customers).

Paragraph GB 54(1)(b) specifies that the facilitator cannot also be the intermediary. This is to ensure that section GB 54(1) (b) does not cause section GB 54 to apply to an ordinary distributor arrangement. In an ordinary distributor arrangement, the distributor would be carrying out all the particular sales activities on its own behalf, rather than on the non-resident's behalf (and the non-resident would not have a separate facilitator in New Zealand assisting with the sales of the kind found in 3rd party channel provider arrangements). Accordingly, in these circumstances the distributor's activities should not give rise to a PE for the non-resident.

The facilitator is associated, an employee, or commercially dependent on the non-resident - paragraph (c)

Section GB 54 is aimed at circumstances where the facilitator is part of the same economic or control group as the non-resident. It is these circumstances which allow the multinational to avoid having a PE by splitting its activities between related companies (the non-resident supplier and the facilitator). Accordingly, for the section to apply, the facilitator must be associated with the non-resident under paragraph (c).

The same concern also arises where the non-resident's sales activities are carried out by a New Zealand entity that is not associated with the non-resident, but is commercially dependent on it. In this case, the non-resident is also able to have sales activities carried out by a special purpose entity over which it has significant de-facto control (by virtue of its commercial dependency). Accordingly, paragraph (c) also applies in these circumstances.

The concept of "commercially dependent" is subjective. Therefore paragraph (c) instead uses the more precise test of whether the facilitator derives more than eighty percent of its assessable income from the non-resident or its associates in both the current and preceding income year. The requirement for the eighty percent test to be met for both years is to protect against the risk of a person unexpectedly falling within the definition for a year, which will give more certainty about when the test applies. It also ensures that a facilitator will not be commercially dependent in its first year of operation, when it is trying to build up its client base and may have a single customer only.

For the sake of clarity, paragraph (c) also states that a facilitator includes an employee of the non-resident. This means that section GB 54 could potentially apply to "fly-in/fly-out" arrangements, where a non-resident sends one of its employees to New Zealand to undertake sales related activities. The reason for this is that there is no black letter rule in DTAs providing that fly in, fly out employees or representatives cannot give rise to a PE for a non-resident (in particular, there is no requirement in our DTAs for a dependent agent's activities to be connected with a fixed and permanent place in New Zealand in order for them to give rise to a PE). Whether a PE arises is always a question of fact and circumstance. There may be some circumstances in which a fly in, fly out employee or representative does give rise to a PE. Fly in, fly out employees and other representatives of the non-resident should therefore not be automatically excluded from section GB 54. Otherwise, a PE could still be avoided in a fly in and fly out arrangement.

However, the dependent agent provision in most DTAs requires that the non-resident's representative (that is, the employee) *habitually* concludes contracts on behalf of the non-resident. This means that the employee's activity in New Zealand must be regular to some degree before it can potentially result in the avoidance of any tax under section GB 54(1)(h). For example if an employee of the non-resident only made a short visit to New Zealand in order to promote or negotiate a single supply, we would not expect this to result in the avoidance of any tax under section GB 54(1)(h) (as the employee's activity would not have given rise to a PE under the DTA even if the employee had executed the contract in New Zealand). Therefore, we would not expect section GB 54 to apply in this case.

However if the employee made regular trips each year to conclude contracts, then the employee potentially could be habitually concluding contracts in New Zealand, even if it only concluded a single contract on each trip[2].

As a result of paragraph (c), any sales-related activity carried on by an unrelated independent agent will generally not give rise to a PE under section GB 54. This also reflects the current definition of a PE in New Zealand's DTAs.

The activity is more than preparatory or auxiliary - paragraph (d)

As stated above, only activities that are designed to bring about a particular supply should be within the scope of section GB 54. To support this, paragraph (d) provides that any activities that are only preparatory or auxiliary to the non-resident's supply of goods or services do not trigger the application of section GB 54. An example of preparatory or auxiliary activities is general marketing or advertising of a non-resident's products. Warehousing and delivery of the supplied goods would also usually be preparatory or auxiliary. However, this would not be the case for example where the main business activity of the non-resident was delivering goods.

Paragraph (d) is also intended to incorporate the exception in most DTAs, which provides that preparatory and auxiliary activities do not give rise to a PE. Therefore in interpreting the meaning of "preparatory or auxiliary" in paragraph (d), it is intended that the OECD's Commentary on the articles of the Model Tax Convention on Income and Capital (OECD Commentary) will be relevant.

The following table sets out examples of when paragraphs GB 54(1)(a) to GB 54(1)(d) (collectively referred to as the "sales test") would apply. Even if the sales test is met for an example, section GB 54 would apply only if the section's remaining requirements were met (in particular, the requirement that the relevant arrangement was carried out for a more than merely incidental purpose or effect of tax avoidance).

New Zealand activity	Application of the sales test in paragraphs GB 54(1)(a)–(d)
There is no activity in New Zealand in relation to the supply.	The sales test is not satisfied. There is no "facilitator" under paragraph (b).
There is an online platform operated by a subsidiary of the non-resident through which New Zealand customers can order goods over the internet. The web-server for the platform is located in Australia and the platform is maintained and run by staff located in Australia.	The sales test is not satisfied. Although the platform can be accessed by customers located in New Zealand, all the activity in respect of the platform is carried on by the subsidiary's employees and assets in Australia. Accordingly, paragraph (b) is not met as the subsidiary does not carry on any activity in New Zealand.
A non-resident operates a website through which customers worldwide can order goods and services. The website is located and maintained outside New Zealand. General advertising and marketing activity is undertaken in New Zealand by a subsidiary of the non-resident to make potential users of the website aware of its benefits and uses. The subsidiary does not deal directly with any particular customers.	In this case, there is an activity carried on in New Zealand, however the activity does not facilitate a particular supply to a customer. Accordingly paragraph (b) is not met. In addition the advertising and marketing activities are considered to be preparatory or auxiliary to making a supply. Consequently paragraph (d) also is not met.
A non-resident operates an off-shore website, through which it sells directly to customers in New Zealand. The non-resident also has a contract with an unrelated third party in New Zealand to store its goods at the third party's warehouse. The third party has several similar arrangements with other, unrelated, suppliers. The non-resident does not have any particular part of the warehouse set aside for it, and it does not have the right to access the warehouse without prior arrangement.	The third party carries on an activity in New Zealand for the non-resident. However the third party is not associated with the non-resident, or commercially dependant on it. Accordingly section GB 54(1)(c) is not met, and so the sales test is also not satisfied.

[2] See paragraphs 98 and 29 of the OECD Commentary to Article 5

A non-resident sells technical equipment to New Zealand customers. It has a subsidiary in New Zealand which undertakes technical demonstrations of the equipment to existing or potential customers to make them aware of the equipment's capabilities. The subsidiary does not discuss any of the sales terms or customise orders for a particular customer.	The sales test is not satisfied. The subsidiary's activity is in the nature of general advertising / marketing and does not relate to a particular supply to a customer. Accordingly paragraph (b) is not met. In addition, the subsidiary's activities would also be preparatory or auxiliary, so paragraph (d) is not met either. However, if the subsidiary went beyond demonstrating the equipment and instead worked with a particular customer to specify the equipment best suited to the customer's needs, and/or directly persuade the particular customer to acquire the equipment, then the subsidiary's activity would relate to any subsequent supply of that specified equipment to the customer, and so paragraph (b) would be met. Such an activity would also be more than preparatory or auxiliary, and so paragraph (d) would be met. Accordingly the sales test would be met in these circumstances.
A non-resident company offers an online platform, under which owners of horses in New Zealand can contract to supply their horses to riders for a fixed period. The platform is accessed via a smartphone app, with the server and all staff responsible for maintaining it located outside New Zealand. The non-resident company does have a subsidiary in New Zealand, which assists horse-owners in meeting the requirements to list their horses on the platform. However the subsidiary does not liaise with any horse riders.	The sales test is not satisfied. The activity of the subsidiary is essentially technical support for horse owners that have already decided they want to join the platform. Accordingly it is preparatory or auxiliary to the supply of platform services by the non-resident. However, if the subsidiary instead persuaded individual horse-owners to sign up to the platform, then the sales test would be met in respect of the platform's recurring supply of services to the horse owner.
A non-resident supplies photocopiers to New Zealand businesses. Its sale team is located offshore. However the non-resident has a subsidiary in New Zealand which provides technical support to existing customers. The subsidiary repairs malfunctioning photocopiers as part of the non-resident's warranty programme and trains new purchasers on how to use the photocopiers.	The sales test is not satisfied. The subsidiary's activity of providing repairs and training is made after the non-resident's supply has occurred, and therefore is not made for the purpose of bringing about the supply. This is the case even though the promise to provide such repairs and training may have encouraged the New Zealand businesses to acquire the photocopiers.
A non-resident has a subsidiary in New Zealand. The non-resident sells cars to the subsidiary. The subsidiary then markets and sells the cars to customers in New Zealand. Sometimes a customer requests a car with specifications that the subsidiary does not stock. In this case, the subsidiary enters into a contract to sell the car to the customer, and then buys that car from the non-resident for on-supply to the customer.	The sales test is not met. The subsidiary is a normal distributor, rather than a facilitator for the sale of cars by the non-resident to New Zealand customers. In particular the subsidiary is not acting as an intermediary for the sale of the cars by the non-resident. This is because there is not a single arrangement under which the non-resident supplies the cars to the subsidiary and the subsidiary on-supplies the cars to the customer. Instead there are two arrangements – one for the sale of the cars to the subsidiary, and another for the sale of the cars by the subsidiary to the customer. It does not matter in this regard whether the subsidiary acquires the car before or after it agrees to sell that car to the customer.
A multinational has a New Zealand subsidiary, whose staff have initial and on-going contact with customers. The subsidiary negotiates the contractual terms for the first sale to the customer. However orders after the first are placed directly with the offshore sales representative.	The sales test will be met for the first order. Whether the sales test is met for subsequent orders will depend on whether the subsequent sales are part of the same arrangement as the sale that was facilitated by the subsidiary. For example, if the subsidiary negotiated an arrangement under which the New Zealand customer could make repeat orders of paper from the non-resident, then the sales test would be met in respect of any repeat orders even if the customer sent the order directly to the offshore sales representative. However if for example the subsidiary facilitated an order for one product sold by the non-resident, but then the New Zealand customer ordered a completely different product and negotiated the terms of sale for that product with the offshore sales representative directly, then the sales test would not be met for that different product.

A non-resident has a subsidiary in New Zealand that discusses a potential sale by the non-resident with targeted customers and ensures that the non-resident's contractual terms for the sale are acceptable to the customer.	The sales test is met. The subsidiary is carrying out an activity in respect of a particular supply and the activity is undertaken for the purpose of bringing that supply about. In this case the subsidiary does not need to actually negotiate the contracts with the customers, as its activities are still made for the purpose of bringing a particular supply about. For example if the subsidiary initiated and arranged the sale in all other respects, but left any disagreement over the non-resident's contractual terms to be negotiated directly between the non-resident and the customers, then the sales test would still be met. This is because the subsidiary would still be carrying on an activity for the purpose of bringing about a particular supply, even though it did not carry on all the activities necessary to bring about that supply.
A non-resident does not have a subsidiary in New Zealand. Instead the non-resident sends one of its employees to New Zealand for 4 weeks every year to meet with potential customers. The employee markets the non-resident's products to potential customers and answers any questions they may have about the operation of the products. However the employee does not discuss contractual terms and does not help customise particular orders for customers.	The employee in this case is a facilitator for the non-resident under paragraph (c)(i). However, the employee's activity does not relate to a particular supply by the non-resident, so paragraph (b) is not met. In addition, the employee's activities are preparatory or auxiliary, so paragraph (d) also is not met. However if the employee instead worked with a particular customer to specify the products best suited to the customer's needs and/or negotiated contractual terms for the supply of those products, then the employee's activity would relate to the subsequent supply of those products to the customer, and so paragraph (b) would be met. Such an activity would also be more than preparatory or auxiliary, and so paragraph (d) would also be met. Accordingly, the sales test would be met.
A non-resident supplies home theatre components to custom installers in New Zealand. The custom installers work with customers to design their home theatres, and on-sell the home theatre components to the customers as part of the installation of the agreed design. The non-resident also has a subsidiary in New Zealand. For large projects, the non-resident's subsidiary works with both the custom installer and the customer to determine the customer's needs, select the products best suited to those needs, and provide expert technical oversight on their installation. The non-resident still supplies the home-theatre components to the custom-installer, who on-supplies them to the customer.	The sales test will be met for large projects (but not for smaller projects that do not involve the subsidiary working with the customer installer and the customer). The non-resident's subsidiary is the facilitator in this example. The non-resident makes a supply to an intermediary in New Zealand (the custom installer) who in turn on-sells the products to another person in New Zealand (the customer). The facilitator (the subsidiary) carries out an activity for the purpose of bringing about the sale to the recipient (the customer). Finally, the supply by the non-resident to the custom installer, and the supply by the custom installer to the customer, are both part of the same arrangement.

The non-resident is relying on a DTA that does not include the OECD's new PE definition – paragraph (e)

As discussed above, the OECD has introduced a new PE definition to counter PE avoidance. This new PE definition has been included in its Model Tax Convention on Income and Capital (Model Treaty), and will also be inserted into the DTAs of participating countries under the MLI (provided both jurisdictions elect to include it).

The OECD's new PE definition has several components. The relevant component here is that contained in article 12(1) of the MLI. In particular, the part of article 12(1) providing that a dependent agent PE will arise for a non-resident where a person habitually plays the principal role leading to the conclusion of contracts by the non-resident that are routinely concluded without material modification. The Government's view is that this amended definition should be sufficient to prevent the kind of PE avoidance we have seen in New Zealand. It is also expected that section GB 54 and the OECD's new PE definition will apply in broadly similar circumstances.

For this reason, paragraph (e) provides that section GB 54 will not apply where the non-resident's income from its supplies to New Zealand customers is covered by a DTA which incorporates the OECD's new PE rule. It does not matter for this purpose whether the OECD's new PE rule is inserted into the DTA by the MLI, or is subsequently agreed by New Zealand and the other party in bilateral treaty negotiations. The new PE rule does not apply automatically to a DTA once the participating countries sign the MLI. Instead each country must first elect to include the new PE rule, then ratify the MLI. The OECD's new PE rule will then apply to the DTA with effect from the date specified in articles 34 and 35 of the MLI.

While article 12(1) of the MLI and section GB 54 are expected to apply in broadly similar circumstances, there may be differences in their application due to their different formulations. In particular paragraphs GB 54(1)(a) to GB 54(1)(d) (referred to in the examples above as "the sales test") will collectively apply more broadly than the requirement under article 12(1) that a person habitually plays the principal role leading to the conclusion of contracts by the non-resident. On the other hand, section GB 54

also requires the arrangement to have a more than merely incidental purpose of tax avoidance (under paragraphs GB 54(1)(h) and (i)), which article 12(1) does not. Therefore section GB 54 might apply to some circumstances which article 12(1) does not, and vice versa

The domestic law definition of a PE does not apply to a non-resident – paragraph (f)

New section YD 4B(3) inserts a definition of a PE into the Act for non-residents to whom no DTA with New Zealand applies. This domestic definition includes the OECD's new PE definition. Accordingly, paragraph (f) provides that section GB 54 does not apply if the non-resident is subject to the domestic definition of a PE under section YD 4B(3).

The income from the supply is not already attributable to a PE – paragraph (g)

This is a mechanical provision. If the non-resident's income is already attributable to a PE, then there should not be any PE avoidance occurring in respect of that income. Accordingly, paragraph (g) provides that section GB 54 will not apply in these circumstances.

The arrangement does not have a more than merely incidental purpose or effect of tax avoidance – paragraphs (h) and (i)

In order for section GB 54 to apply, the relevant arrangement must have a more than merely incidental purpose or effect of avoiding tax under paragraphs (h) and (i). This requirement has been inserted for two reasons:

- to target the rule's application at BEPS activities, rather than more ordinary commercial arrangements; and
- to make the rule consistent with New Zealand's DTA obligations. The OECD Commentary states that, as a general rule, there will be no conflict between anti-avoidance provisions and the provisions of a DTA (as discussed further below under "other matters").

Tax for this purpose means both New Zealand income tax, and a combination of New Zealand income tax and foreign income tax. This is to prevent any argument that an arrangement's avoidance of New Zealand tax was only incidental to its avoidance of foreign tax. For income years starting on or after the enactment date of the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill, sections (h) and (i) will also apply to arrangements that have a purpose or effect of avoiding other types of tax (as specified by section YA 2(3)), such as NRWT.

The general anti-avoidance rule (GAAR) in section BG 1 also requires that an arrangement has a more than merely incidental purpose of tax avoidance. However, in applying the GAAR, the courts have imposed a further requirement that the arrangement uses the relevant provisions in a manner not contemplated by Parliament (see *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115). This further requirement arises out of the need to reconcile Parliament's purpose for the specific tax provisions (which may have been intended to confer a benefit in the circumstances) with its purpose for section BG 1 (see *Ben Nevis* at [102]). This further requirement is usually referred to as the 'Parliamentary contemplation test'.

Section GB 54 is a specific anti-avoidance provision, rather than a GAAR. Further, the scope of section GB 54 has been carefully circumscribed. For these reasons, there is no need to reconcile the application of section GB 54 with the intended application of any other provisions. Instead, the intention is for only the more than merely incidental purpose test to be used in determining whether section GB 54 applies. It is not intended for the Parliamentary contemplation test (or the earlier scheme and purpose test) to also apply.

Subparagraphs (h) and (i) have been drafted to achieve this. It would not be appropriate to refer directly to the Parliamentary contemplation test in the legislation, as this is a judicial rather than a statutory requirement (and so might change in the future). Instead, the subparagraph has been drafted without reference to the definitions of "tax avoidance arrangement" or "tax avoidance" used by section BG 1. This is to make it clear that the test under subparagraphs (h) and (i) does not import the Parliamentary contemplation test (or the earlier scheme and purpose test) associated with those definitions.

Only the case law relevant to whether there is a more than merely incidental purpose or effect of tax avoidance should apply (for example, excluding any Parliamentary contemplation or scheme and purpose component of the test under the GAAR) in determining whether the more than merely incidental purpose test in subparagraphs (h) and (i) is met.

There is a significant body of case law on the more than merely incidental test. This case-law has generally required a degree of artificiality or contrivance before the test can apply (see the decision of Woodhouse P in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA)). In particular, the test has been held not to apply to ordinary commercial arrangements (i.e. arrangements undertaken for commercial purposes only). More information on the application of the merely incidental test is set out in the Commissioner's Interpretation Statement IS 13/01 *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007*, paragraphs 395–438.

An example of the application of section GB 54 is set out below. The facts of this example are loosely based on the French *Valueclick* tax case, in which the non-resident was held not to have a PE under the French/Irish DTA (*Sté Valueclick Ltd.*, n° 17PA01538 (CAA Paris, 9e ch., 1 March 2018)). France does not have an equivalent to section GB 54.

Example

A non-resident (Parent) operates a business of personalised digital marketing, allowing brands to connect with consumers individually. Parent is part of a large multinational group, with consolidated global revenues well in excess of €750 million. Parent is resident in a country with which New Zealand has a DTA, but that DTA does not incorporate the OECD's new PE article.

Parent has a subsidiary in New Zealand (Subsidiary), whose purpose is to promote Parent's services in the New Zealand market.

Subsidiary contractually agrees to provide the following services to Parent:

- marketing and sales support, which includes the identification and prospection of potential customers;
- ongoing management services and back office support services; and
- administrative assistance, including accounting, human resources management, information technology and treasury.

Subsidiary's employees in practice negotiate the terms of the sales agreements and draft certain key terms with the customers. In addition, Subsidiary's employees behave towards customers as if they were representatives of the Parent.

Subsidiary's employees legally cannot bind or otherwise act in the name of Parent. The acceptance of the customer contract always requires Parent to sign the contract offshore. In practice however, the signature is an automatic validation of the contracts negotiated and developed by the employees of Subsidiary.

Applying section GB 54 to this case:

- There is a non-resident (Parent) making supplies to a person in New Zealand (the customers). Consequently, paragraph GB 54 (1)(a) is met.
- A facilitator (Subsidiary) carries on an activity in New Zealand for the purpose of bringing about those supplies under an arrangement with the non-resident (Parent). Consequently, paragraph GB 54(1)(b) is met.
- The facilitator (Subsidiary) is associated with the non-resident (Parent), as it is a wholly owned subsidiary of Parent. Consequently, paragraph GB 54(1)(c) is met.
- Subsidiary carries out significant sales activities for Parent. Accordingly, Subsidiary's activities are more than preparatory for, or auxiliary to, Parent's supplies. Consequently, paragraph GB 54(1)(d) is met.
- Parent's income from the supply is subject to a DTA, but that DTA does not incorporate the OECD's latest PE definition (as set out in article 12(1) of the MLI). Consequently, paragraph GB 54(1)(e) is met.
- Section YD 4B(3) incorporates a definition of a PE into domestic law, but only for non-residents that are not subject to a DTA. In this case, Parent's income from the supply is subject to a DTA, and so section YD 4B(3) does not apply to Parent. Consequently, paragraph GB 54(1)(f) is met.
- The non-resident does not already have a PE in New Zealand. Consequently, paragraph GB 54(1)(g) is met.
- The arrangement results in the non-resident paying less tax in New Zealand compared to if the non-resident had a PE in New Zealand. Consequently, paragraph GB 54(1)(h) is met. Since section GB 54(2) deems a PE to exist, the relevant counterfactual for this purpose is the non-resident having a PE in New Zealand. However if the existence of a PE would not affect the non-resident's tax liability, then paragraph GB 54(1)(h) would not be met.
- The non-resident is part of a large multinational group, as that term is defined in section YA 1. This is because Parent's consolidated accounting group has:
  - over EUR €750 million of revenue for the preceding income year;
  - a member resident in New Zealand (Subsidiary); and
  - a member resident overseas (Parent).

Therefore, section GB 54(1)(j) is met.

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As a result, section GB 54 will apply if the reduction in tax for the Parent is a more than merely incidental purpose or effect of the arrangement between Parent and Subsidiary. In determining whether this test is met, previous case law on the more than merely incidental component of the general anti-avoidance rule in section BG 1 will be applicable. The Commissioner's interpretation of this case law is set out in her Interpretation Statement IS 13/01 Tax Avoidance and the Interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007 (particularly paragraphs 395–438). However, the Parliamentary contemplation component of the general anti-avoidance rule will not apply.

In applying the more than merely incidental test to the arrangement, it is significant that all the sales activity is carried out by Subsidiary in New Zealand. Parent's only role is the pro-forma execution of the contracts negotiated by Subsidiary. There is no convincing commercial purpose for the non-resident to formally execute the contracts offshore when it was not involved in negotiating the contracts. In addition, the legal form of the arrangement does not reflect its substance. This is because in reality Subsidiary creates the customer contracts in New Zealand. The formal execution of the customer contracts by Parent offshore is thus artificial. It is also this feature that also allows Parent to avoid having a PE in New Zealand, and so allows the non-resident to avoid tax in New Zealand. Accordingly it can be objectively concluded that Parent's execution of the contracts offshore was inserted into the arrangement for the purpose of avoiding New Zealand tax. Consequently this tax avoidance purpose is not merely incidental to another purpose of the arrangement.

Therefore, the arrangement has a more than merely incidental purpose or effect of tax avoidance, and so paragraph GB 54(1)(i) is met. As a result, section GB 54 will apply to the arrangement.

Consequences of application (sections GB 54(2), BH 1(4))

If section GB 54 applies, then under section GB 54(2) the non-resident is treated as having a PE in New Zealand. Supplies made by the non-resident are then treated as being made though that PE – but only if section GB 54(2) applies to those particular supplies. So for example, if the non-resident made some supplies in New Zealand in respect of which a related entity in New Zealand carried out sales activities (and the other requirements of the rule were met), then those supplies would be treated as made through the PE. However, if the non-resident also made other supplies in New Zealand and no related entity in New Zealand carried out any sales related activities in respect of those supplies, then those supplies would not be treated as made through the deemed PE for tax purposes.

The activities of the facilitator in relation to the supplies will also be attributed to the PE for the purposes of determining the profit attributable to it (and so the taxable income in New Zealand). Other activities of the facilitator (for example activities in relation to another taxpayer's supplies) will not be attributed to the PE

The normal PE profit attribution rules apply to determine the amount of profits attributable to the deemed PE under section GB 54. In this regard, New Zealand follows an earlier version of the OECD's latest PE profit attribution rules (and not the latest version, which is known as the "authorised OECD approach", or AOA). This is for two reasons:

1. The AOA only applies to DTAs which incorporate the latest version of Article 7 (business profits) of the Model Treaty. None of New Zealand's DTAs incorporate this version of Article 7, so the AOA is not relevant to New Zealand's DTAs.
2. New Zealand does not agree with some aspects of the AOA and has made an explicit reservation against it.

DTAs, as international agreements, do not have any legislative effect except to the extent provided for in domestic legislation. DTAs are given legislative effect for tax purposes by section BH 1(4) of the Income Tax Act. This provides that DTAs have effect, despite anything else in the Act (subject to a list of exceptions). To make it clear that section GB 54 overrides any applicable DTA, an amendment to section BH 1(4) adds GB 54 to the list of sections which a DTA cannot override.This means that section GB 54 will deem a PE to exist for all the purposes of the Income Tax Act notwithstanding anything in that DTA.

The PE under section GB 54 will also be deemed to exist for the purposes of the other articles of the DTA. This is because those articles only have legal effect as provided for in the Income Tax Act, and section GB 54 of the Income Tax Act provides that the taxpayer has a PE in New Zealand. Therefore the Income Tax Act will give legal effect to the other articles of a DTA on the basis that the taxpayer has a PE in New Zealand.

It is important to note that section GB 54 on its own simply deems a PE to exist. It does not directly impose any tax or deem any assessable income to arise. Instead, the tax consequences of a deemed PE will be determined under the other provisions of the Income Tax Act and any applicable DTA.

Example

Section GB 54 applies to a non-resident subject to the New Zealand-Australia DTA. Consequently:

- The taxpayer is deemed to have a PE for the purposes of New Zealand law. This also means it has a PE for the purposes of giving legal effect to a DTA.
- The business profits article of the DTA (Article 7) applies to allow New Zealand to tax the profits attributable to that PE.
- The ordinary tax rules apply on the basis that the taxpayer has a PE in New Zealand. In particular, new section YD 4(17C) deems the income attributable to the PE to have a New Zealand source.
- The PE under section GB 54 exists for the purposes of any other provision of the DTA. For example, it is deemed to exist for the purposes of Article 12(5) of the DTA. This means that New Zealand could impose NRWT on any royalties paid by the non-resident that are borne by or deductible in calculating the profits of the PE. In this regard the Act also inserts new section YD 4(17D), which provides that income has a source in New Zealand if New Zealand has a right to tax it under an applicable DTA. Accordingly if New Zealand was entitled to impose NRWT on royalties under Article 12(5) in respect of the deemed PE, then those royalties would also have a New Zealand source under article YD 4(17D). This means that the royalties would also be subject to NRWT under the Income Tax Act.
- Items of income that are dealt with by other articles of a DTA will continue to be taxed in accordance with those other articles. This is because any conflicts between the tax treatment under a specific article (assuming the existence of a PE) and the tax treatment under Article 7 are dealt with under Article 7(5) of the DTA. Article 7(5) provides that the provisions of the other articles are not affected by the provisions of Article 7. For example, an Australian resident's profits from shipping and air transport would continue to be dealt with under Article 8 of the DTA (rather than Article 7), even if section GB 54 applied to deem the non-resident to have a PE in New Zealand in respect of that activity.

Other matters

The Government anticipates that some multinationals may wish to restructure their New Zealand operations in response to section GB 54. One of the policy goals of section GB 54 is to encourage taxpayers to move away from PE avoidance structures. Therefore, the Government is happy for taxpayers to restructure their New Zealand operations in response to section GB 54 by either adopting a formal PE, or by moving to a standard distributor model (where the goods or services are sold by the non-resident to an associated party in New Zealand, who then on-sells the goods to unrelated customers).

Section GB 54 applies for income years starting on or after 1 July 2018. The standard income year for taxpayers starts on 1 April (see the definition of "income year" and "tax year" in section YA 1 of the Income Tax Act 2007). This means that non-residents to whom section GB 54 applies will also have income years starting on 1 April (meaning section GB 54 will apply to them from 1 April 2019), unless they have applied to the Commissioner for a different balance date under section 38 of the Tax Administration Act 1994.

Non-residents to whom section GB 54 applies may wish to change their New Zealand income year to align it with their financial reporting period. The Commissioner's policy on requests to change balance dates for income years is set out in standard practice statement SPS 18/02 *Requests to change a Balance Date*. The statement notes that the Commissioner will accept retrospective requests to change balance dates provided certain criteria are met.

While section GB 54 will override DTAs, it should not conflict with New Zealand's obligations under those DTAs. This is because New Zealand's DTAs are based on the OECD's Model Treaty. The OECD Commentary is an important part of the context in which these DTAs are internationally understood. Section GB 54 is an anti-avoidance provision, as it only applies to an arrangement with a more than merely incidental purpose of tax avoidance. The OECD Commentary states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. It also confirms that states are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that this should not be lightly assumed).

However, it is important that section GB 54 applies notwithstanding anything in a DTA. This is to simplify the application of the rule. Otherwise it would be necessary to show that the application of section GB 54 was consistent with a DTA in each particular case. This would be a time-consuming and resource intensive exercise. The Government also considers that taxpayers should not be able to rely on DTAs to protect their tax avoidance arrangements. This is the same position that the UK and Australia have taken in respect of their PE anti-avoidance rules. As a result of this, the effect of section GB 54 on a taxpayer will not be reversed under a DTA's mutual agreement procedure.

Several provisions of the Income Tax Act refer to a "fixed establishment". A "fixed establishment" is conceptually similar to a PE, but they are not the same – for example a fixed establishment does not include a dependant agent of a non-resident. Section GB 54 only apples to deem a PE to exist – it does not also deem a fixed establishment to exist. Therefore provisions referring to the existence of a fixed establishment will not be affected by section GB 54.

Finally, the Government expects section GB 54 to apply in broadly similar circumstances to the OECD's new PE definition. However, there will be differences in the application of the two rules, due to their different formulations.

PE source rule

Section YD 4(17C)

Under the new source rule in section YD 4(17C), income of a non-resident will have a New Zealand source if it is attributable to a PE in New Zealand. This is subject to exceptions for certain dividends and income already subject to a specific source rule.

Dividends are excluded from section YD 4(17C), provided they are paid on a share in a foreign company that is not revenue account property. The reason for this exclusion is so that income earned overseas by a subsidiary of a non-resident does not become subject to New Zealand tax just because the shareholding of the subsidiary is managed by the New Zealand PE. However where the shares are held for the purpose of resale (or are otherwise on revenue account), then the dividends will be attributable to the New Zealand PE. This is because such shares will be investment property of the PE (rather than part of its operating structure), and so any returns in respect of them should be assessable.

Officials plan to consider whether this exclusion for dividends should be limited to active income earned by the foreign company (as determined under the CFC rules). This is to address a concern that non-residents could avoid New Zealand tax by shifting passive income out of the New Zealand PE and into an overseas subsidiary that is still managed by the PE. Officials were aware of this concern when the Act was passed, however there was insufficient time to consult on the fairly complex legislation that would be needed to include an active/passive distinction. Officials will consult on proposals to introduce an active/passive distinction before any further legislative action is taken.

Income with a source under section YD 4(17C) has its own apportionment rule under new section YD 5B. However the Income Tax Act currently has specific source apportionment rules for income from sea transport (sections YD 4(15) and YD 6), non-resident general insurers (sections YD 4(16) and YD 8(2)) and non-resident life insurers (sections YD 4(17) and EY 48). The intention is for these specific apportionment rules to still apply to income from these sources, rather than the PE income apportionment rule in section YD 5B. To allow for this, the new source rule in section YD 4(17C) is stated to be subject to sections YD 4(15) to YD 4(17).

Section YD 4B

Section YD 4(17C) only applies if a taxpayer has a PE in New Zealand. New section YD 4B inserts a definition of a PE into the Act for this purpose. Under section YD 4B:

- If a New Zealand DTA applies in respect of the taxpayer, then:
  - The definition of a PE in that particular DTA will be used (section YD 4B(2)). The effect of this will be that where income is attributable to a PE in New Zealand under an applicable DTA, that income will automatically have a New Zealand source under section YD 4(17C).
  - Any PE arising under section GB 54 will also be a PE, as defined under section YD 4B(2). However section GB 54 only applies if the relevant DTA does not incorporate the OECD's new PE definition (section GB 54(1)(e)).
- If no New Zealand DTA applies to the taxpayer, then the new definition of a PE in schedule 23 of the Income Tax Act will apply. The PE definition in schedule 23 is based on New Zealand's model PE article, and incorporates the OECD's new PE definition.

New section YD 4B(4) has been inserted to clarify that the OECD Commentary should be used as a guide in interpreting the definition of a PE in schedule 23. However, the OECD Commentary does not itself have legislative effect. Therefore, the guidance in the OECD Commentary should not be applied in contradiction to the words of schedule 23.

In particular, the OECD Commentary applies in respect of the OECD's model PE definition, which the definition in schedule 23 departs from in some areas. In addition, New Zealand has made reservations and observations on the Commentary to the PE definition (Article 5). The OECD Commentary should therefore be used as a guide subject to these differences, reservations and observations.

It is the OECD Commentary, as amended at the start of the relevant income year, which is to be used as a guide in interpreting schedule 23. This version of the OECD Commentary may be later than the version applying at the commencement of the Act.

Section YD 5B

Under section YD 4(17C), it is only income attributable to the New Zealand PE that has a New Zealand source. New section YD 5B sets out how both the income and the expenses attributable to a PE are to be determined. This section has been drafted to replicate the wording of the business profits articles of most of New Zealand's DTAs (adjusted to reflect differences in terminology between the Income Tax Act and DTAs). Accordingly, whether income and expenditure are attributable to a PE for the purposes of section YD 5B should be determined under the normal PE profit attribution principles (as applied by New Zealand).

As noted above, New Zealand does not follow the AOA for PE profit attribution. The AOA also only applies in respect of the latest version of the business profits article in the OECD's Model Treaty. Section YD 5B has been deliberately worded to follow the earlier version of the business profits article, and not the latest version in respect of which the AOA applies. Accordingly the AOA should not apply to determine the profit attributable to a PE under section YD 5B. Instead, the earlier version of the OECD's profit attribution method currently followed by New Zealand should be used.

It is important to note that sections YD 4(17C) and YD 5B determine the amount of income and expenditure attributed to the PE. They do not determine whether such income and expenditure are assessable or deductible. This will be determined under the Income Tax Act's usual assessability and deductibility rules. This is the same tax treatment as for a PE under the DTA. In particular, the deductibility of expenses attributed to a PE under the DTA is also determined under the Income Tax Act's general deductibility rules (see paragraphs 30–34 of the OECD Commentary to Article 7).

Section YD 5(1BA)

The Income Tax Act 2007 already contains a source apportionment rule in section YD 5 for income from carrying on business in New Zealand (section YD 4(2)) or making or performing a contract in New Zealand (section YD 4(3)). A PE in New Zealand will also usually derive income from carrying on business in New Zealand or making or performing contracts in New Zealand. Accordingly without amendment, section YD 5 would also apply to apportion the income attributable to a PE.

Consequently, section YD 5(1BA) has been inserted to confirm that, where there is a PE, the PE attribution rules in new section YD 5B should be used, rather than the existing apportionment rules in section YD 5.

It is not expected that there would be material differences in the amount of income apportioned to New Zealand under section YD 5B and section YD 5. However, one of the purposes of section YD 4(17C) is to simplify the taxation of income attributable to a PE, by not requiring taxpayers and Inland Revenue to apply two sets of rules (the DTA rules and the domestic source rules). Consequently, section YD 5B has been inserted to remove any doubt that the PE profit attribution methodology which applies under the DTA should also be used in the domestic source rules.

Example

S Co is a company resident in Panama. It carries on a shipping business and has an office in New Zealand through which it enters into contracts to ship goods from New Zealand around the world. It also imports its own goods into New Zealand on its ships and sells them through a retail shop located under its offices.

Whether S Co has a PE in New Zealand is determined under section YD 4B. Because Panama and New Zealand do not have a double tax agreement, the permanent establishment definition in schedule 23 will apply (under section YD 4B(3)). S Co should use the OECD Commentary on article 5 as a guide in determining whether S Co has a PE under the definition in schedule 23, as the OECD Commentary was at the beginning of that income year. For S Co's 2017–18 income year, this means that it should ignore the amendments made to article 5 of the OECD Commentary part way through 2017.

It is clear that S Co has two PEs in New Zealand under the schedule 23 definition, as it has two fixed places of business in New Zealand through which it carries on its shipping and its retail businesses. Therefore S Co has a separate PE for each of those separate businesses.

Under section YD 5B, S Co should determine the amount of profit attributable to its retail PE using New Zealand's standard (non-AOA) approach to PE profit attribution. S Co can use the relevant parts of the OECD's guidance on PE profit attribution for this purpose. In particular, since section YD 5B does not incorporate the wording needed to implement the authorised OCED approach (AOA) to profit attribution, none of the OECD guidance relating to the AOA will be applicable. Inland Revenue will shortly issue guidance on what parts of the OECD's profit attribution guidance are relevant for New Zealand.

Once S Co has determined the profit attributable to the retail PE, the amount of income and expenditure comprising that profit will automatically have a New Zealand source under sections YD 4(17C) and YD 5B. S Co will then need to apply the ordinary tax rules in the Income Tax Act 2007 for assessability, deductibility, and timing to that income and expenditure in order to calculate its taxable income for the year.

In respect of S Co's income from its shipping PE, the source of this income is specifically dealt with under section YD 4(15) and YD 6. Income with a source under section YD 4(15) is specifically excluded from the application of section YD 4(17C). Therefore section YD 4(17C) will not apply to S Co's shipping income (with section YD 4(15) applying instead).

If S Co was resident in a country with which New Zealand had a DTA, then the tax treatment would be the same as above, except that:

- whether S Co had a PE would be determined under the DTA itself (and section GB 54), rather than schedule 23 (see section YD 4B(2));
- S Co's ability to tax the shipping PE's income would be restricted by the terms of the DTA. For example, if the New Zealand/Australia DTA applied, article 8 of that DTA would prevent New Zealand from taxing S Co's shipping activity.

Deemed source rule

YD 4(17D)

The Act inserts new section YD 4(17D) into the Income Tax Act 2007. The new subsection will deem an item of income to have a New Zealand source under our domestic legislation if New Zealand has a right to tax that item of income under a DTA. There is an exclusion from this rule for dividends from shares in foreign companies that are not revenue account property. The new rules aim to both simplify the test for determining whether an item of income has a source in New Zealand, and ensure that all items of income that New Zealand is entitled to tax under a DTA will be taxable under domestic law.

Background

Under our domestic law, New Zealand can only tax income if it has a source in New Zealand. Section YD 4 of the Income Tax Act 2007 sets out the types of income that are treated as having a source in New Zealand for income tax purposes.

- New Zealand has also entered into DTAs, which set out when New Zealand has a right to tax the income of a taxpayer resident in the counterparty to the DTA. These rules override anything in our source rules. This gives rise to two issues:
- The DTA may give New Zealand a right to tax income of the non-resident. However that income may not have a New Zealand source under section YD 4. This means that New Zealand is unable to tax the income, despite the other country having agreed in the DTA that New Zealand may tax that income.
- It is necessary to apply 2 sets of rules – one in the DTA and one in section YD 4, to determine whether New Zealand may tax an item of income.

Australia has a rule deeming income which Australia may tax under its DTAs to have a source in Australia for domestic law purposes.

Detailed analysis

The Act inserts new subsection (17D) into section YD 4. The subsection deems an item of income to have a source in New Zealand if we have a right to tax the item of income under a DTA. There is an exclusion from this rule for dividends from shares in foreign companies that are not revenue account property. This is to preserve the exclusion from dividends under section YD 4(17C), discussed above.

Section YD 4(17D) also provides that the apportionment rules for shipping in YD 6, non-resident general insurers in section YD 8(2)) and non-resident life insurers in EY 48 will continue to apply in respect of income from those sources rather than new subsection (17D).

Application date

The amendment applies for income years starting on or after 1 July 2018.

Hybrid mismatch rule for NRWT

Sections BH 1(4), RF 11C

New section RF 11C inserts a new hybrid mismatch rule allowing New Zealand to charge non-resident withholding tax (NRWT) on payments under certain cross border hybrid financing instruments if New Zealand treats the payment as interest. This rule overrides our double tax agreements (DTAs).

Background

The Government has identified a further hybrid mismatch issue that arises in the following circumstances.

The New Zealand PE of a non-resident company borrows money from another non-resident in the same overseas jurisdiction as the corporate headquarters of the PE. This occurs under a hybrid instrument which New Zealand treats as debt, but the other country treats as shares.

Under our DTAs, New Zealand is able to charge NRWT on interest payments made by a non-resident's New Zealand PE to another non-resident. However, New Zealand is not able to charge NRWT on dividends paid by one non-resident company to another (regardless of whether the dividends are connected with a PE in New Zealand). This means that whether New Zealand can charge NRWT on payments under a hybrid financial instrument in these circumstances depends on whether the payments are classified as interest or dividends for DTA purposes.

Inland Revenue's view has been that New Zealand can charge NRWT on the payments on the basis that the source state's (that is, New Zealand's) classification of the payment determines its tax treatment under the DTA. However, a question has recently been raised as to whether this view is correct.

If this view is not correct, then the PE would be entitled to an interest deduction in New Zealand for the payments (as the payments are characterised as "interest" under New Zealand domestic law), but the payments would not be subject to NRWT (as the payments are characterised as "dividends" under the DTA). This is contrary to the intent of the relevant DTA provisions, as outbound interest, which is deductible in determining the profits of a PE, should always have NRWT withheld unless there is a specific exemption providing otherwise (for example, some of our DTAs provide specific exemptions to the sovereign wealth funds of the other country).

The hybrid mismatch measures in the Act ensure that payments made under such hybrids cannot be both deductible in New Zealand and non-assessable overseas. This removes the incentive to use these types of hybrids in most, but not all cases. In particular the existing hybrid measures still permit payments under a hybrid financial instrument to be deductible in New Zealand, but not subject to NRWT in some cases. This tax treatment differs from that applying to either ordinary interest (which is deductible and subject to NRWT) or dividends (which are non-deductible), and could be attractive to some taxpayers.

Australia already has a rule effectively providing that outgoing payments are not dividends for DTA purposes (and so are subject to Australian NRWT) if they are treated as interest under Australia's domestic law.[3]

Application date(s)

New section RF 11C applies retrospectively from 1 April 2008. A savings provision is available for payments where taxpayers have already adopted the position that NRWT or AIL is not payable in respect of such cross-border interest payments made prior to the introduction of the Bill (on 6 December 2017).

Key features

The Act inserts new section RF 11C. Section RF 11C(1) provides that the section applies to a payment of interest (as defined in section YA 1) by a company that is resident outside New Zealand under an applicable DTA to another person who is also resident outside New Zealand under that DTA. Section RF 11C(2) then provides that the payment is treated as interest under the NRWT rules and the DTA, notwithstanding anything to the contrary in the DTA. The Act also amends section BH 1(4) to clarify that section RF 11C overrides the applicable DTA.

The combined effect of the legislation is that New Zealand may withhold NRWT from a cross border payment that is interest under section YA 1, regardless of whether it is treated as a dividend under the applicable DTA.

[3] Section 3(2A) of Australia's International Tax Agreements Act 1953

BEPS - Hybrid and mismatch rules

OVERVIEW

Sections FH 1 to FH 15, BH 1(4), EX 44(2), EX 46(6)(e), EX 46 (10)(db), EX 47B, EX 52(14C), EX 53(16C), FE 6(2), FE 66(3)(a), FE 6(3)(aba), FE 15(1)(a), RF 2C, RF 11C and YA 1 of the Income Tax Act 2007

Hybrid and branch mismatch arrangements are cross-border arrangements that exploit differences in the tax treatment of an instrument, entity or branch under the laws of two or more countries to eliminate, defer or reduce income tax. This is often referred to as double non-taxation.

The OECD, as part of Action 2 of its BEPS Action Plan, has made a series of recommendations for domestic law changes to help countries neutralise the tax advantages from hybrid and branch mismatches. These recommendations have been picked up (or are being picked) by several countries including the United Kingdom, Australia, the members of the European Union and (to a more limited extent) the United States.

Subpart FH of the Income Tax Act 2007 contains the core aspects of the OECD recommendations with suitable modification for the New Zealand context.[1] There are consequential amendments to other tax regimes including the FIF (foreign investment fund), NRWT (non-resident withholding tax) and thin capitalisation rules.

Background

Hybrid and branch mismatch arrangements exploit the different ways that countries treat financial instruments (hybrid instruments) and entities (hybrid entities and branches) to create tax advantages.

Take the simple example of a hybrid financial instrument issued by a subsidiary to its parent company (resident in another country) that makes a quarterly coupon payment. The instrument is treated as debt by the subsidiary and the coupons result in deductible interest. The instrument is treated as equity by the parent and the coupons are treated as non-assessable dividend income. The hybrid financial instrument results in double non-taxation as there is a deduction in the subsidiary country for an amount that is not taxed in the parent country.

Double non-taxation of this kind is difficult to deal with because it arises even though both countries' tax rules are being complied with. However, a response is desirable because the double non-taxation causes distortions in investment patterns, results in an unintended reduction in aggregate tax revenues, and generally gives multinationals an unfair competitive advantage over local businesses.

To counter such double non-taxation, the OECD made a series of recommendations to address hybrid and branch mismatches through the release of two reports in 2015 and 2017.[2] The reports describe the recommendations as comprised of two kinds of rules.

The first kind are rules to reduce the likelihood of such mismatches arising. For example, the OECD recommended that countries include a rule so that a foreign dividend exemption in the payee country is not available to the extent the dividend payment is deductible to the payer. New Zealand already has such a rule in section CW 9.

The second kind are "linking rules" which apply where the mismatch has not been prevented by other domestic rules. The linking rules effectively adjust the tax outcomes under a hybrid or branch mismatch in one country in order to align them with the tax outcomes in the other country.

Though separately categorised, both types of rules have a common feature. The tax effect of a payment in one country depends on its tax treatment in another country.

Consistent with the approach adopted by several countries around the world, New Zealand has chosen to adopt the OECD recommendations in a comprehensive manner with suitable modification for the New Zealand context. The linking rules are introduced through subpart FH and there are consequential amendments to other tax regimes as well, including the FIF, NRWT and thin capitalisation rules.

[1] Subpart FH was inserted into the Income Tax Act 2007 by the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. The Taxation (Annual Rates for 2018-2019, Modernising Tax Administration, and Remedial Matters) Act 2019 made a number of amendments to subpart FH which have the same effective date as the rest of the subpart. These amendments are incorporated into this commentary.

[2] *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (2015)* and *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (2017).*

While the new rules are relatively complex, it is important to bear in mind that they will have no impact for taxpayers who are New Zealand owned and operate solely in New Zealand.

With the exception of structured arrangements, their impact will be limited to taxpayers that are related to persons subject to tax in one or more other countries, or are themselves subject to tax in another country. Taxpayers who are potentially affected by the rules will need to ensure they understand how payments made to or by them are treated by their counterparty for tax purposes. Attached at the end of this document is a check-list, intended to assist taxpayers to identify when they should be considering the rules.

Key features

Subpart FH includes rules to address the hybrid and branch mismatches arising from the following:

- hybrid financial instruments (sections FH 3 and 4);
- disregarded hybrid payments and deemed branch payments (sections FH 5 and 6);
- reverse hybrids and branch payee mismatches (section FH 7);
- deductible hybrid and branch payments resulting in double deductions (sections FH 8 and 9);
- dual resident payers (section FH 10); and
- imported mismatches (section FH 11).

Where there are two or more parties to a mismatch, the rules generally only apply if there is some degree of association between the parties to the arrangement, or if the arrangement has been structured to achieve a mismatch.

Mismatch amounts, which are deductions denied or assessable income added under sections FH 5-6 and FH 8-10, can be offset against surplus assessable income through the application of section FH 12.[3] The section generally operates by granting a deduction to a taxpayer upon successfully offsetting a mismatch amount against surplus assessable income.

Subpart FH provides some ways for taxpayers to simplify the application of the hybrid and branch mismatch rules to their arrangements. In particular, in respect of:

- inbound hybrid financial instruments, the taxpayer may elect to treat the instrument as a share for New Zealand income tax purposes (section FH 13); and
- wholly-owned outbound foreign hybrid entities existing on 6 December 2017 (the date the Taxation (Neutralising Base Erosion and Profit Shifting) Bill was introduced), the taxpayer may irrevocably elect that the entity should be treated as a company for New Zealand income tax purposes (section FH 14).

The introduction of the linking rules in subpart FH of the Act has flow on implications for other New Zealand tax regimes, including the FIF, NRWT and thin capitalisation rules.

Application dates

The majority of the hybrid and branch mismatch rules apply for income years beginning on or after 1 July 2018. There are two exceptions to this application date.

The first exception is in respect of the financial instrument rule in sections FH 3 and FH 4 for certain banking or insurance regulatory capital instruments issued on or before 6 September 2016 (the date the Government discussion document on *Addressing hybrid mismatch arrangements* was released). This regulatory capital has been grand-parented until the first date on which the person has an unconditional right to call or otherwise cancel the financial instrument without penalty.

The second exception is in respect of the imported mismatch rule in section FH 11 for non-structured imported mismatches. For payments under non-structured imported mismatches, the rule will apply for income years beginning on or after 1 January 2020.

CORE PRINCIPLES AND CONCEPTS

Sections FH 1 and FH 2

The hybrid and branch mismatch rules introduce a number of new concepts to tax legislation. This section highlights a number of the key concepts and principles before considering the specific hybrid and branch mismatch rules introduced in subpart FH and the consequential amendments from those rules.

[3] Surplus assessable income is a reflection of the OECD concept of dual inclusion income.

For simplicity, the rules will generally be referred to interchangeably as the "hybrid and branch mismatch rules" and the "hybrid rules". This is consistent with the definition of "hybrid mismatch legislation" in section FH 15 which covers both the hybrid and branch mismatch rules.

OECD hybrid and branch mismatch reports

The OECD as part of Action 2 of its BEPS Action Plan has made a number of recommendations to help countries change their domestic law so as to neutralise the tax advantages from hybrid and branch mismatches through two reports issued in 2015 and 2017.[4]

The hybrid mismatch report outlined comprehensive recommendations to deal with hybrid mismatch arrangements in October 2015. This report considered mismatches that are the result of differences in the tax treatment or characterisation of an instrument or entity. While some of the hybrid mismatches identified in the report involved branches, it did not directly consider similar issues that can arise through the use of branch structures.

The branch mismatch report considering these issues was issued in 2017. The report considered mismatches that arise as a result of differences in the allocation of income and expenditure between a branch and head office, including situations where the branch country does not treat the taxpayer as having a taxable presence in that country.

The hybrid and branch mismatch rules introduced in subpart FH closely follow the OECD recommendations with suitable modification for the New Zealand context. While the terminology used in the OECD hybrid and branch reports and the legislation is not necessarily the same, the intent is broadly similar and some of the examples in this commentary have been adapted from the OECD reports. Therefore, in addition to the guidance in this commentary, the OECD hybrid and branch mismatch reports may generally be used as interpretive aids for the hybrid and branch mismatch rules.

Hybrid and branch mismatch arrangements

Hybrid and branch mismatch arrangements are cross-border arrangements where differences in the tax treatment of an instrument, entity or branch under the laws of two or more countries mean that income tax is eliminated, reduced or deferred. This can result in double non-taxation, including long term tax deferral.

D/NI and DD mismatches

There are two broad types of hybrid and branch mismatch arrangements addressed in the OECD hybrid and branch mismatch reports: deduction/non-inclusion (D/NI) arrangements and double deduction (DD) arrangements.

D/NI mismatch arrangements occur when a payment results in a deduction in one country with no corresponding income taxed in the recipient country, if that outcome is the result of the different tax treatment of an instrument, entity or branch.

DD mismatch arrangements occur when a taxpayer is entitled to a deduction in two countries for the same payment.

D/NI and DD hybrid and branch mismatches can arise in several ways involving financial instruments, hybrid entities or branches. The OECD identified several ways in which the mismatches can arise and has developed recommendations to neutralise the tax advantages they can provide in the reports noted above. These ways include mismatches that arise through the use of hybrid financial instruments, disregarded hybrid payments, structures producing double deductions, reverse hybrids, dual resident entities, imported mismatches, and deemed branch payments and payee mismatches. Each of these hybrid or branch mismatch arrangements is covered by the rules in subpart FH and discussed in detail later in the special report.

OECD recommendations

The OECD recommended two kinds of rules to address hybrid and branch mismatches.

The first kind are rules to reduce the likelihood of such mismatches arising. For example, the OECD recommended that jurisdictions include a rule so that a foreign dividend exemption in the payee country is not available to the extent the dividend payment is deductible to the payer. New Zealand already has a rule to cover this circumstance in section CW 9.

The second are "linking rules" which apply where the mismatch has not been prevented by any other domestic rules. The linking rules effectively adjust the tax outcomes under a hybrid or branch mismatch in one country in order to align them with the tax outcomes in the other country. Since both countries may have a provision to adjust the tax outcomes under a particular hybrid or branch mismatch arrangement, in a number of cases, there is an order of application through "primary" and "defensive" rules. This ensures that, in situations where both countries have implemented hybrid and branch mismatch rules that would counter a particular arrangement, only one country will counter the mismatch.

[4] *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (2015) and *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (2017).

The primary rule is broadly that the payer country should deny a deduction to the extent it is:

- not included in the taxable income of the recipient country (for a D/NI mismatch); and
- claimed with respect to expenditure of a resident that is also deductible in another country (for a DD mismatch).

If the primary rule is not applied because the payer country has not implemented the hybrid and branch mismatch rules, then the defensive rule can apply:

- requiring the deductible payment to be included in taxable income of the recipient (for a D/NI mismatch); or
- denying the deduction in the country where the payment is made (for a DD mismatch).

Table 1 summarises how the OECD recommendations have been implemented into domestic law. The recommendations are numbered in accordance with the OECD hybrid mismatch report with the corresponding branch mismatch recommendation (if any) showed separately alongside the hybrid recommendations.

Restructuring considerations

The intended outcome of the introduction of hybrid and branch mismatch rules is to reduce the incidence of hybrid and branch mismatch arrangements. Generally, if a taxpayer chooses an ordinary arrangement or structure over one that exploits a mismatch the tax advantage will be removed, without any need to apply the hybrid and branch mismatch rules. Even if this choice does not result in additional tax revenue for the New Zealand Government, this is a desirable outcome. Taxpayers should be able to restructure out of hybrid and branch mismatch arrangements into ordinary structures without attracting tax avoidance risks.

Take the example of a foreign company (resident in a country without hybrid rules) that funds a New Zealand subsidiary company with the use of a hybrid financial instrument. Interest paid by the New Zealand subsidiary under the instrument would be subject to deduction denial under section FH 3 of the hybrid rules (see below for discussion of this rule). The foreign company decides to refinance its New Zealand investment in response to the introduction of New Zealand hybrid rules. The replacement financing might be an ordinary debt arrangement under which the New Zealand subsidiary would pay interest not subject to deduction denial under FH 3, and taxable in the foreign country. This type of refinancing should not be considered tax avoidance despite the possibility that a valid deduction could have replaced a deduction that would have been denied under the hybrid rules, thereby reducing New Zealand taxable income.

Similarly, a foreign company that owns a hybrid entity in New Zealand (such as an unlimited liability company) may wish to restructure its New Zealand operations in response to the introduction of New Zealand hybrid rules. A replacement structure may be a limited liability company with expenditure that is not subject to deduction denial under sections FH 5 and FH 9 (see below for discussion of these rules). This type of restructure should not be considered tax avoidance even if denied deductions of a hybrid entity in New Zealand would be replaced by valid deductions that are not part of a hybrid mismatch arrangement.

Table 1: New Zealand's implementation of the OECD recommendations

Linking rule recommendations

Section	Rec.	Hybrid mismatch	Hybrid arrangement	Corresponding branch arrangement	Counteraction	Scope
FH 3 and 4	1	D/NI (deduction/no inclusion)	Hybrid financial instruments (includes timing)		Primary: deny deduction for payment Defensive: include payment in income	Related parties (generally twenty five percent) or structured arrangements
FH 5 and 6	3	D/NI	Disregarded payments	Deemed branch payments	Primary: deny deduction for payment to the extent expenditure exceeds DII/SAI* Defensive: include payment in income to the extent exceeds DII/SAI*	Control group (generally fifty percent) or structured arrangements
FH 7	4	D/NI	Reverse hybrids – linking rule	Disregarded branch structure and diverted branch payments	Primary: deny deduction Defensive: None	Control group or structured arrangements
FH 8 and 9	6	DD (double deduction)	Double deductions (including those arising by virtue of a foreign branch)	(Recommendation 6 already applies to double deduction branch outcomes)	Primary: parent/head office country denies deduction to the extent exceeds DII/SAI* Defensive: subsidiary/branch country denies deduction to the extent exceeds DII/SAI*	Primary rule limited to related parties (generally twenty five percent) Defensive rule limited to control group (generally fifty percent)
FH 10	7	DD	Payments by dual resident company		Deny deduction in both jurisdictions to the extent exceeds DII/SAI	No limit
FH 11	8	Indirect D/NI	Imported mismatches	Imported branch mismatches	Primary: deny deduction for payment to the extent it funds the hybrid or branch mismatch payment Defensive: None	Control group or structured arrangements. Does not apply if payee subject to hybrid rules

Specific rule recommendations

Section	Rec.	Hybrid mismatch	Hybrid arrangement	Corresponding branch arrangement	Counteraction	Scope
CW 9	1	D/NI (deduction/no inclusion)	Hybrid financial instruments (includes timing)		Primary: deny deduction for payment Defensive: include payment in income	Related parties (generally twenty five percent) or structured arrangements
Subpart EX	8	Indirect D/NI	Imported mismatches	Imported branch mismatches	Primary: deny deduction for payment to the extent it funds the hybrid or branch mismatch payment Defensive: None	Control group or structured arrangements. Does not apply if payee subject to hybrid rules

* Surplus assessable income (SAI) performs the same function as dual inclusion income (DII) in the hybrid mismatch report.

** Section CW 9(1)(c) addresses recommendation 2.1. An amendment is made in the new legislation to the definition of a deductible foreign equity distribution to ensure that it is fully effective to tax dividends that give rise to a D/NI outcome.

*** There have been no legislative changes for recommendation 5 at the time of writing this commentary.

Scope of the linking rules

Where there are two or more parties to a mismatch, the rules generally only apply if there is some degree of association between the relevant parties to the arrangement, or if the arrangement has been structured to achieve a mismatch.

There are four key definitions that determine whether the rules potentially apply: "act together", "control group", "related" and "structured arrangement". We discuss these terms individually in the following section on key definitions.

Ordering of the linking rules

Hybrid and branch mismatch arrangements can arise in several ways and, it is possible, that more than one of the hybrid mismatch rules in subpart FH may apply to a taxpayer. Section FH 2 outlines the order in which the hybrid mismatch rules in sections FH 3 to FH 11 should be applied by a taxpayer.

Subsection FH 2(1) outlines the order of the application of the sections that disallow deduction. These are set out in table 2.

Table 2: The order for applying the rules that disallow deduction

Order	Section	Rule
1	FH 3	Hybrid financial instrument mismatch – primary rule
2	FH 5	Disregarded hybrid payment mismatch – primary rule
3	FH 7	Payments made to a reverse hybrid
4	FH 11	Imported mismatch
5	FH 8	Deductible payment made by a hybrid entity mismatch – primary rule
6	FH 9	Deductible payment made by a hybrid entity mismatch – defensive rule
7	FH 10	Deductible payment made by dual resident payer mismatch

Subsection FH 2(2) outlines the order of the application of the sections that treat receipts as assessable income. These are set out in table 3.

Table 3: The order for applying the rules that treat receipts as assessable income

Order	Section	Rule
1	FH 4	Hybrid financial instrument mismatch – defensive rule
2	FH 6	Disregarded hybrid payment mismatch – defensive rule

Elections

Sections FH 13 and FH 14 provide that, in some circumstances, taxpayers may opt out of the potential application of the hybrid and branch mismatch rules to some of their arrangements. In particular:

- For inbound hybrid financial instruments, the taxpayer may elect to treat the instrument as a share for New Zealand income tax purposes (section FH 13); and
- For a foreign hybrid entity[5] wholly-owned by a person on 6 December 2017 (the date of the introduction of the Bill), the owner may irrevocably elect to treat the entity as a company for New Zealand income tax purposes (section FH 14). This election must be made by the time the owner files their tax return for the first year in which the hybrid rules apply to the owner.

KEY DEFINITIONS

Section FH 15

The hybrid and branch mismatch rules introduce a number of new concepts to the New Zealand tax lexicon. We outline the key definitions that apply broadly across the rules below.v

Financial instrument, hybrid entities and deducting branches

Financial instrument

"Financial instrument" is defined in section FH 15. It is relevant for sections FH 3 and FH 4 (and the borrower election to treat a hybrid financial instrument as a share in section FH 13). The definition is intended to encompass all forms of debt and equity. It builds on the existing financial arrangement definition, which is deliberately very broad. There are then a number of additions, including for:

- shares: this inclusion may be of less significance given the deductible foreign equity dividend exclusion in section CW 9, but it would be odd to leave shares out of the definition;
- annuities: which are excluded from the financial arrangements rules only because they are taxed under their own regime;
- farm-out arrangements;

[5] A foreign hybrid entity is one that is fiscally transparent for New Zealand tax purposes and fiscally opaque for the purposes of the foreign country in which it is formed.

- share lending arrangements: share repurchase agreements (share repos), and share lending arrangements which do not meet the statutory definition of a share lending arrangement in section YA 1, are financial arrangements. Share lending arrangements which do meet the statutory definition are excluded from the financial arrangement definition, but should be included as "financial instruments" for the purposes of the hybrid and branch mismatch rules, as they may be hybrid financial transfers, subject to either sections FH 3 or FH 4; and
- loans in New Zealand currency described in section EW 5(10): these are interest-free, repayable on demand loans that are excluded from the financial arrangement definition for the lender.

Hybrid entity

No entity is inherently a hybrid entity. Hybridity exists only as a result of the inconsistent tax classification of the entity by two countries' tax systems. This is reflected in the definition of a "hybrid entity" in section FH 15 which provides that it means a person or other entity that is recognised as a person subject to tax (that is, is taxed like a company) in a country that treats it as a tax resident, and not recognised as a person that is subject to tax (that is, is taxed like a partnership or a branch) in another country. For example, a limited partnership may be taxed as a resident entity in the country in which it was incorporated, but taxed as a disregarded (or flow-through) entity in a partner (investor) country.

The hybrid entity definition is relevant for sections FH 8 and FH 9 (primary and defensive rules applying to payments resulting in double deductions) to help to define when those rules apply, and section FH 14 to define the kind of entity in respect of which an opaque election can be made. The term is also used in section FH 12 (which is concerned with surplus assessable income). Although the term is not used in sections FH 5 and FH 6, those sections will often apply to payments made by hybrid entities.

Deducting branch

"Deducting branch" is defined in section FH 15. It is relevant for sections FH 5 and 6 (primary and defensive rules for disregarded hybrid payment mismatches), sections FH 8 and 9 (primary and defensive rules applying to payments resulting in double deductions) and section FH 11 (imported mismatches).

A deducting branch is a branch, permanent establishment or other activity of a person in a country or territory where the expenditure or loss attributed by the person to the branch is deductible (or gives rise to other tax relief) in that country or territory against income of the person. This includes a deemed permanent establishment under the new rules in respect of permanent establishments.

Control groups, related parties and structured arrangements

The hybrid and branch mismatch rules generally apply when the mismatch is between related parties (broadly twenty five percent common ownership) or control groups (broadly fifty percent common ownership), or the mismatch arises from a payment under a structured arrangement. These terms are defined in section FH 15.

Related

The definition of "related" is important for sections FH 3 and FH 4 (primary and defensive rules applying to hybrid financial instrument mismatches). It is also relevant to section FH 8 (primary rule applying to payments resulting in double deductions).

The definition of "related" is closely based on the associated person definitions in subpart YB, except that:

- for two companies, it imposes a twenty five percent common ownership test (rather than a fifty percent common ownership test);
- it applies the same twenty five percent rule to a general partnership as for a limited partnership (which means that a partner in a general partnership is not automatically 'related' to that partnership as would be the case for the "associated persons" definition); and
- there is a common control test, which also aggregates interests of persons who act together, as defined in section FH 15.

Control group

Many of the hybrid and branch mismatch provisions only apply to payments between members of a control group (unless there is a structured arrangement). The "control group" definition in section FH 15 is generally intended to include persons who are commonly controlled or meet a fifty percent common ownership threshold.

For companies and partnerships (whether formed under New Zealand or foreign law) these tests are well established for other purposes, and the definition used in the hybrid and branch mismatch rules incorporates these other definitions.

For trusts, it is more difficult to determine ownership (whether by reason of control or economic interests), and accordingly the legislation uses the same tests that apply to determine whether or not parties are associated in sections YB 5 to 11.

In addition, the meaning of "control group" is defined to include:

- members that are consolidated for accounting purposes and/or prepare group financial statements; and
- a common control test, which aggregates the interests of persons who act together, as defined in section FH 15.

Act together

The "act together" definition is relevant for determining whether two persons are in a control group or are related persons by virtue of paragraphs (g) or (h) of the control group and related definitions.

Paragraphs (g) and (h) include two persons in a control group if one effectively controls the other or the same group of persons effectively controls both. In both cases, interests held by persons who are related or who act together are aggregated.

The intent of the acting together test is to:

- prevent taxpayers from avoiding the related party or control group tests by transferring their rights or interests to another person that continues to act under their direction in respect of those interests; and
- target taxpayers who individually hold minority stakes in an entity, but enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into hybrid mismatch arrangements in respect of one or more of them.

The definition of "act together" is highly fact dependent. For instance, two persons will act together if one typically acts in accordance with the wishes of the other, or if their actions are typically controlled by a third person.

There are a number of limbs that determine whether two parties are acting together. The definition is met where two persons (the holders) each have voting rights or equity interests in a person or other entity and at least one of the criteria below are met:

- the holders are associated under section YB 4 (two relatives);
- a holder typically acts in the way preferred by the other holder because of the other holder's preferences;
- the holders have entered into an arrangement that has an effect on the value or control of the rights or interests that is more than incidental and does not arise from a restriction on the sale of the rights or interests;
- the actions of the holder are controlled or expected to be controlled, whether that be legally or typically, by a third person or group of persons (the co-ordinator);
- the holders and a co-ordinator enter an arrangement affecting the ownership or control of the rights and interests and having an effect on the value or control of the rights and interests that is more than incidental; or
- the holders agree with a co-ordinator that the co-ordinator can act on behalf of the holders in relation to the rights and interests.

Subsection FH 15(2) provides an exclusion from the "act together" definition for the last three limbs above where the co-ordinator manages two investment funds that hold voting rights or equity interests in the same person or entity, but the two funds do not act together in relation to their rights and interests.

We comment on these limbs below.

Relatives

Limb (a) of the definition focuses on natural persons and deems a person to hold any voting rights or equity interests that are held by members of that person's family as determined under section YB 4 (Relatives).

Typically acts in the way preferred by the other holder

Under limb (b) of the definition, a person will be treated as acting in the way preferred by another holder where the person is legally bound to act in accordance with the other holder's instructions or if it can be established that the person is expected to act, or typically acts, in accordance with the other holder's instructions. The focus of the test is on the actions of that person in relation to the voting rights or equity interests.

The test is not intended to treat as acting together two or more shareholders that typically vote in a similar way to each other, but make their decisions independently and without reference to each other. It is intended to apply where a holder typically acts in a way preferred by another holder because it is preferred by the other holder.

Entered into an arrangement that has a more than incidental effect on the value or control of the rights and interests

Under limb (c) of the definition, a person will be treated as holding the equity or voting interests of another person if they have an entered into an arrangement that has an effect on the value or control of the rights or interests that is more than incidental. The test covers arrangements concerning the exercise of voting interests and/or regarding beneficial entitlements, such as an entitlement to profits or eligibility to participate in distributions. In addition, it covers arrangements concerning the ownership of those rights, such as options to sell rights.

The test is intended to capture arrangements that are entered into with other investors and does not cover arrangements that are simply part of the terms of the equity or voting interest concerned, or that operate solely between holder and issuer.

The arrangement regarding the control of the voting rights or equity interests must have a more than incidental effect on the value of those rights or interests. The more than incidental threshold means that an investor will not have their rights or interests treated as part of a common holding arrangement simply because the investor is party to a commercially standard shareholder agreement that does not have a significant impact on the ability of the investor to exercise ownership or control over their interests.

Example 1: Commercially standard shareholder agreement

Aardvark Co together with a number of other investors holds one hundred percent of the shares in Badger Co. Aardvark Co is the single largest shareholder holding forty percent, with the remaining 12 investors each holding five percent. The shareholders enter into a shareholders' agreement that provides Aardvark Co with a first right of refusal on any disposal of the shares and drag-along and tag-along provisions in the event that an offer is made for a majority of the shares in Badger Co.

Question

Are Aardvark Co and the other investors in Badger Co acting together within the scope of limb (c) of the "acting together" definition?

Answer

No (generally). The right to buy other shareholders' shares at market value, as well as the drag along and tag along rights are relatively standard terms in a shareholders' agreement for a company that is not widely held. These types of provisions will not generally have a material impact on the value of the holder's equity interest and therefore should not be taken into account for the purposes of limb (c) of the acting together requirement.

Example 2: Shareholders subscribe for proportional debt

There are 10 investors in Crab Co with each holding ten percent of its shares. The 10 investors enter into a shareholders' agreement to subscribe for proportional debt in Crab Co. The proportional debt is a hybrid financial instrument for some of the investors, but not all of them, depending on their tax residence. The 10 investors each voted positively for Crab Co to issue the proportional debt, but exercised their voting rights independently of each other.

Question

Are the investors in Crab Co acting together within the scope of limb (b) or (c) of the "acting together" definition?

Answer

No (generally). If some, or (in this case) all, of the investors agree that they will fund the company pro rata in a certain way, that should not, in and of itself, mean that the investors typically act in the way preferred by the other holders because of the holder's preference per limb (b). While the shareholders' agreement may provide for the issue of proportional debt, it should not generally have a more than incidental impact on the value of the shares. For instance, if Crab Co issues $10m of proportional debt, both its assets and liabilities should increase by $10m, leaving the value of its equity unchanged so limb (c) should not apply.

Co-ordinator

Under limbs (d) to (f) of the definition, two persons or a group of persons will be treated as acting together if their interests are managed, controlled or affected in a way that is more than merely incidental by another person or group of persons (the co-ordinator).

These limbs will not apply to treat two persons as acting together if they are members of different investment funds that hold voting rights or equity interests in the same person or entity, if the two funds do not act together in relation to their rights and interests. This conclusion holds regardless of whether or not the funds have a common co-ordinator.

Example 3: Co-ordinator

Take the facts of example 2, except that instead of investing directly into Crab Co, each investor invests into an investment partnership that holds one hundred percent of Crab Co. The investment partnership has a general partner that decides on the investments of the partnership. The investment partnership makes a debt investment in Crab Co. This debt is a hybrid financial instrument for some of the investors, but not all of them as they are resident in different countries.

Question

Are the investors of the partnership acting together in relation to their interest in Crab Co due to the presence of a co-ordinator within the scope of limbs (d) to (f) of the "acting together" definition?

Answer

The partners are acting together in relation to their interest in Crab Co via their investment partnership under limb (d) of the definition as their investments are controlled by the general partner. The partners will also be acting together based on the partnership agreement if that provides for the decision-making rights of the general partner. (The exception to the co-ordinator rule in FH 15(2) does not apply as there is only one relevant investment vehicle.)

The effect of this is that Crab Co is related to each of the partners under paragraph (g) of the definition, and must separately analyse payments attributable to each investor to determine whether or not a deduction may be denied under subpart FH. This conclusion is not affected by whether or not the investment partnership is treated as an entity for New Zealand tax purposes.

Structured arrangement

The "structured arrangement" definition in section FH 15 is relevant throughout the hybrid and branch mismatch rules. This is because it is used to define the situations where a hybrid or branch mismatch between persons who are not related or in a control group is subject to the rules.

OECD recommendation

The structured arrangement definition is consistent with recommendation 10 of the OECD hybrid mismatch report. In this regard, paragraphs 318 to 319 of the report state that:

> "The purpose of the structured arrangement definition is to capture those taxpayers who enter into arrangements that have been designed to produce a mismatch in tax outcomes while ensuring taxpayers will not be required to make adjustments under the rule in circumstances where the taxpayer is unaware of the mismatch and derives no benefit from it.
>
> The test for whether an arrangement is structured is objective. It applies, regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes. The structured arrangement rule asks whether the mismatch has been priced into the terms of the arrangement or whether the arrangement's design and the surrounding facts and circumstances indicate that the mismatch in tax outcomes was an intended feature of the arrangement."

These principles have been taken into account in incorporating the definition of structured arrangement into domestic legislation.

Definition

The definition of "structured arrangement" in section FH 15 is divided into two limbs, which both must be satisfied for there to be a structured arrangement in a particular case.

The first limb in (a) outlines two (potentially overlapping) circumstances that will be a structured arrangement. The first is where the pricing is based on the existence of a hybrid mismatch. The second is where the facts or circumstances indicate that the arrangement is intended to rely on or produce a hybrid mismatch.

The second limb in (b) is person-specific and reflects that a structured arrangement should only exist for a person where they (or a member of their control group) could reasonably have been expected to have been aware of the mismatch regardless of whether they benefited from it or not. This means that it is possible, albeit not necessarily common, that what may be a structured arrangement to one person will not be a structured arrangement to another.

We discuss these elements of the definition below.

Price assumes existence of a hybrid mismatch

The price of the arrangement will assume the existence of a hybrid mismatch if the mismatch has been factored into the calculation of the return under the arrangement.

This test looks to the actual terms of the arrangement, as they affect the return on the arrangement, and as agreed between the parties, to determine whether the pricing of the transaction is different from what would have been agreed had the mismatch not arisen.

This is a legal and factual test that looks only to the terms of the arrangement itself and the allocation of risk and return under the arrangement, rather than taking into account broader factors such as the relationship between the parties or the circumstances in which the arrangement was entered into. The test would not take into account the consideration paid by a taxpayer to acquire a hybrid financial instrument from another holder (for example, where the instrument is acquired at a premium or a discount from a third party) unless the instrument is issued and sold as part of the same arrangement.

Example 4: Hybrid mismatch priced into the terms of the arrangement

Dolphin Co (a company resident in Country D) and Elk Co (a company resident in Country E) are unrelated parties. Elk Co issues a bond that pays an annual coupon to Dolphin Co. The bond is treated as a debt instrument under the laws of Country E but as an equity instrument under the laws of Country D. Country D generally exempts foreign dividends under its domestic law but taxes interest income. Therefore the payment results in a D/NI outcome that is a hybrid mismatch.

The formula for calculating the coupon payment on the bond provides for a discount to the market rate of interest which is calculated by reference to the company tax rate in Country D (that is, the coupon formula is equal to *market rate* × (*1 – 0.5 of the tax rate*)).

Question

Whether the bond is a structured arrangement for Elk Co?

Answer

Yes. The mismatch has been factored into the calculation of the coupon under the bond so limb (a)(i) of the definition is met. Elk Co could reasonably be expected to be aware of the sharing of the tax benefit that arises to it from the mismatch as the coupon formula reflects a below market rate of interest so limb (b) of the definition is met as well.

Facts or circumstances indicate an intention to rely on or produce a hybrid mismatch

The facts and circumstance test is a wider test than the pricing test noted above and looks to a number of factors to determine whether the arrangement is intended to rely on or produce a hybrid mismatch. These factors include the relationship between the parties, the circumstances under which the arrangement was entered into, the steps and transactions that were undertaken to put the arrangement into effect, the terms of the arrangement itself and the economic and commercial benefits of the transaction.

Facts and circumstances that indicate an arrangement is intended to produce a hybrid mismatch include the following:

- an arrangement that is designed, or is part of plan, to create a hybrid mismatch;
- an arrangement that incorporates a term, step or transaction to create a mismatch;
- an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage is derived from the hybrid mismatch;
- an arrangement that is primarily marketed to taxpayers in a country where the hybrid mismatch arises;
- an arrangement that contains features that alter the terms under an arrangement, including the return, in the event that the hybrid mismatch is no longer available; and
- an arrangement that would produce a negative return absent the hybrid mismatch.

The fact that an arrangement produces a combination of tax and commercial benefits does not prevent the arrangement from being a structured arrangement if, on an objective basis, it would be concluded that part of the explanation for the arrangement was to generate a hybrid mismatch.

Reasonably be expected to be aware

Whether an arrangement is a structured arrangement is person-specific as it depends on whether a person (or a member of that person's control group, whether or not a New Zealand resident) could reasonably have been expected to be aware of the mismatch.

This limb of the definition is consistent with paragraphs 342 to 343 of the OECD hybrid mismatch report which state that:

> "A person will be a party to a structured arrangement when that person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer nor any member of the same control group was aware of the mismatch in tax outcomes or obtained any benefit from the mismatch.
>
> The test for whether a person is a party to a structured arrangement is intended to capture situations where the taxpayer or any member of the taxpayer's control group was aware of the mismatch in tax outcomes and should apply to any person with knowledge of the arrangement and its tax effects regardless of whether that person has derived a tax advantage under that arrangement."

Example 5: Arrangement marketed as a tax-advantaged product

Flamingo Co (a company resident in Country F) subscribes for bonds paying an annual coupon issued by Gorilla Co (an unrelated company resident in Country G). Flamingo Co subsequently sells the bond to Hedgehog Co, another unrelated company resident in Country H.

Due to differences in the treatment of the underlying instrument under the respective laws of Country G and Country H, the coupon payments give rise to a hybrid mismatch resulting in a D/NI outcome.

Flamingo Co subscribed for these bonds after receiving an investment memorandum that included a summary of the expected tax treatment of the instrument (including the fact that payments on the instrument will be eligible for tax relief in Country H). A similar investment memorandum was sent to a number of other potential investors in Country H.

Question 1

Is the bond a structured arrangement for Flamingo Co?

Answer 1

The bonds will give rise to a structured arrangement to Flamingo Co because: (i) the facts indicate that the bond has been marketed as a tax-advantaged product and has been primarily marketed to persons who can benefit from the mismatch; and (ii) Flamingo Co acquired the bond on initial issuance and was aware of the potential mismatch in tax treatment from the investment memorandum.

However, provided F Co is taxable on the return from the bonds, there is no D/NI mismatch to counter.

Question 2

Is the bond a structured arrangement for Hedgehog Co?

Answer 2

Whether or not the bonds are a structured arrangement to Hedgehog Co will depend on the facts. The bond was marketed as a tax-advantaged product and was primarily marketed to persons who could benefit from the mismatch, including persons in Country H. However, it may not be a structured arrangement to Hedgehog Co, if Hedgehog Co paid market value for the bond and could not reasonably have been expected to be aware of the mismatch in tax treatment.

Hybrid mismatch

The "hybrid mismatch" definition is used in section FH 11, the imported hybrid mismatch section, and the definition of structured arrangement. It is a broad definition that effectively covers D/NI and DD mismatch arrangements.

Hybrid mismatch legislation

"Hybrid mismatch legislation" is defined to mean subpart FH and legislation of other countries or territories that has an intended effect corresponding to subpart FH (or a provision in subpart FH). In this regard, foreign legislation will correspond to subpart FH if it is consistent with the effect of the recommendations of the OECD hybrid mismatch report and/or branch mismatch report.

This question is most relevant for the defensive rules in sections FH 4, 6 and 9, because if the foreign country has an equivalent of the corresponding primary rule then the taxpayer will not apply the defensive rule in New Zealand. It is also relevant to the imported mismatch rule in section FH 11. Generally that rule will not apply to a payment made to a payee in a country with hybrid rules.

Whether foreign legislation has an intended effect corresponding to the hybrid mismatch rules will need to be determined at the time of the mismatch. For example, if another country has a rule that denies deductions for duplicate tax losses this could be considered to have the same effect as hybrid rules relating to DD mismatches. The other country would not need to have rules

that correspond to each of the recommendations in the OECD hybrid report and/or branch report. It would only need to have a rule that corresponds to the particular hybrid or branch mismatch that would be countered in New Zealand if not addressed by the foreign country.

It is not expected that another country's legislation will be exactly the same as New Zealand's. This means that the amount that New Zealand might counteract, in a given situation, could be different from that which would be counteracted by another country's rules in that same situation. Alternatively, another country's rules may only apply to certain types of payments (for example, interest and royalty payments but not others). These circumstances should not prevent that other country's rules qualifying as hybrid mismatch legislation. However, the question of whether a defensive rule in subpart FH applies or not is not determined simply by whether or not the other country has hybrid rules. For instance, section FH 6, which is discussed in detail below, is a defensive rule that only grants priority to another country's hybrid mismatch legislation if that country's rule applies to the relevant payment and payer in the income year.

The US dual consolidated loss (DCL) rules are an example of hybrid mismatch legislation. Inland Revenue understands that these rules generally operate as follows:

- A US company is denied the ability to reduce its US tax in relation to losses that are used under the laws of a foreign country to offset income that is not taxed by the US. These may be losses incurred by a foreign branch of the US company, through a foreign hybrid owned by the US company, or by a dual resident company.
- The denial can be turned off if the US company makes a domestic use election. This election requires the company to elect not to use the loss under the laws of another country to offset income which the US does not tax. The non-foreign use period is limited to five years following the year of the loss.
- If a domestic use election is made, but the loss is used to offset income which the US does not tax during the five year period, or other "triggering events" occur (such as a sale of the foreign hybrid that incurs the loss), the US tax reduction resulting from the US use of the loss is recaptured and there is also an interest charge. If the loss is so used (or another triggering event occurs) after the five year period, there is no penalty.

On the basis of this understanding, the US DCL rules appear to be hybrid mismatch legislation corresponding to section FH 8. Expenditure incurred by a US taxpayer, or a New Zealand hybrid entity which is deductible by a US owner, will not be subject to section FH 9 so long as the US taxpayer is subject to the DCL rules and has not made a domestic use election. If the US taxpayer has made a domestic use election, then section FH 9 will apply to deny a deduction for the expenditure. That is because the domestic use election is an election that the DCL rules do not apply to the US taxpayer in respect of the relevant expenditure. During the five year "non-foreign use" period imposed by the terms of the domestic use election, this should not be a practical issue, since the terms of the domestic use election will in any event prohibit the use in New Zealand of that expenditure against income which the US does not tax. Once that period has passed, the US DCL rules will not deny the US person the ability to use the expenditure in New Zealand against income which the US does not tax. However, section FH 9 will continue to apply, to similar effect.

Mismatch situation

"Mismatch situation" means a situation that may give rise to denial of a deduction, or assessable income, under sections FH 5, FH 6, or FH 8 to FH 10. The definition is important as mismatch situations result in "mismatch amounts" discussed below, which are where the hybrid counteraction may be offset against surplus assessable income in section FH 12. A situation can be a mismatch situation in a year even if there is no denial of a deduction (or inclusion of income under FH 6) in the relevant year.

A person can be involved in more than one mismatch situation. Further, a single mismatch situation can give rise to more than one kind of mismatch. For instance, a New Zealand resident hybrid entity can make payments which are subject to both section FH 5 (because they are made to a foreign owner who disregards the entity) and section FH 9 (because they are deductible in New Zealand and a foreign country).

Mismatch amount

"Mismatch amount" means an amount, arising from a mismatch situation, for which a deduction is denied or assessable income is increased under sections FH 5, FH 6, FH 8, FH 9, or FH 10. Deduction denials or assessable income increases under these sections can be reversed if the amounts are set off in a tax year against an amount of surplus assessable income.

HYBRID FINANCIAL INSTRUMENT RULE

Sections FH 3 and FH 4

Background

The hybrid financial instrument rule is recommendation 1 of the OECD hybrid mismatch report and addresses D/NI mismatches.

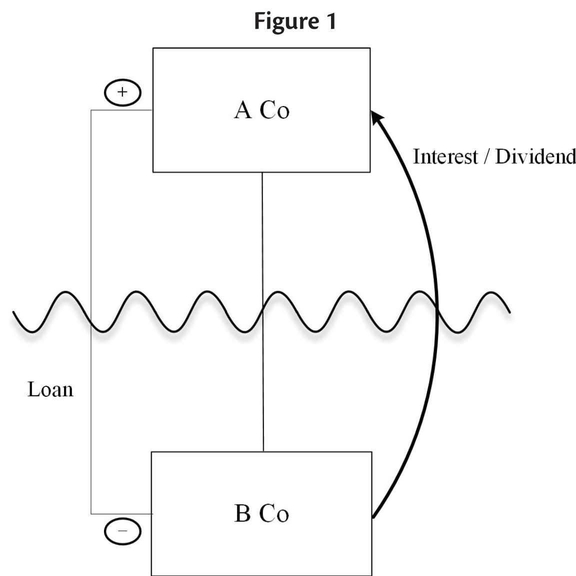
Hybrid mismatches that fall within the scope of the hybrid financial instrument rule in sections FH 3 and FH 4 can be split into two categories: character mismatches and timing mismatches.

Recommendation 2.1 of the OECD hybrid mismatch report, which recommends that countries should not grant an exemption for dividends that are treated as deductible in a foreign country, is also important in considering the application of this rule.

Character mismatch

Figure 1 illustrates a character mismatch arising from a financial instrument that pays coupons:

Figure 1

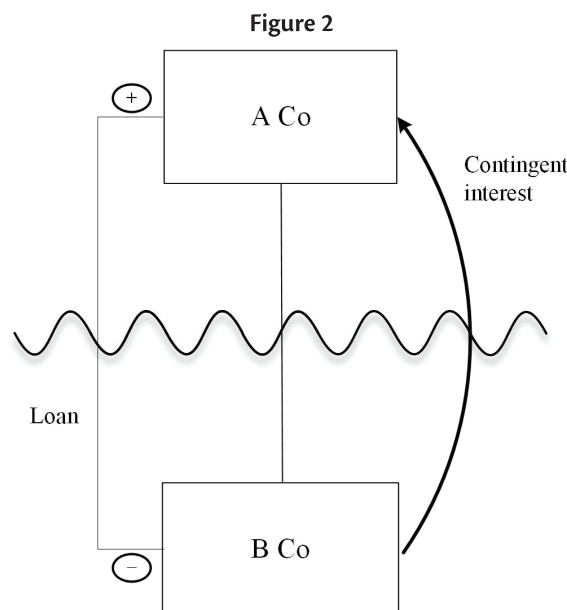


In this character mismatch, the financial instrument (loan) is treated as debt by B Co and the coupons are treated as deductible interest. However, the instrument is treated as equity by A Co and the coupons are treated as non-assessable dividends. This results in double non-taxation.

Timing mismatch

Figure 2 illustrates an example of a timing mismatch arising from a financial instrument that pays interest upon maturity.

Figure 2



In this timing mismatch, A Co and B Co enter into a five-year term loan where interest accrues on the loan, but is only payable at maturity or earlier at the discretion of B Co. The loan is treated as debt by both A Co and B Co. Interest payments on the loan are treated as deductible by B Co in the year the interest accrues but will only be treated as income by A Co when (and if) such interest is actually paid. This results in double non-taxation in the sense that there is a significant deferral (up to five years) between when the interest is deductible to B Co and when it is assessable to A Co.

Summary of legislative response

Sections FH 3 and FH 4 implement recommendation 1 of the OECD hybrid mismatch report. They are respectively the primary and defensive rules relating to hybrid financial instruments (which include, but are not limited to, financial arrangements plus shares).

Section FH 3 is the primary rule and applies to inbound investment to deny a New Zealand income tax deduction for a payment under a hybrid financial instrument taking into account the extent to which it is subject to tax in the payee country. Denial of a deduction prima facie has no effect on the payer's obligation to pay NRWT. The payment is still treated as interest, unless the payer elects to treat the debt as a share for tax purposes, under section FH 13 (discussed below). Denial of a deduction will be taken into account in determining whether the loan gives rise to non-resident financial arrangement income (as discussed below).

Section FH 4 is the defensive rule and applies to outbound investment to tax a payment under a hybrid financial instrument in New Zealand taking into account the extent to which it is deductible in the payer country. Section FH 4 is expected to have limited application in New Zealand as deductible payments under a hybrid financial instrument would not qualify as exempt foreign dividends under existing section CW 9.

The definition of "deductible foreign equity distribution" has also been amended in section YA 1.

Application date

Sections FH 3 and 4 apply for income years beginning on or after 1 July 2018. This means that section FH 3 applies to payments for which deductions are claimed in that income year or subsequently. The date on which the payment giving rise to the deduction is paid is not relevant. Section FH 4 on the other hand applies only to payments received on or after the start of a person's income year beginning on or after 1 July 2018.

There is an exception to section FH 3 for banking and insurance regulatory capital entered into on or before 6 September 2016 (the date the Government discussion document *Addressing hybrid mismatch arrangements* was released). Such regulatory capital is grand-parented until the first date on which the issuer has an unconditional right to call or otherwise cancel the financial instrument without penalty.

Detailed analysis

Section FH 3 – primary rule

Section FH 3 is the primary rule of recommendation 1 of the OECD hybrid mismatch report. It applies with priority over the defensive rules of foreign countries. It applies when a person is a party to a financial instrument under which the person makes a payment if:

- the person incurs in an income year expenditure that relates to the financial instrument and does not arise solely from a foreign exchange fluctuation;
- the expenditure is deductible (in the absence of the hybrid mismatch rules);
- the tax law of a country outside New Zealand treats the payment when made as received by a person in that country (who may be a resident of that country or a non-resident carrying on business there). It does not matter if the other country will not treat the payment as received until a later year than the year in which the deduction for the payment arises in New Zealand;
- the financial instrument is, or is part of, a structured arrangement, or the payer and payee are related; and
- the tax treatment of the payee in its country meets either subsection (2) or subsection (3). Subsection (2) relates to character mismatches and subsection (3) relates to timing mismatches.

Example 6: No mismatch with respect to measurement of foreign exchange differences

Falcon Co (a company resident in Country F) owns all the shares in Kiwi Co (a company resident in New Zealand). Falcon Co provides Kiwi Co with an ordinary loan denominated in F$ (FD). Interest on the loan is payable annually in arrears at a market rate and the principal on the loan is payable at maturity. The loan is treated as a debt instrument under the laws of both Country F and New Zealand and the countries take a consistent position on the characterisation of the payments made under the loan. The interest payable on the loan is deductible in Kiwi Co and included in ordinary income under the laws of Country F.

The value of NZD falls in relation to FD while the loan is still outstanding so that payments of interest and principal under the loan become more expensive in NZD terns. Under NZ law, Kiwi Co is entitled to a deduction for this increased cost. There is no similar adjustment under Country F law as it is simply receiving the payments it expected to receive in FD.

Question

Does the adjustment under New Zealand law for the increase in costs attributable to the fall in the value of NZD against FD give rise to a hybrid mismatch within the scope of the hybrid financial instrument rule in section FH 3?

Answer

No. While the fall in the value of NZD gives rise to a deduction under NZ law that is not reflected by a corresponding inclusion in Country F, this difference does not give rise to a D/NI outcome provided the proportion of the interest and principal payable under the loan is the same under the laws of both countries. Gains and losses that result from converting foreign exchange into local or functional currency are attributable to the way countries measure the value of money, rather than the value of the payment itself.

Character mismatches

Subsection (2) applies to character mismatches. Character mismatches arise if two criteria are met.

The first criterion is that neither the foreign payee country, nor any other foreign country, recognises the payment as ordinary income of the payee. For instance, if the foreign payee's country of residence did not recognise the payment as ordinary income, but it was included as part of the ordinary income of the payee in another country through a branch, then the first criterion would not be met (that is, there could be no character mismatch).

The second criterion is that the payment would be recognised as ordinary income in the payee country if the classification of the payment or payment instrument were varied, and the payee had the usual tax status for a person or entity of the payee's class. This criterion is based on two key principles:

- *The rule should only apply where the mismatch in tax treatment between the two countries is attributable to how the payee and payer countries treat the instrument for tax purposes*

  The primary example of a character mismatch is where the payer country treats the instrument as debt and the payee country treats the instrument as equity resulting in deductible interest in the payer country and exempt dividends in the payee country. The D/NI mismatch in such a case is attributable to the classification of the payment or payment instrument.

  The test the legislation effectively sets is whether the D/NI mismatch would cease to exist if the payee country treated the financial instrument and/or payment in the same way as New Zealand. Taking this approach to the example in the preceding paragraph, if the payee country treated the instrument as debt (instead of equity), it would treat the payments received as taxable interest (rather than exempt dividends). Therefore, as long as the interest payments would be treated as ordinary income in the payee country (assuming a usual tax status of the payee as discussed below), the D/NI mismatch would cease to exist, which means that there is a character mismatch.

- *The rule should not apply where the mismatch is solely attributable to the status of the taxpayer or the context in which the instrument is held*

  This reflects that D/NI results can be due to factors other than the hybridity of a financial instrument. However, character mismatches should only arise because of the contrasting ways in which the payee and payer countries treat the instrument for tax purposes.

  For example, a vanilla loan paying interest could produce a D/NI result where the payee is a sovereign wealth fund or tax resident in a country with no income tax or a territorial tax regime. However, this would not be a hybrid mismatch.

  The test the legislation applies is whether the mismatch would still arise if the classification of the instrument were varied in the payee country, and the instrument was held by a payee of usual or ordinary status for a person in the payee's class.

If it would, then the mismatch should be attributed to the classification of the instrument, rather than the status of the taxpayer or the context in which the instrument is held, and section FH 3 can apply to the New Zealand payer.

Example 7: Hybrid financial instrument

Zebra Co (a company resident in Country Z) owns all the shares in Kiwi Co (a company resident in NZ). Zebra Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of NZ Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. New Zealand treats the subordinated loan as a debt instrument, while Country Z treats the loan as akin to equity and treats payments under the loan as exempt foreign-sourced dividends.

The payments on the loan fall within the scope of the hybrid financial instrument rule. Country Z does not recognise the arrangement between Zebra Co and Kiwi Co as giving rise to ordinary income for Zebra Co, as it is an exempt dividend that is not taxed at the payee's full marginal rate. If the classification of the arrangement were varied such that Country Z viewed the arrangement as an ordinary loan, the payments would be recognised as interest income that is fully taxable to Zebra Co. As a result, the counterfactual requirement in FH 3(2) is satisfied. Kiwi Co is denied a deduction for its interest expenditure under FH 3(4).

Example 8: Interest payment to an exempt person

Elephant Co (a company resident in Country E) owns forty percent of the shares in Kiwi Co (a company resident in NZ). Elephant Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of NZ Co and can be suspended if Kiwi Co fails to meet certain solvency requirements. Both Country E and New Zealand treat the subordinated loan as a debt instrument.

Elephant Co is a sovereign wealth fund established under Country E law that is exempt from tax on all income. E Co is therefore not taxable on the interest payment. If it were not tax exempt, it would be taxable on interest income from Kiwi Co, but not taxable on dividend income from Kiwi Co.

Question 1

Do the interest payments under the loan fall within the scope of the hybrid financial instrument rule in section FH 3?

Answer 1

No. The interest payments under the loan give rise to a mismatch in tax outcomes as they are deductible under NZ law, but are not included in ordinary income under Country E law. However, the D/NI result is not dependent on the classification of the financial instrument (that is, the subordinated loan). Rather, it applies solely because of the tax exempt status of Elephant Co as a sovereign wealth fund. The mismatch in tax outcomes would not have arisen had the interest been paid to a taxpayer of usual status (say a company), so cannot be attributed to the classification of the instrument.

Question 2

Does the outcome described above change if the subordinated loan is instead a hybrid financial instrument that is treated as an equity instrument by Country E (with dividends treated as exempt if derived by a company) but a debt instrument by New Zealand (with interest treated as deductible)?

Answer 2

Yes. The D/NI result now arises for two reasons: (1) Elephant Co is a tax exempt sovereign wealth fund; and (2) Country E treats the hybrid financial instrument as an equity instrument but Kiwi Co treats it as a debt instrument. Whether there is a character mismatch under subsection FH 3(2) then depends on whether there would be a D/NI result if Elephant Co had the usual tax status for a person of the its class (say a company in this case). This will depend on how Elephant Co would be taxed if it were not specifically tax exempt. In this case, Elephant Co would be taxed on the payments on the instrument if it were treated as interest in Country E. In that case there would be a character mismatch under subsection FH 3(2).

Example 9: Interest payment to a person established in a no-tax jurisdiction

Horse Co (a company resident in Country H) owns all the shares in Kiwi Co (a company resident in New Zealand). Horse Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of Kiwi Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. Both H Co and Kiwi Co treat the subordinated loan as a debt instrument.

Country H does not have a corporate tax system and Horse Co does not have a taxable presence in any other country. Horse Co is therefore not liable in any country on payments of interest under the loan.

Question 1

Do the interest payments under the loan fall within the scope of the hybrid financial instrument rule in section FH 3?

Answer 1

No. The interest payments under the loan give rise to a mismatch in tax outcomes as they are deductible under New Zealand law, but are not included in ordinary income under Country H law. However, the D/NI result is not dependent on the classification of the financial instrument (that is, the subordinated loan). Rather, it applies because Country H does not have a corporate tax system for any taxpayers.

Question 2

Does the outcome described above change if the subordinated loan is instead a hybrid financial instrument that is treated as an equity instrument by Horse Co but a debt instrument by Kiwi Co (with interest treated as deductible)?

Answer 2

No. The D/NI result would still arise if Horse Co treated the subordinated loan as a debt instrument (mirroring Kiwi Co's treatment of it). This is because Country H has no corporate tax system.

Example 10: Interest payment to a taxpayer resident in a territorial tax regime

Tiger Co (a company resident in Country T) owns all the shares in Kiwi Co (a company resident in New Zealand). Tiger Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of Kiwi Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. Both Tiger Co and Kiwi Co treat the subordinated loan as a debt instrument.

Country T has a pure territorial tax system and does not tax income unless it has a domestic source. Interest income paid by a non-resident is treated as foreign source income and is exempt from tax.

Question 1

Do the interest payments under the loan fall within the scope of the hybrid financial instrument rule in section FH 3?

Answer 1

No. The interest payments under the loan give rise to a mismatch in tax outcomes as they are deductible under New Zealand law, but are not included in ordinary income under Country T law. However, the D/NI result is not dependent on the classification of the financial instrument (that is, the subordinated loan). Rather, it applies because Country T taxes on a purely territorial basis.

Question 2

Does the outcome described above change if the subordinated loan is instead a hybrid financial instrument that is treated as an equity instrument by Tiger Co but a debt instrument by Kiwi Co (with interest treated as deductible)?

Answer 2

No. The D/NI result would still arise if Tiger Co treated the subordinated loan as a debt instrument (mirroring Kiwi Co's treatment of it). This is because Country T has a pure territorial tax system and the interest income paid by a non-resident is treated as foreign source income.

Ordinary income is defined in subsection (9). It is income taxed at the full (or usual) marginal rate of a person for income from financial instruments, and which is not eligible for any exemption, exclusion, credit or tax relief, other than for withholding tax imposed on the payment.

Example 11: Ordinary income I

An offshore parent tax resident in Country A lends money to a New Zealand subsidiary on the basis that the loan is subordinated to general creditors and interest payments are subject to a solvency requirement. If the interest is not paid, it compounds. The loan is treated as a share under Country A tax law, and payments are treated as dividends. Country A taxes only ten percent of any dividend received from a foreign subsidiary. The tax rate imposed on this ten percent is the same as the tax rate imposed on interest income.

In this case, ninety percent of the interest payment is not taxed as ordinary income. However, it would be taxed as ordinary income if the loan were treated as a debt instrument for purposes of Country A tax law. Accordingly, the payment meets the requirements of subsection FH 3(2).

Example 12: Ordinary income II

Take the facts of example 11, but now assume that Country A also has a rule that denies the ninety percent exclusion to dividends from foreign subsidiaries if they are deductible to the subsidiary (similar to section CW 9(2)(c) of the Income Tax Act 2007). In this case section FH 3 would not apply. The interest would remain deductible, since it is taxable as ordinary income to the offshore parent.

It should not matter if there is a timing difference between when the payment is treated as deductible to the New Zealand subsidiary (that is, interest deducted on an accrued basis under the financial arrangements rules) and when it is taxable to the offshore parent (that is, when it is received) under subsection FH 3(2), unless subsection FH 3(3) relating to timing mismatches applies.

Varied facts

Now suppose that the loan from the offshore parent is to the New Zealand branch of a subsidiary also resident in Country A, and the offshore subsidiary and the offshore parent are in a tax consolidated group in Country A, pursuant to which payments between the two companies are disregarded for Country A tax purposes. In that case, the payment would not be included in the offshore parent's income regardless of the classification of the payment or the loan. Accordingly, the payment is not subject to section FH 3 (though it may well be subject to section FH 5).

Timing mismatches

Subsection (3) applies to "timing mismatches". These arise if:

- an amount of a payment is recognised as ordinary income;
- the financial instrument, including extensions contemplated by the financial instrument, does not have a duration of three years or less; and
- the payee is not using a reasonable accrual method to recognise income from the payment and the payment is not, or is not reasonably expected to be, recognised in the payee country in an accounting period beginning within 24 months of the year in which the amount is deductible.

One example of where a timing mismatch can arise is where the instrument is treated as equity in the payee country and the payee country has adopted hybrid recommendation 2. Recommendation 2 will ensure the (dividend) payment is taxable, but may not put it on an accrual recognition basis.

Example 13: Timing mismatch I

An offshore parent company makes an advance to a New Zealand subsidiary company, with interest accruing but payable only if demanded by the parent. The loan has no specified maturity date. The New Zealand subsidiary deducts interest as it accrues, but the parent only recognises the interest when it is paid under the tax law in its country of residence.

In this case, although demand for repayment of the advance could be made at any time, there is no requirement for the advance to be repaid within three years, so the three year de minimis does not apply. In the absence of section FH 3, the group can expect to generate a tax advantage by the subsidiary not paying the interest. Accordingly, unless there is some evidence to support an expectation that the interest will be paid within the required period, the interest payment will be subject to deduction denial under subsection FH 3(4).

If the New Zealand subsidiary in example 12 does pay interest to its offshore parent in the future, the New Zealand subsidiary will receive a deduction for any interest previously denied under subsection FH 3(7) to the extent the interest payment is recognised as income by the parent.

Hybrid counteraction

Subsection (4) defines the amount for which the payer is denied a deduction when subsection (1) is satisfied. The deduction has two components.

The first component is for the incurred amount. This is the expenditure incurred by the payer relating to the payment instrument and the payee. For financial instruments denominated in a foreign currency, the expenditure should be calculated taking into account the effect of changes in the NZD value of both the principal amount and the payment itself (to the extent these changes are otherwise taken into account in determining income). In such cases, the incurred amount in subsection (4) is also intended to include both amounts.

The second component is a formula with a fraction, which is: *1 – payee tax/ordinary tax*. This is intended to reduce the deduction denied to the extent that foreign tax is imposed on the payment.

Payee tax is the total of:

- the tax for which the payment is liable in the payee country within the timing in subsection (6), and to the extent that the payment is ordinary income in the payee jurisdiction. This could be tax on income recognised in the payee country in the same year as the deduction is claimed in New Zealand, but also includes tax on income recognised in an accounting period beginning within 24 months of the year in which the deduction is claimed in the payer country. It is calculated by multiplying the amount of the payment that is recognised as income by the applicable rate of tax; and
- the amount of income tax actually imposed on the income under CFC rules in another country again within the timing in subsection (6). In relation to this second element, there must be actual tax payable on the income. This test will not be met if the CFC tax is reduced by losses or credits, other than credits for withholding tax imposed by New Zealand on the payment.

Ordinary tax is the amount of tax which would be imposed on the payment if it were ordinary income in the payee country.

Example 14: Timing mismatch II

Take the facts of example 11. In this case the incurred amount is the deduction claimed by the payer in a given year.

If a payment is made, or is reasonably expected to be made, within the 24-month timing in subsection (6) for which the deduction is claimed, "payee tax" will include an amount equal to ten percent of the payment times the payee's ordinary tax rate. The formula in section FH 3(4) will deny a deduction for the incurred amount times ninety percent.

If the timing requirement is not met, payee tax will be zero, and the full amount of the deduction will be denied. If tax is later paid by the payee outside the 24-month timing in subsection (6), a deduction will be allowed to that extent, under subsection (7).

Example 15: Variable rates

Rimu Ltd is a New Zealand company that is wholly owned by a foreign limited partnership, Redwood LP. Redwood LP has funded Rimu Ltd through a combination of shares and debt. Redwood LP has a number of individual investors in Country U. Those investors treat the debt in Rimu Ltd as shares. The investors are taxable on dividends at a flat rate of 20%. However, the interest payments on the hybrid shareholder debt can sometimes be treated as a return of capital in Country U. If the debt were treated as debt in Country U, the payments would be treated as interest, and taxable at each investor's marginal rate.

In this case, none of the income of the investors is recognised as ordinary income. Accordingly, all of the deductions for the payments will be denied, even though a significant amount of foreign tax is paid. This is the same tax outcome as would apply if the shareholder loan were replaced by non-hybrid equity. Redwood LP may wish to replace the hybrid debt with non-hybrid debt, so that the interest is again fully deductible in New Zealand.

Subsection (7) applies to amounts for which a deduction is denied because of a timing mismatch (that is, the amounts fall within subsection (6)). Once the payment is recognised as ordinary income in the payee country, the payer is allowed a deduction for the amount previously denied under subsection (4).

Example 16: Reversal of timing mismatch

Take the facts of example 11. Suppose that $1,000 of expenditure has been incurred, of which $900 is not taxed to the offshore parent, and $100 is taxed, but not within the time frame in subsection (6). The $900 will never be deductible, but the $100 will be deducted when the payment is made by New Zealand subsidiary and recognised by Offshore Parent.

The intention of subsection (8) is to deal with the effect of foreign currency gains of a person who, but for such gains, would be denied a deduction for expenditure incurred under a financial arrangement because it falls within subsection (2). If such a person has net income from the financial arrangement due to the foreign currency gain, subsection (8) provides that the income will be excluded income. If the deduction for the payment would have been only partially denied, the income is excluded income in the same proportion.

Section FH 4 – defensive rule

Section FH 4 is the defensive rule of recommendation 1 of the OECD hybrid mismatch report.

Section FH 4 applies when a person subject to New Zealand tax receives a payment under a financial instrument if:

- the payment would not give rise to assessable income of the payee, or gives rise to assessable income not meeting the timing requirements in subsection (7). The timing requirements are that the income must be allocated to an accounting period beginning within 24 months of the end of the accounting period to which the deduction is claimed in the payer country;
- the payment is treated in another country as deductible (or entitled to equivalent tax relief) to a person in that country;
- that country does not have an equivalent to section FH 3 (the primary rule for hybrid financial instruments);
- the financial instrument is part of a structured arrangement or the payee and payer are related; and
- the payment meets the requirements of subsection (2) or (3). Subsection (2) relates to character mismatches and subsection (3) relates to timing mismatches.

Character mismatches

Subsection (2) applies to character mismatches, which arise when a payment does not give rise to assessable income to the payee, but would do so if the classification of the payment or the financial instrument were varied.

Generally, it is not expected that subsection (2) would apply to a dividend, since New Zealand already taxes deductible dividends (as the section CW 9 exemption does not apply to deductible dividends). Nor is it intended that section FH 4 would apply to payments under a finance lease where the payer in another country treats the lease as an operating lease and claims a deduction for the entire amount of the payment. In this case, so long as the instrument remains a financial instrument, there is no variation to its terms that would result in the payments being assessable to the extent they represent a payment of principal in respect of the deemed loan under the finance lease.

Example 17: Deemed interest on interest-free loan

Kiwi Co (a company resident in New Zealand) lends money to Beetle Co (a company resident in Country B) on interest-free terms. The laws of Country B allow Beetle Co to claim a deduction for tax purposes as if it had paid interest on the loan at a market rate.

NZ treats the loan as a debt instrument.

Question

Does the loan fall within the scope of the hybrid financial instrument rule in section FH 4?

Answer

The loan does not fall within the scope of the hybrid financial instrument rule because there is no payment under the loan that gives rise to a deduction for tax purposes in Country B. (Note that this example does not consider the application of the transfer pricing rules. If the transfer pricing rules apply to the loan, they may also treat Kiwi Co as earning income under the loan.)

Example 18: Potential character mismatch

Camel Co (a company resident in Country C) issues 10 year redeemable preference shares (RPS) to Kiwi Co (a company resident in New Zealand), which owns one hundred percent of the voting interests in Camel Co.

The RPS pay an annual return (dividend) that accrues daily and, to the extent accrued dividends are unpaid, forms part of the redemption price.

In Country C, the RPS are treated as debt for tax purposes and the coupons are ordinarily deductible as they accrue.

Country C does not have a tax rule equivalent to the primary rule for recommendation 1 of the OECD hybrid report.

Question

Does the RPS fall within the scope of the hybrid financial instrument relating to character mismatches in section FH 4(2)?

Answer

In New Zealand, the coupons would be assessable as dividend income because the exemption in section CW 9 for foreign dividends does not apply to a deductible foreign equity distribution. Therefore, there is no D/NI mismatch arising from the RPS that section FH 4(2) might counter.

Timing mismatches

Subsection (3) applies to timing mismatches. It applies to a payment under a financial instrument which does not have a duration, including extensions contemplated by the financial instrument, of three years or less.

Subsection (3) applies if the payment gives rise to assessable income, but the gap between the year in which the deduction is claimed by the payer in its country and the derivation of assessable income in New Zealand meets the requirements of subsection (7). An amount meets the requirements of subsection (7) if it is not included, or is not reasonably expected to be included, in income in New Zealand in an income year beginning within 24 months of the end of the accounting period in which it is deductible in the payer country.

Example 19: Timing mismatch of RPS

Take the facts in Example 18 ("Potential character mismatch".

Question

Does the RPS fall within the scope of section FH 4(3)?

Answer

Yes, depending on the facts. If there is no expectation the RPS will be redeemed within 24 months of the end of the foreign tax year in which Camel Co claims a deduction, Kiwi Co will need to recognise the income in the same year Camel Co deducts the expense.

Example 20: Prepaid interest

Kiwi Co (a company resident in New Zealand) owns one hundred percent of the voting interests in Donkey Co (a company resident in Country D) and provides it with an interest-bearing loan for a fixed term of three years.

Donkey Co pays the interest upfront in a lump sum payment for which it is entitled to an immediate deduction in the foreign country.

Kiwi Co returns the interest payment on an accruals basis over the three-year term.

Question 1

Does the loan fall within the scope of the hybrid financial instrument rule relating to timing mismatches in section FH 4?

Answer 1

The loan will not give rise to a timing mismatch under section FH 4(3) for Kiwi Co as it has a term of three years (limb (b)).

Question 2

Does the answer change if the loan is for a five-year term instead?

Answer 2

The loan will give rise to a timing mismatch under section FH 4(3). The portion of the interest income which under the financial arrangements rules in subpart EW would not be derived in or before the income year beginning 24 months after the end of the borrower's income year would be taxed upfront on receipt under section FH 4(4), instead of spread on an accruals basis under the financial arrangements rules in subpart EW. The remaining portion of the interest income would be taxed in the usual way.

Hybrid counteraction

Subsection (4) is the main operative subsection for a character mismatch. It provides that a payment which is subject to the section gives rise to assessable income equal to the amount that would be assessable if the classification of the financial instrument were varied. Under subsection (6), this income is allocated to the year in which:

- in the case of a character mismatch, it would be derived if the terms of the instrument were varied so that the payment gave rise to income; or
- in the case of a timing mismatch, the relevant deduction is allowable in the payer country.

Replacement payment under returning share transfer

Subsection (5) provides for the case where a New Zealand taxpayer receives a replacement payment under a returning share transfer. Replacement payments are taxable income. However, if the returning share transfer is also a share lending arrangement as defined in section YA 1, the replacement payment can carry an imputation credit (section OB 64). If the share borrower is entitled to a deduction in its country for the replacement payment, the attachment of such a credit would give rise to a hybrid mismatch. In order to reverse this, the imputation credit is denied.

Deductible foreign equity distribution definition

The exclusion in section CW 9(2)(c) for deductible foreign equity distributions will continue to apply to such distributions with priority over the hybrid mismatch rules (including the defensive hybrid financial instrument rule) of other countries, consistent with the OECD's recommendation 2.1. For example, the adoption of hybrid rules in Australia will have no effect on the tax treatment of a New Zealand company in respect of a deductible dividend received from an Australian company.

The definition of "deductible foreign equity distribution" has been amended in section YA 1 to include distributions on shares in a foreign company for which a deduction against income or equivalent tax relief or tax benefit is allowed, or would be allowed in the absence of the hybrid mismatch legislation (including situations where the distribution is sourced directly or indirectly from an amount paid to the foreign company that is deductible).

Example 21: Foreign unit trust

Koala Trust is a unit trust established and managed in Westland (a foreign country). Kauri Co (a company resident in New Zealand) holds 40% of its units.

In the year to 30 June 2019, Koala Trust earns W$200,000, and passes resolutions sufficient to ensure that this amount is treated for Westland tax purposes as the income of its beneficiaries (including Kauri Co). These resolutions mean that sum is absolutely vested in the unit holders. If these resolutions had not been passed, the income would have been taxed in Westland to the trustee at a tax rate of 48%.

Question 1

Assume Koala Trust's income is sourced from a third country. The effect of the source of Koala Trust's income and the vesting of the income in the beneficiaries of Koala Trust (including Kauri Co) is that Westland does not impose any tax on that income. What is the tax treatment of this income in New Zealand?

Answer 1

The absolute vesting of the 2019 year income means that Kauri Co is deemed to have received a dividend of W$80,000 (due to Kauri Co's 40% interest in Koala Trust), under section CD 9. Generally, this dividend would be exempt under section CW 9(1). However, in this case the dividend is not exempt because it is a deductible foreign equity distribution. The definition of deductible foreign equity distribution (as amended) includes an amount giving rise to a deduction or equivalent tax relief or tax benefit. The vesting of the income in unitholders results in a tax benefit (as there is no tax paid in Westland), so the amount will be a taxable dividend in New Zealand for Kauri Co.

Question 2

Now assume that Koala Trust's income is passive income sourced in Westland. If the income were not income of the beneficiaries, it would be taxed to the trustee of Koala Trust at a rate of 48% under Westland law. However, due to the resolutions vesting the income in beneficiary unitholders, in Westland it is taxed as income of (a) the trustee, but taxable at 15%; and (b) the beneficiaries, taxable at the 15% rate, with a credit for tax paid by the trustee. What is the tax treatment of Kauri Co's share of the income in New Zealand?

Answer 2

Again, due to the tax benefit that results from vesting the Koala Trust income in its beneficiaries, the amount will be a deductible foreign equity distribution and taxable dividend for Kauri Co.

Question 3

Finally, assume that Koala Trust's income is active income sourced in Westland. It is taxed under Westland law at the usual rate applying to foreign entities doing business in Westland which is 30%. Both the trustee and the unitholder are liable to tax. What is the tax treatment of the income in New Zealand?

Answer 3

The amount vested in Kauri Co is still a deductible foreign equity distribution and a taxable dividend in New Zealand unless the rate applying to the income due to its vesting is the same as the rate that would apply if the income was undistributed.

DISREGARDED HYBRID PAYMENTS AND DEEMED BRANCH PAYMENTS

Sections FH 5 and FH 6

Background

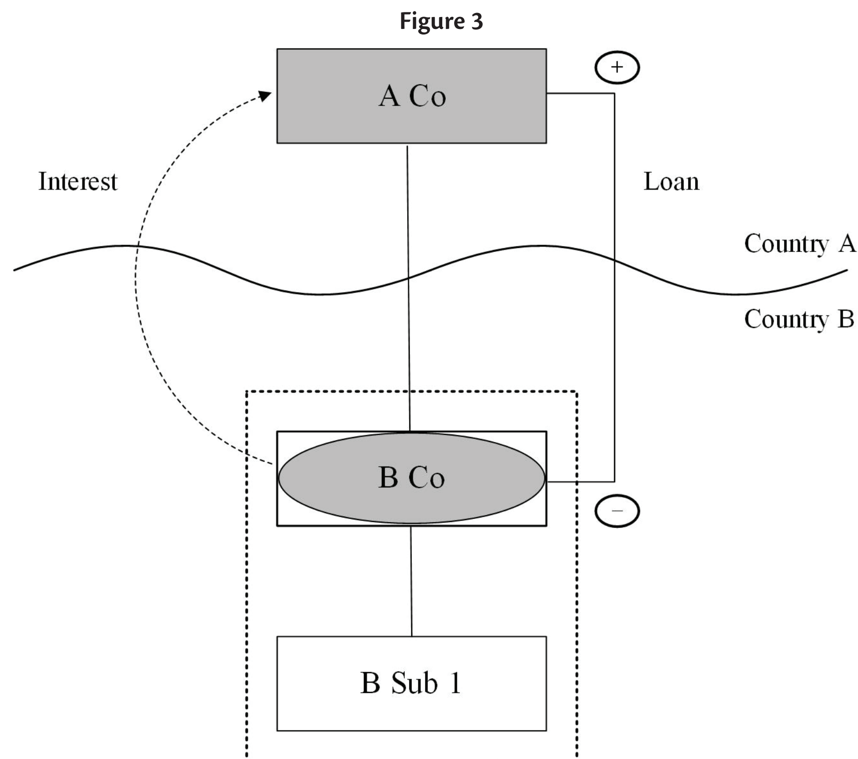
The disregarded hybrid payment rule is recommendation 3 of the OECD hybrid mismatch report. The deemed branch payment rule is recommendation 3 of the OECD branch mismatch report.

Disregarded hybrid payments

Figure 3 illustrates an example of a disregarded hybrid payment mismatch. Such mismatches always involve a payment by a hybrid entity.

A hybrid entity is an entity which is transparent for tax purposes in the country of an investor (Country A) but opaque for tax purposes in another country, generally where it is established (Country B). In Figure 3, B Co is the hybrid entity.

Figure 3



An interest payment from a hybrid entity (B Co) to its investor (A Co) will be deductible in Country B and disregarded in Country A. This results in a D/NI hybrid mismatch. The mismatch results in double non-taxation if B Co groups its tax loss with the income of another entity (B Sub 1 in the example) whose income is not taxable in Country A.

Deemed branch payments

The same outcome can arise if B Co is instead a branch of A Co in Country B and is entitled in Country B to a deduction for a charge made to it by A Co, if that charge is not also recognised as income in Country A.

Summary of legislative response

Sections FH 5 and FH 6 identify amounts of expenditure relating to:

- payments that are deductible in the country of the payer and are disregarded in the country of the payee due to the status of the payer; and
- mismatches in the deductibility and recognition of charges by a head office to a branch in another country which are deductible for tax purposes in the branch country, generally as a way of a branch country ensuring that it taxes only that portion of a multinational entity's income that corresponds to the activities undertaken in the branch country. These charges are only subject to the sections to the extent they do not reflect a simple allocation of actual third party costs. For example, these sections would apply to a profit margin charged by head office to a branch, or a charge for some internally-performed function.

Section FH 5 applies where the deduction is in New Zealand, whereas FH 6 applies where New Zealand is not including a payment (or deemed payment) as income and the payment (or deemed payment) is deductible in another country.

These identified amounts are treated as non-deductible under FH 5 or are included as assessable income under FH 6. A deduction for them is provided under section FH 12 to the extent they do not exceed surplus assessable income under the offsetting rule in that section.

Application date

The rules apply to income years beginning on or after 1 July 2018. Section FH 5 applies to payments for which deductions are claimed in that income year or subsequently. Section FH 6 applies only to payments that are paid on or after the start of the payee's income year.

Detailed analysis

Section FH 5 – primary rule

Section FH 5 is the primary rule for recommendation 3 of the OECD hybrid mismatch report and recommendation 3 of the OECD branch mismatch report. It applies with priority over the defensive rules of foreign countries.

The primary rule concerns New Zealand residents and New Zealand branches of non-residents that incur an amount of expenditure relating to disregarded hybrid payments, or a charge relating to deemed branch payments.

Subsection (1) sets out the conditions that must be satisfied for the primary rule to apply. They include that:

- there must be an amount of expenditure relating to either a disregarded hybrid payment under subsection (2) or a deemed branch payment under subsection (3);
- the expenditure or charge is deductible in New Zealand;
- the payment or charge is treated as not being received in a foreign country due to the status of the payer;
- the payment or charge would be treated as received in a foreign country if the tax status of the payer were different;
- the payment or charge does not give rise to tax under CFC rules in a foreign country.

For the primary rule to apply to a disregarded payment, subsection (2) must be satisfied in addition to (1). Subsection (2) requires that:

- the payee is a non-resident and is not receiving the payment through a New Zealand taxable branch; and
- the payer (who can be a New Zealand resident or a branch of a non-resident) either makes a payment to another person in the same control group or makes the payment under a structured arrangement. This requirement is set out separately because it is not necessary for the deemed branch payments context.

A disregarded hybrid payment structure of note is a consolidated group of entities resident in a foreign country (such as Australia) where one of those entities operates in New Zealand through a branch. Payments made by an entity through its branch to a consolidated entity might be disregarded in the foreign country, which would be a D/NI outcome. Section FH 5 would deny a deduction to the payer in this instance.

For the primary rule to apply to a deduction claimed by a New Zealand branch for a charge paid to a non-New Zealand part of the same legal entity (deemed branch payments) the charge must satisfy the requirements of subsection (1) and some further requirements set out in subsection (3). The purpose of these requirements is to distinguish deduction for allocation of third party expenditure (which are dealt with by section FH 9) from true intra-entity charges.[6]

Where the relevant conditions are met, the payer of the payment is denied a deduction for all expenditure (including foreign exchange gains and losses) relating to the payment, under subsection (4). However, under section FH 12, if the payer has surplus assessable income the mismatch amount may be set off against that amount.

Example 22: Disregarded hybrid payment mismatch (primary rule)

Jefferson Co, a foreign company resident in Washington Country (a foreign jurisdiction) owns one hundred percent of Hamilton Co, an unlimited liability company resident in New Zealand. Jefferson Co provides Hamilton Co with a foreign currency loan under which interest is payable annually. In the relevant income year, the foreign currency strengthens relative to the New Zealand dollar.

The interest payments and any foreign currency movements on the loan are deductible (before applying the hybrid rules) to Hamilton Co in New Zealand. The laws of Washington Country allow Jefferson Co to treat Hamilton Co's income and expenditure as attributable to Jefferson Co because of Hamilton Co's unlimited liability. This means that the interest payment is disregarded in Washington Country due to the status of the payer (Hamilton Co). If Hamilton Co were treated differently, for example if it were treated as a separate entity in Washington Country, the interest payment would be treated as received by Jefferson Co.

[6] See paragraphs 85–88 of the OECD Branch Mismatch Report for a fuller discussion of the difference between deductions for allocation of third party expenditure and true intra-entity charges.

NEW LEGISLATION

Question 1

How does section FH 5 apply to Hamilton Co?

Answer 1

Under section FH 5(5), Hamilton Co has a mismatch amount for its incurred expenditure on the debt instrument. This expenditure is non-deductible under section FH 5(4). Hamilton Co would have to apply section FH 12 to determine whether a deduction can be claimed.

Variation of facts

Suppose that even though Hamilton Co is disregarded for Washington Country tax purposes, Washington Country exempts the income earned through Hamilton Co from tax, on the basis of an active offshore branch income exemption. Suppose also that because of this exemption, for Washington Country tax purposes, Jefferson Co is denied a deduction for a portion of its interest expense.

Question 2

Will this interest deduction denial in Washington Country affect the application of section FH 5?

Answer 2

No.

Example 23: Deemed branch payment mismatch (primary rule)

Root Co, a foreign company resident in Ashes Country (a foreign jurisdiction) operates through a branch in New Zealand. Root Co manufactures cricket bats in Ashes Country, and sells them to retail stores in various countries, generally via branches of Root Co in those countries, including the one in New Zealand. Root Co transfers its cricket bats from Ashes Country to its branch in New Zealand. Each cricket bat transfer is compensated for tax purposes by a $250 charge from the branch to Root Co representing $150 of costs per cricket bat to Root Co as well as a $100 arm's length mark-up in recognition of the profit generating activities of the manufacturing process in Ashes Country. This $100 mark-up is approximately the same as the marginal profit Root Co receives upon selling a cricket bat in Ashes Country.

Currently, the entirety of the $250 charge is deductible to Root Co's branch in New Zealand and can be offset against income earned by the branch for cricket bat sales. Ashes Country exempts active branch income from taxation.

The $250 is potentially within scope of proposed section FH 5 as a deemed branch payment.

The $150 cost component of the charge is not within scope of section FH 5. This is because it does not satisfy section FH 5(3)(c) due to the amount being determined by reference to the actual costs of Root Co. (though this amount may be subject to section FH 9). However, the $100 arm's length mark-up component of the charge meets the requirements of section FH 5(3)(b) as it is a profit-based amount and so it is not determined by reference to any payments made by Root Co. or any other person in a control group with Root Co.

To the extent that the $100 mark up portion of the transfer price for each bat is not treated as income of Root Co. in Ashes Country, it will be denied a deduction under section FH 5(4). It will also be a mismatch amount under FH 5(5) until there is surplus assessable income against which it may be set off under section FH 12.

Section FH 6 – defensive rule

Section FH 6 is the defensive rule for recommendation 3 of the OECD hybrid mismatch report. It also applies as a defensive rule for recommendation 3 of the OECD branch mismatch report, though the report does not recommend a defensive rule.

The defensive rule mirrors the primary rule and is targeted at:

- payments that are deductible to a foreign entity but disregarded in New Zealand; and
- foreign branches of New Zealand persons who are entitled to a deduction in another country for a deemed branch payment or charge.

Subsection (1) of section FH 6 sets out the following requirements for the defensive rule to apply:

- A non-resident, or foreign branch of a New Zealand resident, must be treated by the relevant foreign country as having made a payment (a disregarded hybrid payment) meeting the requirements of subsection (2) to a person in New Zealand or having incurred a deemed branch payment meeting the requirements of subsection (3).
- The relevant foreign country allows the payer a deduction for the payment or equivalent tax relief.

- The relevant foreign country does not have hybrid mismatch legislation corresponding to section FH 5 (the primary rule) that applies to the payer and the charge for any part of the relevant year (in that case, the foreign country's primary rule would take priority).
- The person in New Zealand does not derive assessable income from the payment.
- The payment would result in assessable income for the person in New Zealand if:
  - in the case of a hybrid mismatch, the tax status of the payer were different. New Zealand tax law does not generally provide for foreign entities to be entirely disregarded. Even if they are fiscally transparent, such as partnerships, a payment by the entity to a member is generally taken account of for tax purposes (albeit that inclusion by the member of the payment may be largely offset by attribution to the member of a share of the deduction – this deduction means the payment is potentially subject to section FH 9). One case where a payment can be disregarded in this way is where it is made by one member of a tax consolidated group to another member see section FM 8(2); or
  - in the case of a branch mismatch, the payer and payee were separate persons.

For the defensive rule to apply to a disregarded payment, subsection (2) must be satisfied in addition to subsection (1). Subsection (2) requires that the relevant parties are a payee in New Zealand that is in the same control group as the payer (who can be a non-resident or a foreign branch of a New Zealand resident) or that the payment is made under a structured arrangement.

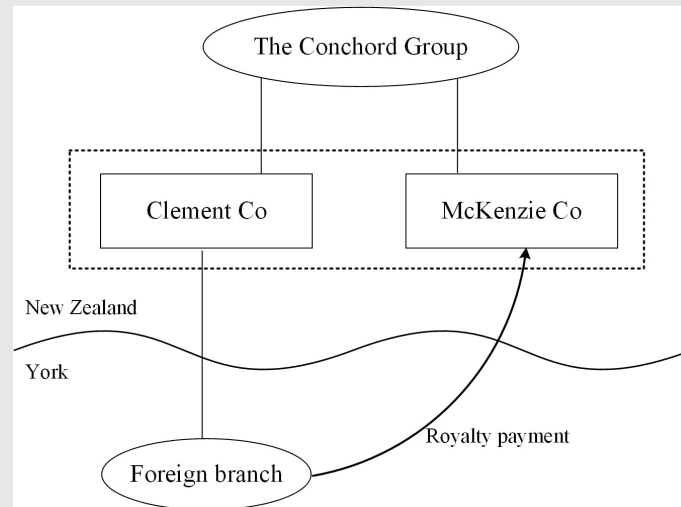
For the defensive rule to apply to a deemed branch payment from a foreign branch of a New Zealand person, that charge must satisfy the requirements of subsection (1) and some further requirements set out in subsection (3). As with section FH 5(3), the purpose of these requirements is that section FH 6 should only apply to a mismatch arising because of an intra-group charge deduction in a foreign country being unmatched by income in New Zealand. Section FH 8 rather than FH 6 is intended to apply to double deductions arising due to the allocation of the same expenditure to two countries.

Where the conditions referred to above are met, the amount of the payment or charge is assessable income (it is treated as being zero, if the payment or charge gives rise to a loss, for example, due to foreign exchange fluctuations), under subsection (4). This assessable income is derived in the year in which it would be derived if the payer and payee were separate persons or the payer's tax status was different, under subsection (5). The assessable income is further treated as a mismatch amount under subsection (6), which can be reversed if the taxpayer has surplus assessable income under section FH 12 to offset against it. Because New Zealand taxes income of foreign branches, section FH 12 generally will mean that there is a deduction under section FH 12 to match the section FH 6 inclusion. This will not be the case if foreign branch income taxable in New Zealand is less than the amount of the foreign charge.

Subsection (7) prevents a mismatch amount under subsection (5) from being carried forward if the payer country introduces hybrid mismatch legislation corresponding to the primary rule for disregarded hybrid payment and/or deemed branch payment mismatches.

Example 24: New Zealand consolidated group and disregarded hybrid payment

Figure 4



McKenzie Co and Clement Co are two companies resident in New Zealand in the entertainment business. They are both part of a consolidated group (the Conchord group) under New Zealand law. Clement Co has a branch in York, a foreign country that does not have hybrid rules.

Clement Co makes a royalty payment to McKenzie Co through its foreign branch. Under the laws of York, Clement Co is entitled to a deduction for the payment. Under New Zealand's consolidation rules in subpart FM, the payment is treated as excluded income for McKenzie Co with no deduction for Clement Co.

The counterfactual test in FH 6(1)(d) is satisfied because if Clement Co's tax status were changed such that it is no longer consolidated with McKenzie Co, the payment would be assessable income for McKenzie Co. McKenzie Co must include the royalty payment as assessable income. This amount is a mismatch amount. If McKenzie Co's foreign branch earns income which meets the definition of surplus assessable income in section FH 12 (considered below), then the group will be entitled to a deduction to offset the hybrid inclusion.

REVERSE HYBRID RULE AND BRANCH PAYEE MISMATCH RULE

Section FH 7

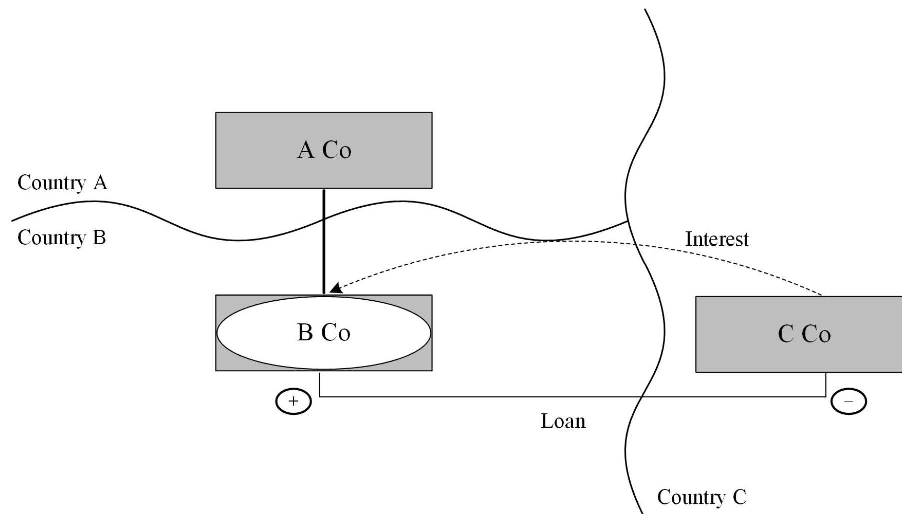
Background

Section FH 7 implements recommendation 4 of the OECD hybrid mismatch report, denying a deduction for a payment to a reverse hybrid in certain cases. It also implements recommendation 2 of the OECD branch mismatch report, denying a deduction for a payment which is not taxed due to a branch mismatch in certain cases.

Figure 5 illustrates an example of a reverse hybrid mismatch. Such mismatches always involve a payment to a reverse hybrid entity.

A reverse hybrid entity is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In the diagram below, B Co is the reverse hybrid.

Figure 5



If B Co receives a payment that is deductible for the payer (C Co), that payment may not be taxed in Country A or Country B. This is because Country B views the payment as being earned by A Co, while Country A views the payment as being earned by B Co. If the payment would have been taxable had it been made directly from C Co to A Co, this is a deduction/no inclusion (D/NI) hybrid mismatch outcome.

A similar outcome can arise as a result of a branch payee mismatch. For example, if the diagram above is modified so that there is no B Co, but:

- Country A treats C Co.'s payment as received by a Country B branch of A Co, and exempts it under a territorial approach to active income; and
- Country B does not recognise the payment as received by a permanent establishment in Country B,

the result will be that the payment by C Co is deductible in Country C, but not taxed anywhere due to the different allocation rules in Countries A and B, which is once again a D/NI mismatch.

Application date

Section FH 7 applies to deductions claimed in income years beginning on or after 1 July 2018.

Detailed analysis

Section FH 7(1) denies a deduction for expenditure relating to a payment:

- to a person who exists under the law of another country (the payee country). This requirement assumes that the person is not a natural person, and owes their existence to the laws of a particular country. For example, in the case of a company, the company must be formed or otherwise owe its existence to a particular country's laws;
- where the expenditure would be allowed as a deduction for the payer in the absence of the hybrid rules;
- treated in the payee country as either:
  - received in another country. This will be the case where there is a potential branch mismatch. A branch mismatch requires that the payee treats the payment as attributable to operations outside its residence country; or
  - income of another person in the same control group as the payer. This will be the case where there is a potential reverse hybrid mismatch. The payee country treats the reverse hybrid as fiscally transparent, so that the payment is treated as the income of its owners. The requirement is only met in the case of an owner who is in the same control group as the New Zealand payer;
- where the payee and payer are also in the same control group, or the payment is made under a structured arrangement;
- where the payment is not subject to taxation of a person in the same control group as the payee. This will be the case where:
  - in the case of a potential branch mismatch, the branch country does not tax the payment;
  - in the case of a reverse hybrid, the owner country does not tax the payment;
- the payment would have been taxable if it were made:
  - in the case of a branch mismatch to the payee directly in the payee country;
  - in the case of a reverse hybrid, directly to the owner.

If these requirements are met, section FH 7(2) denies a deduction for the payment and any related expenditure from foreign currency movements (which would be included as part of 'interest' expenditure under the financial arrangements rules in subpart EW).

Example 25: Diverted branch payment mismatches

Pavlova Co (a company resident in New Zealand) makes a deductible payment to a group member, Banana Cake Co (which is incorporated and resident in Country B and has a branch in Country C).

The domestic law of Country B (the payee country) exempts foreign branch profits and considers the payment to have been paid to the Country C branch of Banana Cake Co.

In Country C, Banana Cake Co is recognised as having a permanent establishment (PE) but the payment is regarded as having been paid to Banana Cake Co in its own right, instead of being allocated to the PE.

The payment is therefore not subject to income tax in either Country B or Country C. The payment thus meets the requirements of section FH 7(1)(a), (b), (c), and (d).

The counterfactual requirement in section FH 7(1)(e) is also met as the payment would have been subject to income tax in Country B had it been treated as a payment to Banana Cake Co's head office in Country B.

As the requirements in Section FH 7(1) are satisfied, subsection (2) denies Pavlova Co a deduction for its payment to Banana Cake Co.

Example 26: Disregarded branch payment mismatches

The facts are the same as in example 25, except that Banana Cake Co is not regarded as having a PE in Country C. Country B still considers that there is a PE in Country C.

This mismatch therefore satisfies each of the requirements of Section FH 7(1) in the same way as the diverted branch payment example above. Pavlova Co will similarly be denied a deduction under subsection (2) for its payment to its group member Banana Cake Co.

DEDUCTIBLE HYBRID AND BRANCH PAYMENTS (DOUBLE DEDUCTIONS) RULE

Sections FH 8 and FH 9

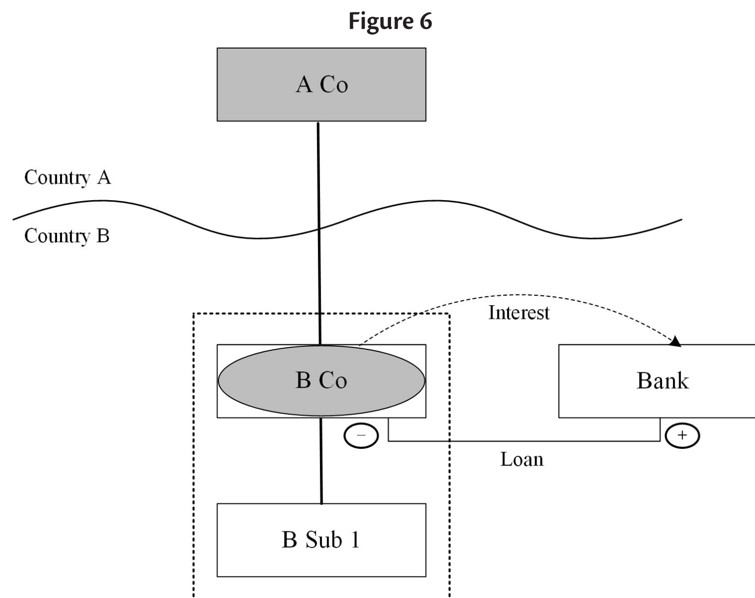
Background

The deductible hybrid rule is recommendation 6 of the OECD hybrid mismatch report and the branch payments rule is recommendation 4 of the OECD branch mismatch report.

Figure 6 is an example of a deductible hybrid payments mismatch. Such mismatches always involve a payment from a hybrid entity.

Hybrid entities are treated as transparent under the laws of the investor's tax country and opaque under the laws of the establishment or operating country. This hybrid treatment can result in the same item of expenditure incurred by the hybrid being deductible under the laws of both the parent and payer countries.

Figure 6



In the example, B Co is a wholly-owned subsidiary of A Co. B Co is disregarded for Country A tax purposes. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is disregarded, A Co is treated as the borrower under the loan under Country A's tax laws. The arrangement therefore results in an interest deduction under the laws of both Country B and Country A (unless Country A denies a deduction for some reason, for example under an active foreign income exemption).

B Co is consolidated for tax purpose with its operating subsidiary (B Sub 1), which allows it to utilise the tax benefit of the interest deduction to B Sub 1. The ability to utilise the tax benefit through the consolidation regime allows the two deductions for the interest expense to be offset against separate income arising in Country A and Country B. This is a double deductions (DD) mismatch.

Branch structures can also achieve the same result, particularly if the country where the entity with the branch is resident in a country that taxes the branch income (as New Zealand does).

Summary of legislative response

Sections FH 8 and FH 9 implement recommendation 6 of the OECD hybrid report and recommendation 4 of the OECD branch report. They are respectively primary and defensive rules designed to deal with hybrid and branch payment mismatches which produce double deduction (DD) outcomes.

The primary rule applies where the hybrid entity or branch is owned by a New Zealand resident and located in a foreign country, whereas the defensive rule applies where the hybrid entity or branch is in New Zealand and owned by a person in another country. The primary rule applies with priority over the defensive rules of foreign countries.

Notably, the primary rule's application is restricted. Only foreign branches or hybrid entities that are capable of offsetting their losses against the income of an existing foreign (non-hybrid) entity are within scope of the rule. This means that simple offshore structures, such as a New Zealand company with only a foreign branch in a country are excluded from the rule. The primary rule also contains a transitional rule that ensures that a person that transitions into the scope of the rule will not benefit from the restricted scope in relation to previous year foreign losses.

The effect of these provisions is to identify gross amounts of expenditure relating to a person's branch or hybrid entity. These identified amounts are non-deductible in New Zealand unless they can be offset against surplus assessable income under section FH 12 (see below).

Application date

The rules apply to income years beginning on or after 1 July 2018.

Detailed analysis

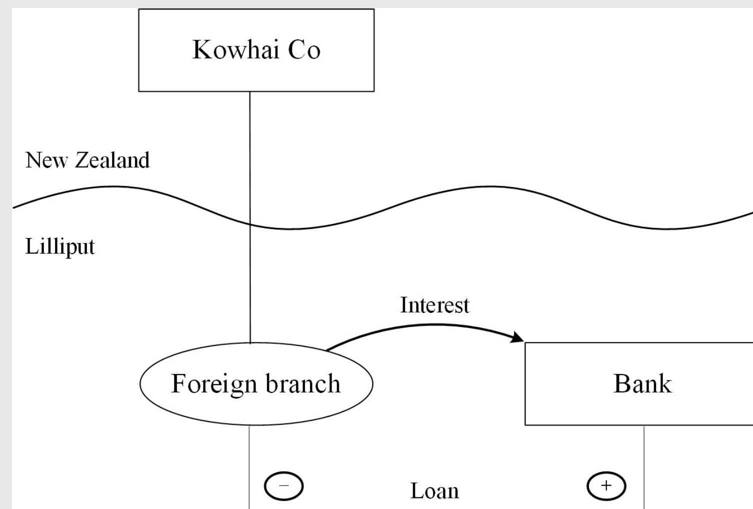
Section FH 8 (primary rule)

New Zealand residents that are related to a foreign hybrid entity or have a foreign branch may fall within the scope of this rule.

The key requirement for the rule to apply is in sections FH 8(1)(a) and FH 8(1)(b) which together mean the section only applies if the relevant foreign country allows losses of the hybrid entity/branch to be offset against income of an existing person whose income is not taxed in New Zealand (other than that which is sourced in New Zealand). This is generally referred to as non-dual inclusion income in the OECD hybrid and branch mismatch reports, and is income which is not surplus assessable income under the new legislation.

Example 27: New Zealand company with a simple foreign branch structure

Figure 7



Kōwhai Co, a company resident in New Zealand, sells native wood carvings in New Zealand and in Lilliput (a foreign country). Kōwhai Co conducts its Lilliput business through a branch in that country. Kōwhai Co borrows from a bank to support its activities in Lilliput. This loan is attributed to its Lilliput branch.

As New Zealand taxes its residents on their worldwide income, Kōwhai Co will be entitled to a deduction in New Zealand for interest paid on the loan. The interest expenditure will also be deductible in Lilliput for Kōwhai Co's branch.

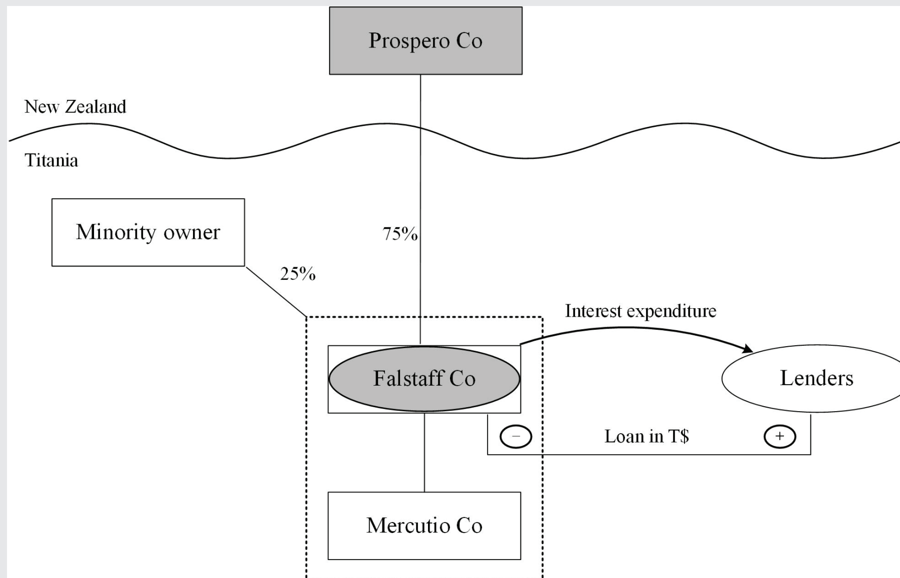
FH 8(1)(a) is not satisfied as Kōwhai Co has not used the income of another person or entity) to offset against its Lilliput branch interest expenditure (there is no such person or entity).

Accordingly, Kōwhai Co's New Zealand tax position has not been altered by the introduction of hybrid and branch mismatch rules. Even if Lilliput has a rule equivalent to section FH 9 (the defensive rule for double deductions in hybrid entities and branches) in these circumstances that rule should have no practical effect. All it will do is deny Kōwhai Co the ability to use its branch loss against non-branch income in Lilliput, of which there is none.

Section FH 8(2) denies a New Zealand person a deduction for the expenditure it incurs through the hybrid entity or branch. This expenditure is treated as a mismatch amount that can be offset (that is, deducted) to the extent there is surplus assessable income under section FH 12.

Example 28: Foreign hybrid entity structure

Figure 8



The Shakespeare group consists of Prospero Co, Falstaff Co and Mercutio Co. Prospero Co, a company resident in New Zealand, owns seventy five percent of Falstaff Co, a hybrid entity resident in Titania (a foreign country). Falstaff Co is treated as a company in Titania, but is treated for New Zealand tax purposes as a partnership. Its income and expenditure is thus attributed to its owners (Prospero Co and the twenty five percent minority owner). Falstaff Co owns one hundred percent of Mercutio Co, a company resident in Titania, and the two entities are consolidated. The consolidation regime of Titania allows the losses of one entity to be offset against the income of the other. Mercutio Co is treated for New Zealand tax purposes as a company, and undertakes an active business in Titania, such that its income is not attributed to Prospero Co under the CFC regime.

Falstaff Co performs a financing function for the Shakespeare Group, and its financing costs are deductible in Titania which means that it regularly makes tax losses in Titania. The financing expenditure is also attributed to Prospero Co under New Zealand law, and Prospero Co claims deductions for its seventy five percent share of that expenditure. Because Falstaff Co borrows in Titanian dollars, fluctuations in the NZ$/T$ exchange rate mean the amount of its deductions attributed to Prospero Co under New Zealand tax rules can be much larger or smaller than the amount calculated for Titanian tax purposes.

Prospero Co satisfies section FH 8(1) due to the ability of its related hybrid entity Falstaff Co to offset its losses against the income of Mercutio Co, which is not generally assessable in New Zealand under the CFC regime. Under sections FH 8(2) and (3), Prospero Co has a denied deduction and mismatch amount equal to its expenditure from Falstaff Co. There is no need to compare the amount of this expenditure with the amount of expenditure Falstaff Co calculates for Titanian tax purposes.

If Mercutio Co were a partnership, so that its income was subject to New Zealand tax in the hands of Prospero, section FH 8(1) would not apply, and no deduction for the financing costs would be denied to Prospero under section FH 8.

If a person is outside the scope of section FH 8(1) because its foreign hybrid or branch is not able to set off expenditure or loss against another person's non-dual inclusion income and subsequently falls within the scope of the subsection due to a change of group structure, that person is subject to the rule on a prospective basis and also must consider subsections (4) and (5) of section FH 8. These provisions function as a transitional rule for persons in such a situation to reverse their historic foreign hybrid or branch losses if they become usable in the other country in a way that would defeat the integrity of the primary rule.

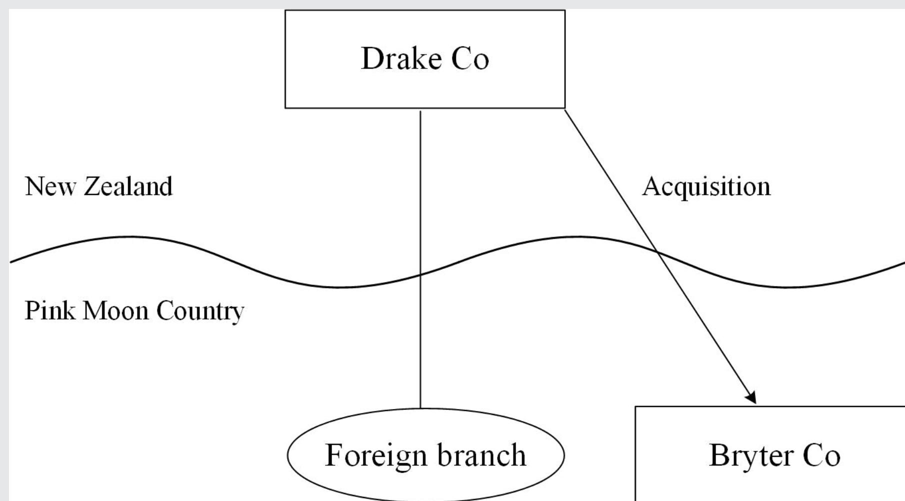
This transitional rule only applies if:

- the person was related to a foreign hybrid entity or had a foreign branch prior to subsection (1) applying to the person; and
- the laws of the relevant foreign country allow accumulated losses of the hybrid entity or branch to be set off against income that is not assessable in New Zealand under the new structure.

To the extent those requirements are met, section FH 8(5) treats the net loss of the hybrid entity or branch occurring since the introduction of the hybrid rules as assessable income and a mismatch amount.

Example 29: New Zealand company with foreign branch making acquisition

Figure 9



Drake Co, a company resident in New Zealand, has for many years sold guitars in Pink Moon Country (a foreign country) through a branch. In the last two years trading conditions have been poor in Pink Moon Country and the branch has made losses. These losses accumulate in Pink Moon Country and can also be offset against Drake Co.'s assessable income from other activities. Drake Co has had no other activities or interests in Pink Moon Country.

Drake Co does not satisfy the section FH 8(1)(a) and section FH 8(1)(b) requirements because the branch losses cannot be offset against the income of an entity that is not taxable in New Zealand.

However, Drake Co believes its prospects in Pink Moon Country will improve, and has now decided to expand its operations there by acquiring Bryter Co a company resident in Pink Moon Country that sells pianos and has a profitable track record. Bryter Co is treated as a company for New Zealand tax purposes.

The tax laws of Pink Moon Country allow Drake Co to group its Pink Moon branch operation losses with Bryter Co profit such that its future branch losses can be offset against the income of Bryter Co. Drake Co must now apply section FH 8 to any future branch losses; they will become non-deductible mismatch amounts under sections FH 8(2) and (3). The laws of Pink Moon Country have no rules preventing the branch losses of Drake Co accumulated before the Bryter Co acquisition being carried forward and offset against Bryter Co income post-acquisition. Drake Co meets the requirements of FH 8(4) and so must apply section FH 8(5) and include as assessable income the accumulated Pink Moon Country branch losses (as calculated for New Zealand tax purposes) in its New Zealand income in the income year of the Bryter Co acquisition.

Section FH 9 (defensive rule)

The defensive rule mirrors the primary rule. It applies to a foreign resident operating in New Zealand through a branch or a New Zealand hybrid entity in the same control group as a foreign resident. The defensive rule does not apply where the country of that foreign resident has enacted hybrid mismatch legislation corresponding to the primary rule.

The rule applies when expenditure of the hybrid entity/branch is deductible in New Zealand and the country of the foreign resident also allows that expenditure as a deduction for the foreign resident.

Section FH 9(2) denies a deduction for the expenditure incurred in New Zealand, and section FH 9(3) treats the denied deduction as a mismatch amount unless and until it is set off against surplus assessable income under section FH 12.

Example 30: Foreign-owned hybrid entity resident in New Zealand

Jefferson Co, a foreign company resident in Washington Country (a foreign jurisdiction) owns one hundred percent of Hamilton Co, an unlimited liability company resident in New Zealand. Hamilton Co is a hybrid entity.

Hamilton Co incurs various expenses in carrying out its business. These expenses are deductible in New Zealand and are also treated as deductible against the income of Jefferson Co under the tax laws of Washington Country. Washington Country has not enacted hybrid rules.

Under sections FH 9(2) and FH 9(3), Hamilton Co has a denied deduction and mismatch amount for its incurred expenditure. This expenditure will be non-deductible, except as provided for in section FH 12. This denial is intended to ensure that the expenses incurred by Hamilton Co cannot be used to offset income which is taxable in New Zealand but is not taxable to Jefferson Co in Washington Country.

Suppose Washington Country introduces hybrid rules with effect from 1 January 2022. Jefferson Co will not be required to apply section FH 9 for the income year that includes 1 January 2022 (see section FH 9(1)(c). However, it will also lose the right to deduct any expenditure for which a deduction has been denied under section FH 9 before 1 January 2022 (see section FH 9(4)).

DUAL RESIDENT PAYER RULE

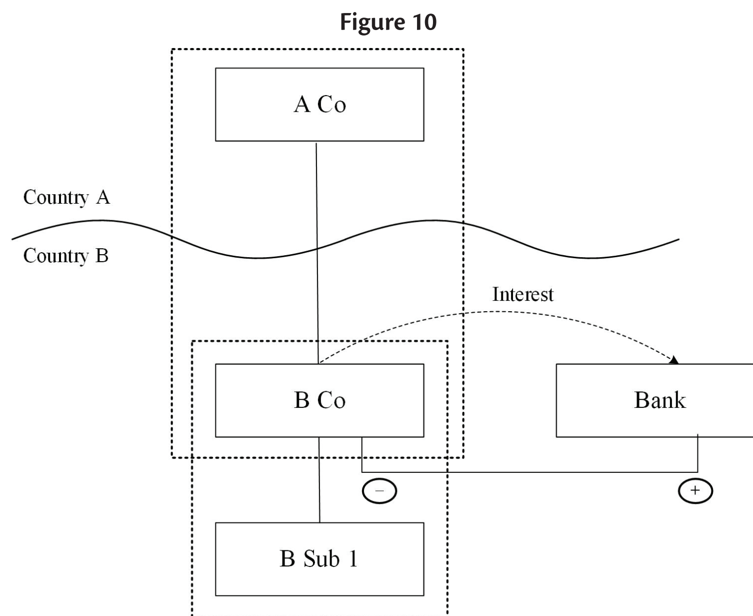
Section FH 10

Background

The dual resident payer rule is recommendation 7 of the OECD hybrid mismatch report. It is similar to recommendation 6 of the OECD hybrid mismatch report in that it deals with a single payment that is deducible in two countries. However, in this case, there is only one entity (a company) involved, which both countries treat as tax resident and can lead to double deduction (DD) mismatches.

Figure 10 illustrates an example of a dual resident payer mismatch.

Figure 10



In the example, B Co (a company incorporated in Country B but tax resident in both Country A and Country B) is a wholly-owned subsidiary of A Co (a company incorporated and tax resident in Country A). B Co owns the shares in B Sub 1 (also incorporated and tax resident in Country B). B Co is consolidated for tax purposes with A Co (under Country A law) and B Sub 1 (under B Country law).

Similar to the deductible hybrid payment example above, B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is resident in both Country A and Country B it is subject to tax on its worldwide income in both countries on a net basis and can utilise any net loss under the tax consolidation regimes of both countries to offset income of other resident companies. This creates the potential for the two deductions for the interest expense to be set off against separate income arising in Country A and Country B.

Summary of legislative response

Section FH 10 implements recommendation 7 of the OECD hybrid mismatch report. It deals with companies that are resident in two countries and which produce double deduction (DD) outcomes by denying the deduction in New Zealand (noting that the other country will also deny the deduction if they have an equivalent to recommendation 7). The deduction denied will be treated as a mismatch amount until there is surplus assessable income under section FH 12.

New Zealand tax law already prevents a dual resident company from grouping its losses or being a member of a tax consolidated group, which are two ways that dual resident company losses can be offset against income that is not taxed in both countries. This rule will more thoroughly prevent this outcome by removing the ability of a dual resident company to offset its expenditure against income earned through a reverse hybrid, such as (potentially) a New Zealand limited partnership.

Application date

The rule applies to income years beginning on or after 1 July 2018.

Detailed analysis

Section FH 10(1) provides that the rule applies to a company that is a New Zealand resident and is liable to tax in another country due to its domicile, residence or place of incorporation.

Section FH 10(2) states that a company meeting the requirements of subsection (1) is denied a deduction for all of its expenditure. The deduction denied is a mismatch amount under section FH 10(3). Such a company must then consider whether there is any surplus assessable income under section FH 12 to determine whether the denial can be reversed. Generally, the two sections will interact by allowing the expenditure to be offset against the income of the company, less any income that is not and will not be included in the other country that the company is resident in. This might include:

- income earned through a New Zealand limited partnership, if the other residence country treats the limited partnership as a company for its tax purposes; or
- income earned in a foreign branch, if the other country has a foreign branch exemption.

Section FH 10 does not apply to expenditure that is not deductible in the other residence country because it relates to income that is not taxable in that country. This would typically occur if the dual resident company had operations in New Zealand, and the other residence country did not tax active foreign branch income. Such expenditure cannot give rise to a double deduction, and therefore is not problematic under the hybrid rules.

IMPORTED MISMATCH RULE

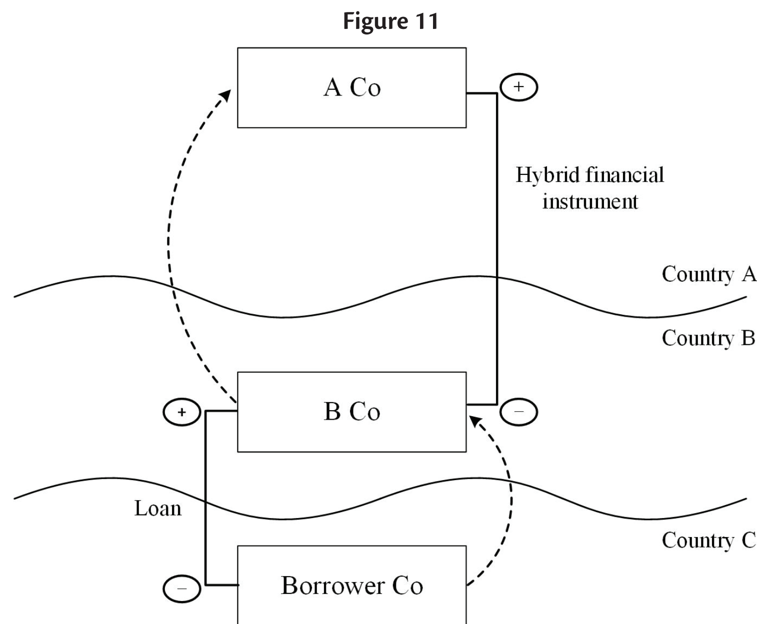
Section FH 11

Background

The imported mismatch rule is recommendation 8 of the OECD hybrid mismatch report and recommendation 5 of the OECD branch mismatch report.

An imported mismatch occurs when a payment that does not directly result in a hybrid mismatch outcome funds another payment that does result in a hybrid mismatch outcome. Figure 11 is an example of an imported mismatch.

Figure 11



The imported mismatch here occurs between B Co and Borrower Co. Borrower Co gets a deduction for its payment and B Co includes that payment as taxable income, meaning there is no direct hybrid mismatch on that payment. However, that payment is used to fund the payment on a hybrid financial instrument from B Co to A Co. Assuming neither Country A nor Country B has hybrid rules, this payment results in a deduction for B Co, but no corresponding income inclusion for A Co. The loan between Borrower Co and B Co then 'imports' the hybrid mismatch back to Country C.

Summary of legislative response

Section FH 11 implements recommendation 8 of the OECD hybrid mismatch report and recommendation 5 of the OECD branch mismatch report.

Section FH 11 denies a deduction for a payment (the imported mismatch payment) which does not itself give rise to a hybrid or branch mismatch, but which is treated as funding such a payment (the funded payment). Imported mismatch payments are split into payments where the imported mismatch payment and the funded payment are part of an arrangement (a structured arrangement) and those where they are not.

Unstructured arrangements can be further divided into direct and indirect arrangements. This is relevant for determining how much of a deduction is denied under subsection (4).

A practical issue New Zealand businesses making payments to foreign control group members or under structured arrangements will need to pay particular attention to is obtaining the necessary information from the foreign group members to determine whether or not a foreign hybrid mismatch exists.

Application date

Section FH 11(3), which denies a deduction for an imported mismatch payment which is part of a structured arrangement, applies to payments made in income years beginning on or after 1 July 2018. Deductions for other imported mismatch payments (unstructured imported mismatches) are not denied until income years beginning on or after 1 January 2020.

Detailed analysis

General

The imported mismatch rule in section FH 11 prevents taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore hybrid mismatch into New Zealand through the use of a non-hybrid instrument such as an ordinary loan.

In brief, the imported mismatch rule denies deductions for a broad range of payments, including interest, royalties, rents and payments for services, if the income from such funds is offset, directly or indirectly, against a payment that arises under a hybrid mismatch arrangement in a foreign country. This means that the hybrid or branch mismatch will be between two foreign countries, rather than between New Zealand and a foreign country, but there will be a deductible payment in New Zealand that is helping fund the hybrid or branch mismatch payment.

Conditions

Subsection (1) provides that the imported mismatch rule applies where there is a person that makes a payment (the funder) to another person in a foreign country that does not have the hybrid and branch mismatch rules corresponding to subpart FH and which:

- directly or indirectly funds a hybrid or branch mismatch payment. In order for the funded payment to be a hybrid mismatch payment, it must be between two non-residents who do not have hybrid or branch mismatch rules that counteract the mismatch (paragraphs (a), (d) and (e));
- is otherwise deductible to the funder (paragraph (b)); and
- is:
  - made under a structured arrangement; or
  - funds a hybrid mismatch between two persons (the payer and the payee) where the payer is in the same control group as the funder (paragraph (c)).

Structured and unstructured imported mismatches

The amount of the deduction denied to the funder depends on whether the payment is made under a structured arrangement or not. The definition of a structured arrangement is the definition used for the hybrid rules generally (discussed above). A structured arrangement can exist between control group members. For example if funds are provided by a foreign parent to a New Zealand borrower via a series of consecutive intra-group funding transactions, and a transaction in that series gives rise to a hybrid mismatch, it is highly likely that the loan to the New Zealand borrower is part of a structured arrangement. Interest on the loan is subject to denial under section FH 11.

In determining whether or not a payment is made under a structured arrangement, it is not relevant when the arrangement was entered into, only when the payment is made. For example, suppose that in 2010, a multinational group set up a structure which gave rise to a hybrid mismatch not involving New Zealand, but where payments from New Zealand funded a part of the hybrid mismatch payment. A payment made as part of such a structure by a New Zealand person in a tax year beginning on or after 1 July 2018 will be subject to section FH 11.

If the payment is under a structured arrangement, the amount of the denial is given by subsection (3). It is the amount of the deduction, limited to the amount of the funded payment for which a deduction would be disallowed to the payer of the hybrid mismatch payment if hybrid mismatch legislation applied to that person.

If the payment is not under a structured arrangement, the amount denied is the amount that can fairly and reasonably be treated as providing funds for the funded payment giving rise to a hybrid mismatch under subsection (4). Subsection (5) provides that this amount should be determined consistently with the approach used in chapter 8 of the OECD hybrid mismatch report.

OECD imported mismatch approach

One of the complexities with the imported mismatch rule arises because there may be multiple countries (including New Zealand) with deductible payments that are helping fund the hybrid mismatch arising between two other foreign countries. Some co-ordination and order is required so that the double non-taxation is countered appropriately. The OECD hybrid mismatch report outlines three tracing and priority rules to determine the order and extent to which deductions should be denied for imported hybrid mismatches which should be applied in the following order. This ordering is not codified in the legislation, although subsection (5) states that the amount of deduction denied under unstructured hybrid mismatches should be determined consistently with the approach used in chapter 8 of the OECD hybrid mismatch report.

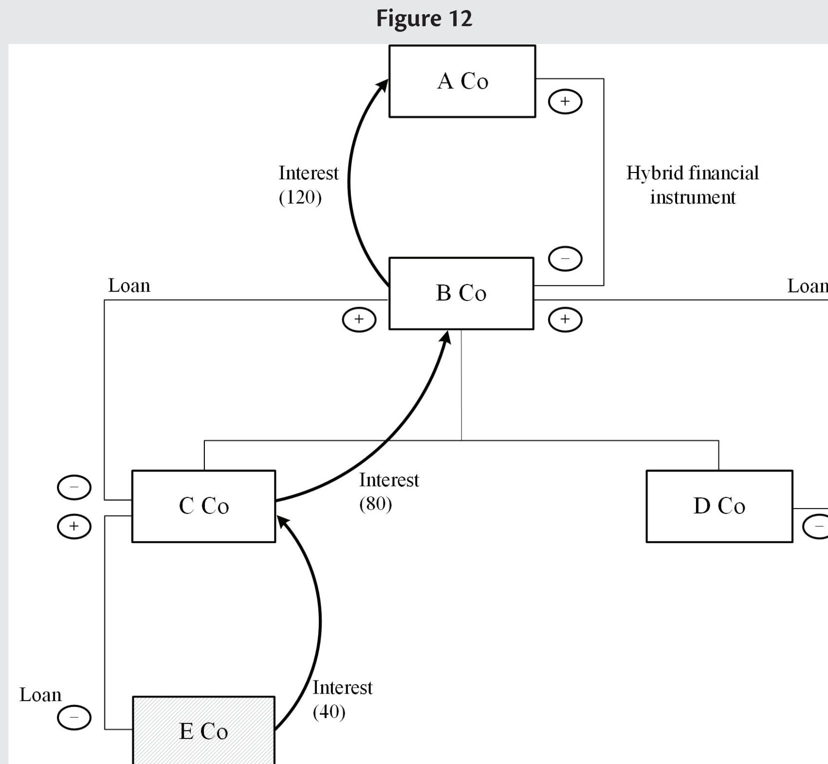
Structured imported mismatches

The structured imported mismatch rule applies first to deny deductions to the extent there is a payment made under a structured arrangement that results in an overseas hybrid mismatch under subsection (3). This rule applies a tracing approach to determine the extent to which an imported mismatch payment made under a structured arrangement has funded a hybrid payment under the same arrangement.

Example 31: Structured imported mismatch rule

In the example illustrated in Figure 12, A Co (a company resident in Country A) is the parent company of the ABCDE Group. A Co provides financing to B Co (a wholly-owned subsidiary of A Co resident in Country B) under a hybrid financial instrument. Interest payments on the hybrid financial instrument are deductible under Country B law but not included in ordinary income under Country A law. B Co on-lends the money provided under the hybrid financial instrument to C Co and D Co (companies that are resident in Country C and Country D respectively). C Co on-lends money to E Co (a wholly-owned subsidiary of C Co resident in New Zealand).

Figure 12



The loans are all part of the same intra-group financing arrangement. The figure illustrates the group financing structure and the total gross amounts of interest payments made in each accounting period under this structure. E Co is the only group entity resident in a country that has implemented the OECD hybrid and branch recommendations.

Question 1

Are the interest payments made by E Co to C Co subject to adjustment under the imported mismatch rule in section FH 11 and, if so, the amount of the adjustment required under that rule?

Answer 1

Yes. E Co's imported mismatch payment to C Co and B Co's payment under the hybrid financial instrument to A Co are payments made under the same structured imported mismatch arrangement. New Zealand should, therefore, deny the full amount of the interest deduction (40) under the structured imported mismatch rule under section FH 11.

New Zealand will still impose non-resident withholding tax at the applicable rate on the interest paid by E Co to C Co.

Question 2

Does the answer change if Country C is a country that has implemented the OECD recommendations?

Answer 2

Yes. E Co is no longer making a payment to a person in a foreign country that does not have hybrid mismatch legislation (as C Co is in Country C which has implemented the OECD recommendations), which means that section FH 11 will not apply. This is because the imported mismatch should instead be countered by C Co in Country C.

Question 3

Whether the answer changes if Country B is a country that has implemented the OECD recommendations.

Answer 3

Yes. If B Co is resident in a country that has implemented the OECD recommendations it should apply its hybrids rules so the payment from B Co to A Co is non-deductible. If this happens, there will be no hybrid mismatch for New Zealand to counteract.

NEW LEGISLATION

Question 4

What if E Co knows nothing about the transactions occurring above the level of C Co?

Answer 4

The hybrid rules mean that E Co is required to determine, in relation to any payments to a non-resident control group member in a country with no hybrid rules whether or not the payment is part of a structured hybrid mismatch arrangement. This will usually require inquiries to be made of other members of the group, and answers to be received. The appropriate level of investigation and assurance depends on the size of the payment and any other relevant facts and circumstances.

Direct imported mismatches

To the extent the overseas hybrid mismatch has not been neutralised by one or more countries applying the structured imported mismatch rule, there is an unstructured imported mismatch, and subsection (4) applies. Subsections (4) and (5) provide that the amount denied should be determined consistent with the approach in chapter 8 of the hybrid mismatch report. Chapter 8 provides for a two rules to allocate unstructured imported hybrid mismatch payments. The first rule is the direct imported mismatch rule. This rule applies to a New Zealand taxpayer making a payment to the non-resident person who is the payer in the overseas hybrid mismatch.

The rule applies an apportionment approach to help determine the extent to which a country should counter the overseas hybrid mismatch where more than one country has a direct imported mismatch. The intent of the apportionment approach is to prevent more than one country counteracting the same overseas hybrid mismatch such that there would be double taxation.

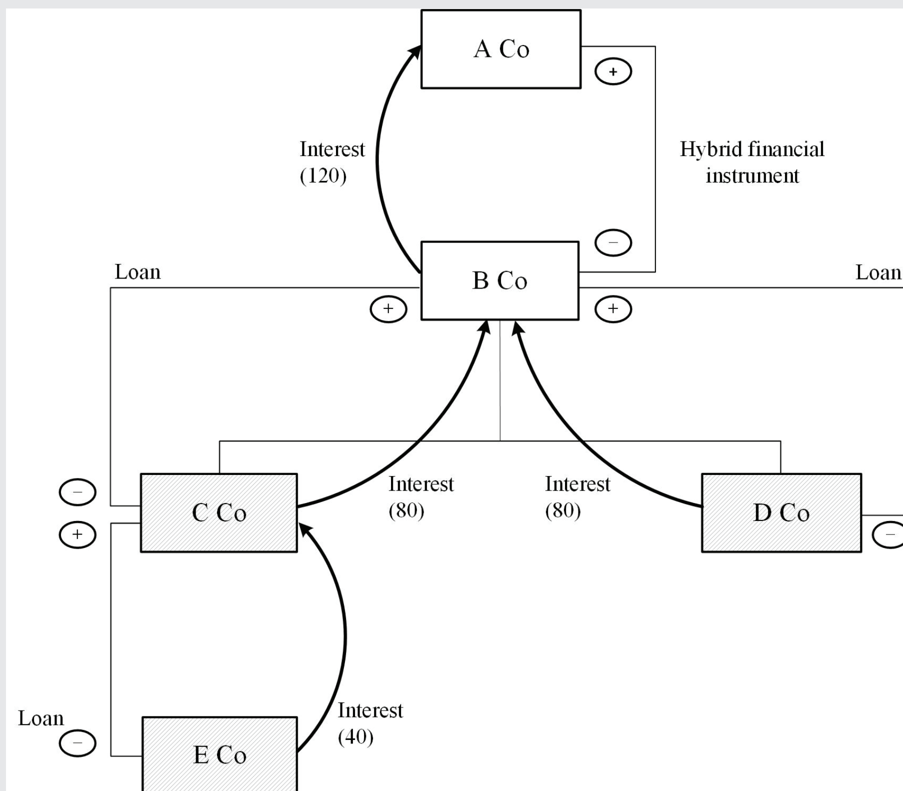
Example 32: Structured imported mismatch rule and direct imported mismatch rule

The facts are the same as in Example 31, except that B Co already has an existing funding arrangement in place with D Co that is unconnected with the group financing structure and that C Co, D Co and E Co (the shaded entities) are all resident in countries that have implemented the OECD hybrid and branch recommendations.

Assume in this example that D Co is resident in New Zealand and E Co is not.

Figure 13 illustrates the total gross interest payments made in each accounting period under the group's financing structure.

Figure 13



Questions

Whether the interest payments made by C Co and E Co would be expected to be adjusted under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Whether the interest payments made by D Co are subject to adjustment under the imported mismatch rule in section FH 11 and, if so, the amount of the adjustment required under the rule.

Answers

The structured imported rule should apply in Country C to deny the full amount of C Co's interest deduction (80).

The interest payment by E Co is made to a payee that is subject to the hybrid mismatch rules. The payment should therefore not be an imported mismatch payment.

The interest payment made by D Co should not be treated as made under a structured arrangement unless the D Co loan and the other group financing arrangements were entered into as part of the same overall scheme, plan or understanding (in which case a structured arrangement would arise). New Zealand should, however, apply the direct imported mismatch rule to deny half of the interest payment paid by D Co to B Co (40) under subsections FH 11(4) and (5).

Indirect imported mismatches

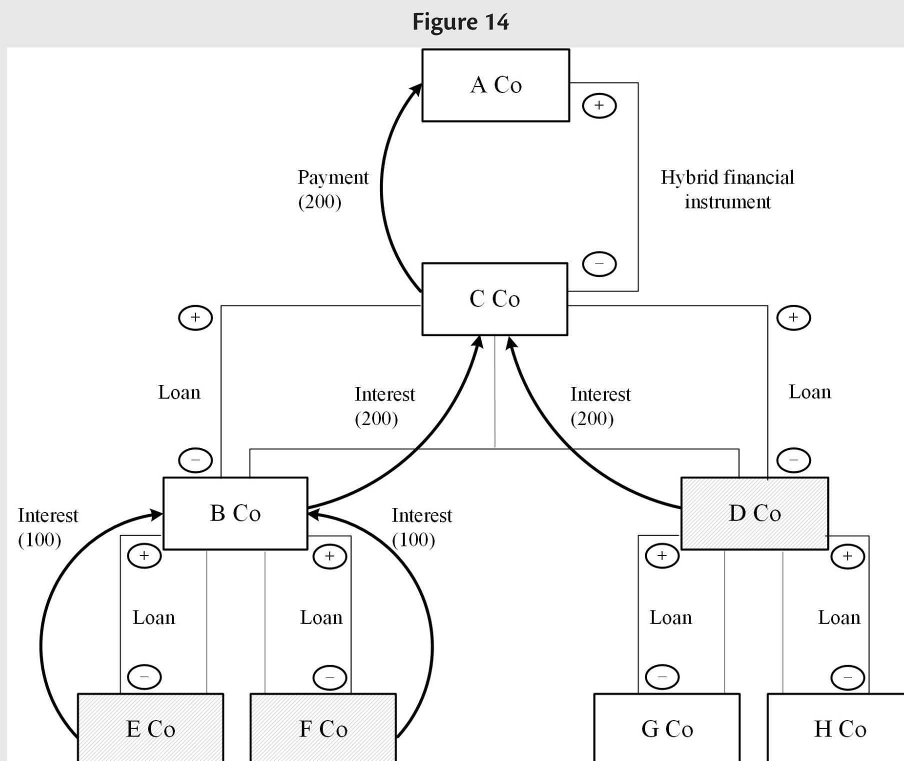
If the overseas hybrid mismatch has not been fully neutralised by one or more countries applying the structured imported mismatch rule and direct imported mismatch rule, the second unstructured rule is the indirect imported mismatch rule. This rule applies a tracing methodology to determine the extent to which the hybrid deduction from an overseas hybrid mismatch has been indirectly funded by imported mismatch payments from other group members. So it applies to a payment made by a New Zealand taxpayer t a person who is not a payer under an overseas hybrid mismatch but who is a payer, directly or indirectly, to such a person.

Like the direct imported mismatch rule, the indirect imported mismatch rule applies an apportionment approach to help determine the extent to which countries should counter the overseas hybrid mismatch which are direct imported mismatches for other countries. The intent of this approach is again to help prevent more than one country counteracting the same overseas hybrid mismatch such that it would result in double taxation.

Example 33: Direct and indirect imported mismatch rule

Figure 14 sets out the financing arrangements for companies that are members of the same group. In this case A Co has lent money to C Co. C Co has lent money to B Co and D Co and B Co and D Co have lent money to their subsidiaries. Each company is tax resident in different countries.

Figure 14



As illustrated in Figure 14, the loan between A Co and C Co is a hybrid financial instrument. The hybrid financial instrument is not, however, entered into as part of a structured arrangement. The hybrid deduction arising under the hybrid financial instrument is $200. E Co and F Co each make a deductible intra-group interest payment to B Co of $100 and D Co makes a deductible intra-group interest payment to C Co of $200. D Co, E Co and F Co are the only entities in the group that are resident in a country that has implemented the OECD hybrid and branch recommendations.

Assume that E Co is resident in New Zealand.

Question 1

Whether the interest payments made by F Co and D Co would be expected to be adjusted under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Whether the interest payments made by E Co are subject to adjustment under the imported mismatch rule in section FH 11 and, if so, the amount of the adjustment required under the rule.

Answer 1

The direct imported mismatch rule should apply in Country D to deny D Co a deduction for all of the interest paid to C Co ($200). This fully counteracts the hybrid mismatch between C Co and A Co. Therefore, E Co and F Co do not need to apply the indirect imported mismatch rule (that is, there is no counteraction required in New Zealand).

Question 2

Whether the above changes if the hybrid deduction arising under the hybrid financial instrument is $300 instead of $200.

Answer 2

The direct imported mismatch rule should still apply in Country D to deny D Co a deduction for all of the interest paid to C Co ($200). This leaves $100 of the hybrid mismatch between C Co and A Co to counteract by E Co and F Co.

E Co and F Co apply an apportionment methodology to each deny half of their interest deduction ($50). This leaves the other half of their interest deduction ($50) as deductible.

SURPLUS ASSESSABLE INCOME

Section FH 12

Background

Section FH 12 introduces the key OECD hybrids concept of 'dual inclusion income' which is referred to as 'surplus assessable income' in the Act. It is important as deductible/not includible (D/NI) payments and double deduction (DD) payments do not result in double non-taxation if they are deducted against dual inclusion income.

For instance, consider a deductible hybrid payment under section FH 8 where a New Zealand company is the sole investor in a hybrid entity in a foreign country. The hybrid entity makes payments that result in deductible expenditure in both New Zealand and the foreign country which results in denied deductions and a mismatch amount under subsections FH 8(2) and (3). However, the hybrid entity derives significant income that is taxable in both New Zealand (to the owner of the entity) and the foreign country. This means that there is net taxable profits in both countries, and there is no potential for the double deductions to be utilised against income that is only subject to tax in one country, so there is no tax mischief.

The purpose of section FH 12 is to reverse the denial of deductions (or inclusion of income, in the case of section FH 6) that arises under sections FH 5, FH 6 and FH 8 to FH 10 where there is surplus assessable income.

Summary of legislative response

Section FH 12 allows a deduction for hybrid mismatch amounts to the extent that the person paying or deriving the amounts has income which is taxable in New Zealand and can be expected to also be taxed in the other country giving rise to the hybrid mismatch. This income can arise in a different income year from the year the hybrid mismatch amount is disallowed.

Section FH 12 applies separately to each mismatch situation to which a person is party, but it applies to all mismatch amounts with respect to that situation. Both mismatch amount and mismatch situation are discussed separately above in the definitions part of this special report.

Section FH 12 defines surplus assessable income through a formula. Generally, it is surplus assessable income from earlier years which has not been offset by deductions for mismatch amounts, plus assessable income arising during the year from the structure which can be expected to be taxed in the other country also. There are adjustments for other items as well, including exempt dividends which can be included as surplus assessable income in some cases.

The carry forward of surplus assessable income and hybrid mismatch amounts is subject to the usual forty nine percent ownership continuity test that applies to tax losses.

Application date

Section FH 12 applies to income years beginning on or after 1 July 2018.

Detailed analysis

The importance of surplus assessable income

Deductible/not includible (D/NI) payments result in double non-taxation where the deduction is used against income which is taxed only in the payer country. In that case the effect of the D/NI payment is to reduce payer country tax without increasing payee country tax. To the extent that the entity or branch earns income which is taxable in both countries (surplus assessable income), the D/NI payment will still reduce payer country tax, but it will increase payee country tax. That is because the payee country income calculation will not give a deduction for the D/NI payment. So, any tax reduction as a result of that payment in the payer country will simply reduce the amount of payer country tax for which a credit can be claimed in the payee country, and there is no tax mischief.

The same result holds for double deduction (DD) payments. If a DD payment by a hybrid payer is used against non-surplus assessable income, that can result in double non-taxation. However, if the hybrid is profitable in both the hybrid and owner countries, all of the double deduction expenditure (DD) will, broadly speaking, be deducted against surplus assessable income, and there is no tax mischief.

The purpose of section FH 12 is to reverse the denial of deductions (or inclusion of income, in the case of section FH 6) that arises under sections FH 5, FH 6 and FH 8 to FH 10 where there is surplus assessable income so that taxpayers are not inappropriately affected by the denied deductions (or inclusion of income) under the hybrid mismatch rules.

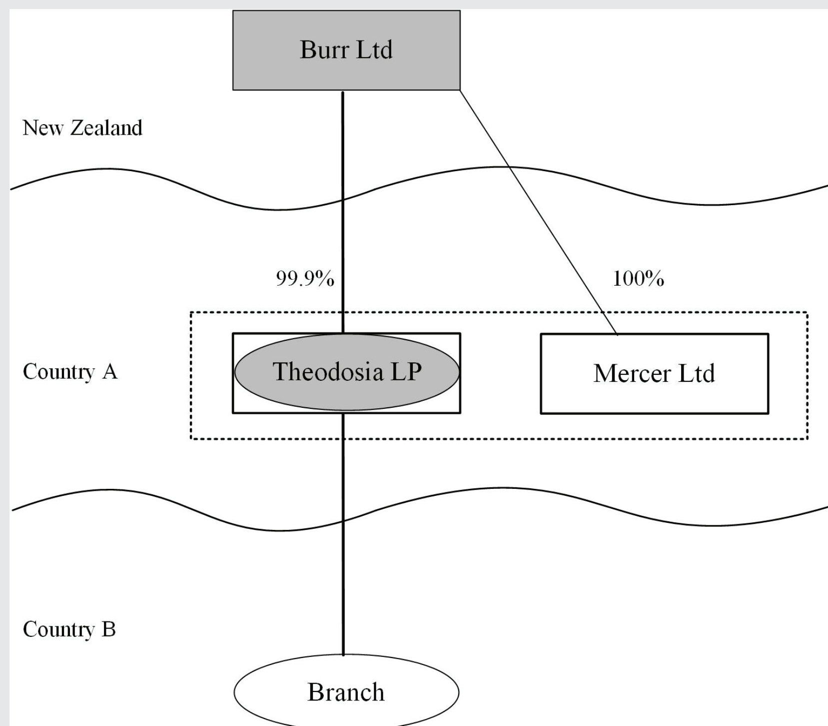
Unlike the OECD's dual inclusion income, surplus assessable income does not depend on the actual assessable amounts in each country. This is for reasons of pragmatism rather than principle. The approach is to focus on the New Zealand income as a starting point. For instance, if a $100 amount of assessable income derived through a mismatch situation in New Zealand corresponds to a $50 amount of taxable income offshore (because of a foreign exchange fluctuation, or because the income is recorded in a different way to New Zealand), the entire $100 can be applied to the surplus assessable income formula. However, where income which is taxable in New Zealand will not be taxable in the other country because of more fundamental factors, like the structure through which that income is earned (for example, it is earned in a foreign branch, and the other country has an active foreign branch exemption, or its earned through a reverse hybrid entity) the income is not treated as surplus assessable income.

Section FH 12

Section FH 12(1) applies when a person has a hybrid mismatch amount for a mismatch situation. A person can have more than one mismatch situation.

Example 34: Two mismatch situations

Figure 15



Burr Ltd, a New Zealand resident company, owns 99.9 percent of Theodosia LP, a limited partnership formed under the laws of, and operating in, Country A (the remaining 0.1 percent is held by another group company). Theodosia LP is a hybrid entity, because it is taxed as a company in Country A and a partnership in New Zealand. It has a branch in Country B. Income and expenditure of the branch is not taxed in Country A because of an exemption for active branch income. Burr Ltd also owns one hundred percent of Mercer Ltd, a company incorporated and tax resident in Country A, which is in a tax consolidated group with Theodosia LP for Country A tax purposes.

Payments by Theodosia LP that relate to its Country A activities are deductible in New Zealand (to Burr Ltd) and Country A (to Theodosia LP).

Payments by Theodosia LP that relate to its Country B activities are not deductible in Country A but are deductible in New Zealand and Country B.

In this case, Burr Ltd is party to two mismatch situations, one with respect to its interest in Theodosia LP and one with respect to its interest in Theodosia LP's Country B branch. It will have a different mismatch amount for each one.

Subsection (2) requires a person's mismatch amounts (which can arise under different sections in subpart FH) from a mismatch situation to be set off against the person's surplus assessable income from the situation. This effectively reverses the impact of denied deductions (or inclusion of income) under the hybrid rules once the potential tax mischief is no longer present.

The formula for surplus assessable income in subsection (3) comprises a series of defined amounts; earlier plus assessable plus exempt less unrecognised less protected less deductions plus status. The explanations for each formula components are:

- **Earlier**: Surplus assessable income not offset by mismatch amounts in previous years (subject to a reduction also for foreign tax credits in the other country, discussed below).
- **Assessable**: Assessable income that the person derives from the mismatch situation during the year.
- **Exempt**: If the person is a New Zealand resident hybrid entity owned by a non-resident, exempt consists of the New Zealand source dividends derived during the year if these are taxable to the foreign owner with no tax credit other than for withholding tax. This item recognises that the hybrid treatment of the New Zealand entity can cause a payment to be taxable in a foreign country with no deduction in New Zealand.
- **Unrecognised**: Assessable income from the mismatch situation which is not subject to tax in the foreign country because of the residence of another person (who is not another owner), the source of the income, or the tax status of the payer. This item recognises that a taxpayer's mismatch situation may generate assessable income that is not taxable in the relevant other jurisdiction. This income should not count towards surplus assessable income, because it is not taxed in both countries.

An example of "unrecognised" is income of a New Zealand resident partner in a partnership formed in Country A from a branch of the partnership in Country B. If Country A has an active foreign branch exemption, the branch income from Country B will not be taxed in Country A, though it is taxed in New Zealand.

- **Protected**: The amount of assessable income earned by the entity through its mismatch situation which is protected from New Zealand tax by a foreign tax credit. For a given year, this amount should be calculated under subpart LJ before a hybrid mismatch rule counteraction is made under subpart FH.
- **Deductions**: Deductions for expenses incurred in earning assessable income which do not give rise to mismatch amounts.
- **Status**: The amount of expenditure on a payment by the person to a payee in New Zealand that is a mismatch amount and not deductible in a foreign country because of the tax status of the person and the payee. For instance, a payment made by a New Zealand hybrid entity that is denied a deduction under section FH 9 may have an amount of Status if that payment was made to another New Zealand hybrid entity if the tax status of those entities results in the payment being disregarded in the relevant foreign country.

Example 35: "assessable" and "unrecognised"

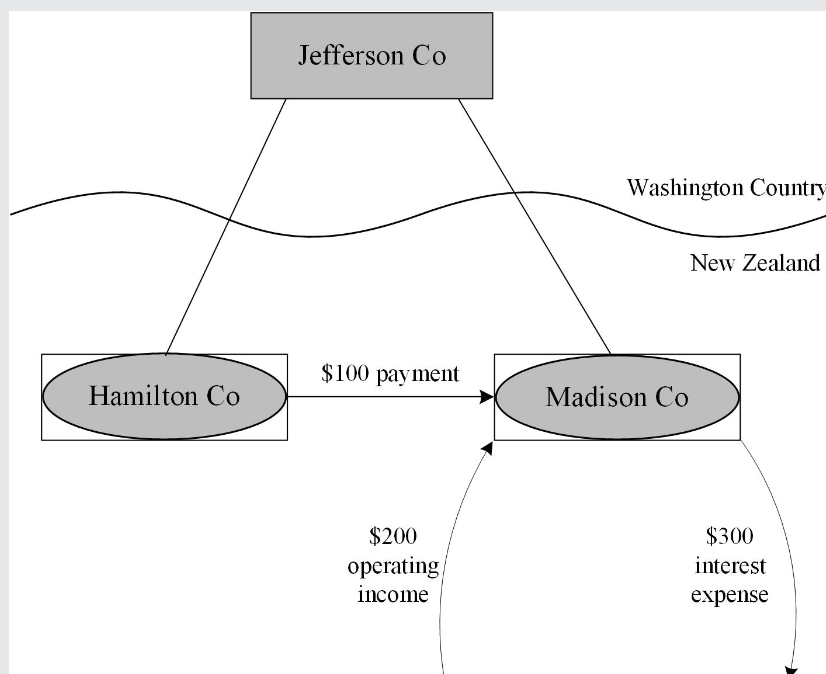
Take the facts of example 23 ("Deemed branch payment mismatch"). Suppose the New Zealand branch sells the cricket bats for $300 each, and that no portion of this amount is taxable in Ashes Country, because of the active foreign branch exemption. The $300 will be "assessable income", but it will also be "unrecognised", since it is not taxable in Ashes Country due to its source. Surplus assessable income would therefore be zero, and the $100 mark up that would be allowed as a deduction in New Zealand but for section FH 5 will remain non-deductible.

If Ashes Country does not exempt active branch income from tax, the $300 would not be "unrecognised". Assuming Ashes Country has hybrid rules, section FH 9 will not apply to the $150 deduction allowed in New Zealand for the cost of manufacture of each bats. Therefore "deductions" will be $150, and surplus assessable income will be $100 per bat. This means Root Co will be able to deduct the $100 per bat charge. If Ashes Country does not have hybrid rules, the $150 cost deduction will be both a hybrid mismatch amount under section FH 9, and not included in "deductions" in the surplus assessable income formula. Accordingly the outcome will be the same.

The overall outcome is that the hybrid rules will not deny any expenditure in New Zealand if Ashes Country is fully taxing the New Zealand income and the New Zealand branch has net taxable income. This is appropriate, as there is no double non-taxation.

Example 36: New Zealand hybrid entity deductions and surplus assessable income

Figure 16



Jefferson Co, a foreign company resident in Washington Country (a foreign jurisdiction) owns one hundred percent of Hamilton Co, an unlimited liability company resident in New Zealand. Hamilton Co is a hybrid entity. Jefferson Co also owns one hundred percent of Madison Co which is also a hybrid entity of the same form as Hamilton Co. As hybrid entities, Hamilton Co and Madison Co are disregarded under Washington Country tax law and their income and expenditure is generally attributed to Jefferson Co.

Madison Co earns $200 of operating income in New Zealand and incurs interest expense to a third party lender resident in New Zealand for $300. These amounts are both attributed to Jefferson Co under the laws of Washington Country.

Hamilton Co makes a $100 deductible payment to Madison Co (that is assessable for Madison Co).

Question 1

How do the hybrid rules treat Madison Co?

Answer 1

Section FH 9 denies Madison Co a deduction for its $300 interest expense. This $300 amount is a mismatch amount.

Under section FH 12, Madison Co has $200 of surplus assessable income. This figure is calculated by taking the entity's total assessable income of $300 ($200 of operating income and $100 from its payment received from Hamilton Co) and subtracting $100 as an "unrecognised" amount, as explained below. All other components of the surplus assessable income formula are equal to zero under the facts of this example.

The $100 payment from Hamilton Co is subtracted from the surplus assessable income calculation as an "unrecognised" amount because the payer and payee of the payment are both disregarded under Washington Country law. This means the $100 income of Madison Co will be disregarded in Washington Country (i.e. it will not be attributed to Jefferson Co) and will not be subject to tax in that jurisdiction due to the tax status of the payer, Hamilton Co.

Madison Co can set off its $300 mismatch amount against its $200 surplus assessable income and is entitled to a deduction for $200 under FH 12(5). The remaining $100 will be carried forward as a mismatch amount to the next tax year (provided the continuity requirements in FH 12(8) are met).

Question 2

How do the hybrid rules treat Hamilton Co?

Answer 2

Section FH 9 denies Hamilton Co a deduction for its $100 payment to Madison Co. Under FH 12 Hamilton Co will have surplus assessable income of $100 because that payment is a "status" amount. As above with Madison Co receiving $100, Hamilton Co's $100 expenditure is a payment that is disregarded under the laws of Washington Country because it is a payment between two hybrid entities. Jefferson Co will not be entitled to a deduction in Washington Country for the payment.

Under Section FH 12, Hamilton Co's $100 payment will be deductible as its $100 mismatch amount can be set off against its $100 of surplus assessable income.

Example 37: Surplus assessable income

Taking the facts of Example 34 ("Two mismatch situations"), suppose the following amounts of income and expenditure during the year. The tax rate in all three countries is 25%.

Burr Ltd (before applying subpart FH):

	New Zealand only	Country A only	Country B only	Total
Assessable income	$300	$200	$100	$600
Expenses	$150	$210	$40	$400
New Zealand taxable income	$150	($10)	$60	$200

For the Country A mismatch situation, Burr Ltd has a double deduction amount of $210 and surplus assessable income of $200, being:

- Assessable: $300 (the amount of assessable income earned through Theodosia LP including through the Country B branch); less
- Unrecognised: $100 (the amount not recognised in Country A because it is from an active business in Country B).

(There is no Earlier amount as this is a one-year example. There is no Exempt amount on the facts. There is no Protected amount assuming no tax is paid in Country A. There is no Deductions or Status amounts as there are no deductions incurred in deriving assessable income from the mismatch situation other than hybrid deductions.)

Accordingly, of the $210 deduction denied to Burr Ltd under section FH 8, $200 is allowed as a deduction under section FH 12, and Burr Ltd has $10 of denied deduction to carry forward to the next year.

For the Country B mismatch situation, Burr Ltd has a double deduction amount of $40 and surplus assessable income of $100, being the $100 assessable income earned through the Country B branch. The other amounts in the calculation of surplus assessable income are zero.

So all of the $40 deduction denied under section FH 8 for the Country B mismatch situation is allowed under section FH 12. For the Country B situation, Burr Ltd also has $60 surplus assessable income which it can carry forward to the next year under subsection (6). This surplus assessable income cannot be used to claim a deduction for the $10 of denied deduction for Theodosia LP's Country A double deductions because that deduction arises under a different mismatch situation.

Example 38: Protected

Kaikoura Ltd, a New Zealand resident company, owns 99.9% of Decatur LP, a limited partnership formed under the laws of, and operating in, Country A (the remaining 0.1% is held by another group company). Decatur LP is a hybrid entity, because it is taxed as a company in Country A and a partnership in New Zealand. Kaikoura Ltd also owns 100% of Kalamazoo Ltd, a company formed in Country A. Country A allows Decatur's losses (or income) to be grouped with Kalmazoo's income (or losses). Country A imposes tax on Decatur LP income at a rate of 28%. Income and loss over the two years ended 31 March 2021 and 2022 is as follows:

Year	Decatur LP		Kaikoura other	Kalamazoo
	Gross income	Gross deduction	Net income	Net Income
2021	NZ$400 A$1,000	NZ$500 A$1,250	NZ$1,000	NZ$200 A$500
2022	NZ$500 A$1,250	NZ$400 A$1,000	NZ$1,000	NZ$200 A$500

Question

What is the effect of the hybrid rules on Kaikoura's income tax obligations?

Answer

Because Decatur LP's expenditure can be offset against income which New Zealand does not tax, all $500 is denied under section FH 8.

NEW LEGISLATION

In 2021, there is $400 of surplus assessable income (that is, the $400 of "assessable"), so $400 of the amount disallowed under section FH 8 can be deducted. The net amount disallowed under the hybrid rules is $100, and this amount can be carried forward for possible set off in a future year. Kaikoura's taxable income will be $1,000. This correctly reflects the fact that the $100 Decatur loss has been used against income that New Zealand does not tax.

In 2022, Decatur LP has a further NZ$400 denied under section FH 8. For purposes of the formula in section FH 12(3), it has $500 of "assessable". It then needs to determine the amount of "protected". It will have Country A tax to pay of $28. This should be fully creditable against its New Zealand income tax. "Protected" will therefore be $28/.28 = $100. Accordingly its surplus assessable income is $400. On a FIFO basis, it can claim a deduction for all of the $100 of the 2021 mismatch amount not deducted in that year, and $300 of the 2022 amount. This leaves $100 of 2021 hybrid mismatch amount unable to be deducted in 2022.

Kaikoura's taxable income in 2022 will therefore be $1,100. It will have a New Zealand tax liability of $308, and a tax credit of $28, giving a net liability of $280.

Carry forward

Mismatch amounts not offset against surplus assessable income in a year can be carried forward to the next tax year under subsection (6) provided that they meet the same forty nine percent continuity of ownership test as applies to tax losses (this is set out in subsection (8)).

Surplus assessable income that is not offset against mismatch amounts in a year can also be carried forward to the next tax year in the same way. However, before continuity is considered, subsection (7)(a) reduces the amount of surplus assessable income by the amount that is subject to the foreign tax credit regime of a foreign country equivalent to New Zealand's subpart LJ. This is to ensure that net New Zealand income from a mismatch situation cannot be offset against future mismatch amounts if double tax has been relieved by a foreign country through foreign tax credits in relation to that net New Zealand income.

Example 39: Disallowed carry forward of mismatch amount

Further to examples 34 and 37, Theodosia LP (excluding its branch in Country B) has $30 of double deductions and $50 of surplus assessable income in year two. The $10 mismatch amount for which a deduction was not allowed in year one can prima facie be deducted against the $20 of surplus assessable income. However, the group that includes Burr Ltd, Theodosia LP and Mercer Ltd is sold to a new owner at the beginning of year two. This sale will terminate the carry forward of the $10 denied deduction with respect to the Country A mismatch situation. So that amount cannot be deducted in year two.

Stranded losses

Subsection (9) provides for a situation where an amount for which a deduction is denied under section FH 8 (a double deduction amount) ceases to be a mismatch amount because the person treated as having the loss in the other country ceases to exist before the loss is used in the other country. This means the loss is no longer able to be used in that other country. This is referred to in the hybrid mismatch report as a "stranded loss".

The subsection applies where:

- a New Zealand person has a mismatch amount arising under section FH 8 available to be carried forward at the end of a year;
- the person who incurred the loss under the other country's rules (which may be the New Zealand person or a hybrid entity) ceases to exist; and
- under the law of the other country, in the year in which the mismatch arose or any later year, the person has not offset a loss against income which is not assessable in New Zealand.

If these requirements are met, the mismatch amount will be:

- in the case of a loss incurred by a foreign branch of a New Zealand person, treated as a tax loss component in the year the entity with the branch ceases to exist, in which case it can be offset against another group company's income in that year; or
- in the case of a loss incurred by a hybrid entity which ceases to exist, treated as an ordinary tax loss of the owner.

Grouping

Subsection (10) is a grouping provision that allows a company to set off a mismatch amount from a mismatch situation against another company's surplus assessable income (from a different mismatch situation) if those companies are in the same group.

The subsection is available if:

- two companies are in the same wholly-owned group when the mismatch amount and surplus assessable income amount arise;
- the two companies have each applied FH 12 to offset their mismatch amounts and surplus assessable income mismatch amounts themselves, and the surplus assessable income amount are excess; and
- the offset could be made if the offset company and the group company were the same company. There does not need to be a nexus between the income and the expenditure for the two items to be grouped under this grouping rule.

A company cannot carry forward a mismatch amount or surplus assessable income amount that it has used for a grouping offset under subsection (10).

DIVIDEND/SHARE ELECTION

Section FH 13

Background

If a deduction is denied for an interest payment on a hybrid financial instrument under section FH 3 and the payment is also subject to NRWT (generally at 10% or 15%), there is an element of double taxation. Taxpayers can generally avoid this result by entering into non-hybrid arrangements. For instance, if a company raised funds by borrowing under a vanilla debt arrangement, the interest would be deductible (and not denied under section FH 3), and NRWT would be deducted at the appropriate rate (generally at 10% or 15%). Conversely, if a company raised funds by using equity, any dividends paid would not be deductible (such that section FH 3 would have no application), and NRWT would not apply where the dividends are either fully imputed, or where the taxpayer is entitled to NRWT at 0% under an applicable tax treaty.

The dividend/share election option in section FH 13 allows a New Zealand resident who makes a payment under a hybrid loan to treat the loan as a share for all circumstances in order to avoid any inconsistencies arising as a result of its being treated differently for different tax purposes. This means that any interest paid on the instrument will be treated as dividends for tax purposes. Distributions under the instrument may then be made without deducting NRWT if the payer attaches imputation credits to the deemed dividend, or where the taxpayer is entitled to NRWT at 0% under an applicable tax treaty.

Summary of legislative response

Section FH 13 allows a person who pays interest that is non-deductible by reason of section FH 3 to elect to treat the hybrid financial instrument on which the interest is paid as a share, and the payment as a dividend, for all tax purposes.

Taxpayers that wish to make this election should send their election notices to **hybridelections@ird.govt.nz** where they will be monitored by Inland Revenue.

Application date

The election is available for income years beginning on or after 1 July 2018.

Key features

Section FH 13 allows a person who pays interest which is non-deductible by reason of section FH 3 to choose to treat the hybrid financial instrument on which the interest is paid as a share, and the payment as a dividend, for all tax purposes.

The election must be notified to the Commissioner before it takes effect, specifying the date on which it takes effect. On the effective date, the amount owing under the loan is treated as fully repaid by the person (which may trigger an NRWT obligation) and subscribed for an issue of shares having the same terms as the loan.

An election ceases to have effect if the interest payments are no longer subject to deduction denial under section FH 3. At that time the deemed shares are treated as cancelled for an amount equal to the amount payable under the loan, and that amount is treated as re-subscribed for the loan.

Detailed analysis

Subsection (1) states who can make the election – a borrower who would be denied a deduction of interest under section FH 3 (the primary version of the hybrid financial instrument rule).

Subsection (2) states the broad result of the election, which is that while the person is eligible to make it, the financial arrangement giving rise to the payment is treated as a non-participating redeemable share for all purposes of the Act. This means that distributions on the financial arrangement will be treated as dividends for tax purposes. These dividends will be subject to the benchmark dividend rule in section OB 61.

Subsection (3) requires the election to be notified to the Commissioner specifying an elective date which must be on or after the date of the notice. Taxpayers that wish to make this election should send their election notices to **hybridelections@ird.govt.nz** where they will be monitored by Inland Revenue. There is no prescribed form for the notice; however, it should include the taxpayer's name and IRD number, the financial arrangement to which the election applies, and the date on which the election is to be effective.

Subsections (4) and (5) outline in more detail the effect of an existing financial arrangement being subject to an election (the election can also be made for a financial arrangement yet to be entered into), and also the effect of it ceasing to be subject to the election.

On the effective date for the election, the borrower is treated as paying all amounts owing under the financial arrangement. If this includes unpaid interest, this interest will give rise to an NRWT or AIL obligation as appropriate. The amount so repaid, less any NRWT, is then treated as subscribed for a non-participating redeemable share.

There is no provision for an election to be revoked. However, once the interest payments on the instrument are no longer subject to section FH 3 (for example, because the payee country implements recommendation 2 of the OECD hybrids report), the election becomes ineffective. The deemed shares are then treated as redeemed for the amount owing (which will include any accrued "dividend") and that amount, again less any NRWT, is treated as re-advanced by way of the loan.

OPAQUE ELECTION

Section FH 14

Background

The hybrid rules impose a compliance burden on a person who is subject to New Zealand tax and has an interest in a foreign hybrid entity (that is, an entity which is fiscally opaque under the tax law of a foreign country, but transparent for New Zealand tax purposes. The person has to determine whether there are any deductions claimed by the entity in the other country for payments which are deductible in New Zealand as well (that is, DD mismatch under section FH 8). If section FH 8 applies, the person will also have to determine the expenditure attributable to the foreign entity and treat it as ring-fenced expenditure, only able to be deducted against surplus assessable income.

Section FH 8 is part of hybrid rules that target double non-taxation due to different rules relating to the tax classification of entities. Double non-taxation can also be addressed by New Zealand classifying the relevant entity in the same way as the other country. Section FH 14 allows a New Zealand owner of a foreign hybrid entity to take this approach in limited circumstances.

Summary of legislative response

Section FH 14 allows a New Zealand resident who has a wholly owned foreign hybrid entity when the Bill is introduced to elect to treat it as a company for New Zealand tax purposes. It is intended to simplify compliance for people who set up foreign hybrid vehicles before the hybrid rules were introduced.

Taxpayers that wish to make this election should send their election notices to **hybridelections@ird.govt.nz**

Application date

The election applies for income years beginning on or after 1 July 2018. It must be made before the due date for the return of income for the first year in which the hybrid mismatch rules apply to the person.

Key features

Section FH 14 applies to a New Zealand resident who has, or is a member of a wholly owned group that has, a wholly owned hybrid entity. By making the election such a person can treat the entity as a company for New Zealand tax purposes. This will mean the person does not have to apply many of the hybrid rules in relation to the entity, particularly section FH 8. Of course, it will also mean that the entity's income is separate from the owner's income so that, for example, losses from the entity do not reduce the owner's taxable income.

Detailed analysis

Subsection (1) outlines who can make the election – a New Zealand resident who owns, or is a member of a wholly-owned group that owns, all the ownership interests in a hybrid entity on the date the Bill was introduced (6 December 2017). This is because the election is intended to simplify compliance for people who set up foreign hybrid vehicles before the hybrid rules were introduced.

Subsection (2) states the broad result of the election, which is that the hybrid entity is treated as a company for all purposes of the Act.

Subsections (3) to (7) then outline the specifics regarding the election and how it operates.

The owner must notify the Commissioner of the election on or before the due date for the person's tax return for the first income year in which the hybrid rules apply to the person (subsection (3)). Taxpayers that wish to make this election should send their election notices to **hybridelections@ird.govt.nz** There is no prescribed form for the notice; however, it should include the taxpayer's name and IRD number, specific the foreign hybrid entity to which the election applies, and the tax year on which the election is to be effective.

The election will be effective from the first income year in which the hybrid rules apply to an owner and later income years (subsection (4)). This election will determine the New Zealand tax treatment of the entity for the remainder of its existence, regardless of who owns it in the future, as the election is irrevocable (subsection (7)).

The effect of the election is that the owners of the entity are treated as selling, on the first day of the income year, the hybrid entity's undertaking to a new company in return for the shares in the company (paragraph (5)(a)). The sale will in most cases trigger some taxable gain or loss, after which point the hybrid entity's undertaking will no longer directly be in the New Zealand tax base (that is, flow through treatment will not apply to the foreign hybrid entity's income and expenses immediately after the deemed sale has taken place). The CFC regime will apply in the usual way to the foreign hybrid entity following the election with distributions from the hybrid entity treated as dividends unless they qualify to be treated as a return of capital or capital gain distribution.

The available subscribed capital of the deemed new company will equal the net value of the undertaking it is deemed to acquire (subsection (6)).

Example 40: Opaque election

Kiwi Co has had a wholly-owned foreign hybrid entity in Country F since 1 April 2010. The foreign hybrid entity incurs tax losses each year in New Zealand which would effectively be ring-fenced under section FH 8. Kiwi Co understands that it will no longer benefit from potential double deductions from the foreign hybrid entity and wishes to reduce the compliance costs of the hybrid rules by making the opaque election in section FH 14. Kiwi Co has a standard balance date of 31 March.

Question 1

When does Kiwi Co need to make the election in election FH 14 by?

Answer 1

Kiwi Co must file the election before the due date for its 2019–20 tax return. If Kiwi Co has an extension of time for filing its tax return, this will be by 31 March 2021.

Question 2

What will the effect of the election be?

Answer 2

Kiwi Co will be deemed to sell the undertaking (or business) of the foreign hybrid entity to a new company in exchange for the shares in the company on 1 April 2019. If there is any taxable gain or loss from the sale, this will flow through to Kiwi Co. From that point onwards, foreign hybrid entity will be treated as a company for all purposes of the Act. Kiwi Co will file controlled foreign company disclosures for the foreign hybrid entity and treat equity distributions from the foreign hybrid entity prima facie as dividends.

Question 3

Kiwi Co sells the foreign hybrid entity on 1 April 2020 to Tuatara Co. Tuatara Co would prefer to treat the foreign hybrid entity as transparent for New Zealand tax purposes. How does Kiwi Co's section FH 14 election impact this preference of the new owner?

Answer 3

Kiwi Co election is irrevocable and so Tuatara Co must continue to treat the foreign hybrid entity as a company for all purposes of the Act.

FIF RULE CHANGES RELATING TO HYBRID RULES

Sections EX 44(2), EX 46(6)(e), EX 46(10)(db), EX 47B, EX 52(14C) and EX 53(16C)

Summary of legislative response

The Act contains some amendments to the foreign investment fund (FIF) regime designed to ensure that a person holding a FIF interest must use the comparative value (CV) method to calculate FIF income from the interest if a distribution on the interest might otherwise be subject to counteraction under the hybrid rules. The amendments also turn off the ability for a share supplier of a FIF interest under a returning share transfer to use the fair dividend rate (FDR) method in relation to an arrangement within the scope of the hybrid rules.

Application date

The changes apply for income years beginning on or after 1 July 2018.

Key features

The key features of the FIF rule changes relating to the hybrid rules is that they require a person to use the CV method in relation to a FIF interest if:

- the FIF is entitled to a deduction or equivalent tax relief in relation to the distribution (subject to certain additional requirements); or
- the person holds the shares as a share user under a returning share transfer which is within the scope of the hybrid rules.

They also turn off the ability of a share supplier in a returning share transfer to use the FDR method in relation to FIF interests which are within the scope of the hybrid rules.

Background

Scenario 1

A straightforward situation where the hybrid rules could apply to a New Zealand resident holding a FIF interest is where the arrangement is within the scope of the hybrid rules and the FIF is entitled to a deduction or equivalent tax relief for a distribution in its country. If the person is applying the FDR method:

- technically, the dividend is exempt income (section CW 9(1)); and
- the distribution may be greater than the amount recognized under the FDR method.

This may make it difficult to determine for the FIF to determine whether and to what extent the hybrid rules should apply in its country to the deductible dividend.

Scenario 2

A more complex scenario arises in relation to a FIF interest held by a New Zealand resident share user pursuant to a returning share transfer. The hybrid rules apply to hybrid transfers giving rise to a deductible/non-includible (D/NI) result. One way this can occur is if a New Zealand person lends money to a foreign related party by way of a returning share transfer which is a share repo arrangement. In a share repo arrangement, the loan takes the form of an initial sale of shares by the borrower to the lender, followed by a sale back of equivalent shares. The lender may make a financing return by:

- receiving and retaining the dividend on the shares;
- receiving a greater amount for the sale back of the shares than it paid to acquire them.

In some countries, the cash borrower in a share repo arrangement is treated for tax purposes as continuing to own the shares, which it has provided as security for a loan. In this case, the tax law applying to the borrower will usually treat any dividend paid on the shares and retained by the lender as if it were both income to the borrower from the share and a deductible payment by the borrower to the lender. If the lender is a New Zealand person and exempt from tax on the dividend, this payment is deductible (to the borrower (share supplier)) and non-includible (to the lender/share user).

Application of the FDR regime, which taxes a deemed 5% return, complicates the picture, and would make it difficult to know whether or how to apply the hybrid rules to such a dividend payment. In order to avoid these complications, the legislative changes provide that the New Zealand lender (the share user) in such situations has to use the CV method to determine its income from the share. This ensures that the dividend is taxable to the lender, and the hybrid rules do not need to apply. It is analogous to the taxation of a deductible foreign equity distribution.

Scenario 3

A third scenario arises when a New Zealand resident supplies FIF interests under a returning share transfer which is a share loan. Under current law the person can continue to apply the FDR method as if they still held the shares. If the person is a share lender and receives a substitute payment which is deductible to the payer, this can give rise to a hybrid mismatch. In order to prevent this possibility, the legislative changes prevent such a person from applying the FDR method if the counterparty is related to the person, or the returning share transfer is a structured arrangement.

Detailed analysis

Scenario 1

New paragraph EX 46(10)(db) deals with scenario 1 in the background above. It provides that in such a case the share is a non-ordinary share, which means income from it must be determined using the comparative value (CV) method. This method includes dividends in the calculation of the income, so there can be no hybrid mismatch arising from the payment.

New paragraph (db) only applies if:

- the arrangement is within the scope of the hybrid rules, because the parties are related or it is a structured arrangement;
- the non-resident is not a foreign PIE equivalent. In many countries, widely-held investment funds are entitled to a deduction or equivalent tax relief for distributions, designed to ensure that their investors, rather than the fund, are subject to tax on underlying income from the fund's investments. One example is an Australian unit trust (AUT), where income to which unit holders are presently entitled is taxed to them rather than the trust. This change is not intended to remove the ability for a New Zealand taxpayer to use the FDR method in relation to an AUT undertaking portfolio investment.

Scenario 2

New section EX 47B deals with scenario 2 in the background above In such circumstances, the New Zealand share user is required to use the CV method to calculate their FIF income or loss from a FIF interest subject to a returning share transfer if:

- the share supplier is resident in another country;
- the share user is related to the share supplier, or the returning share transfer is or is part of a structured arrangement. "Related" and 'structured arrangement" are defined terms in new section FH 15 (discussed above); and
- the share supplier is treated as the owner of the shares for the purposes of the tax rules where it is resident.

This is because the share supplier may be deducting the dividends paid on the shares as a financing cost in the foreign country, whereas the share user may be applying the fair dividend rate (FDR) method to tax the FIF interest. The difference between the income returned under the FDR method and the dividend paid results in a potential D/NI mismatch.

There are consequential changes to related provisions in the Act:

- Section EX 44(2) has been amended so that new section EX 47B has been added to the list of the provisions which limit a person's choice of FIF income calculation methods.
- Section EX 46(6)(d) has been amended so that a person who holds a FIF interest as a share user in a returning share transfer can use the comparative value method to calculate FIF income from that interest if section EX 47B applies to the person.
- The definition of a "returning share transfer" in section YA 1 has been amended so it does not require that the transfer shares are listed.

Scenario 3

Subsections EX 52(14C) and EX 53(16C) have been amended to deal with Scenario 3 in the background above. These subsections previously allowed a person who held a FIF interest and calculated income from that interest under the FDR method (whether it be the annual or periodic method) to continue to apply that method even if the person has disposed of the shares under a returning share transfer.

In practice, this seemed to mean that replacement payments paid by the share user could be treated as exempt (as dividends would be), and the share supplier would continue to pay tax only on the "fair dividend". In order to avoid the potential for a hybrid mismatch counteraction in such a case (where the share user is a non-resident in a country with hybrid rules), subsections EX 52(14C) and EX 53(16C) have been amended to deny the ability take this approach if the share user is related to the share supplier, or the returning share transfer is part of a structured arrangement ("related" and "structured arrangement" are defined terms in new section FH 15 discussed above). In such circumstances, the share supplier now has to apply the financial arrangements rules to the returning share transfer. The financial arrangements rules are comprehensive, and will ensure that replacement payments are taxable.

NRWT CHANGES CONSEQUENT ON HYBRID RULES

Section RF 2C

Background

One purpose of the non-resident financial arrangement income ("NRFAI") definition is to identify situations where there is a sufficient degree of deferral between deductions and payments under a financial arrangement between associated parties that NRWT should be imposed on an accrual basis, rather than the usual payments basis. Applying NRWT on an accrual basis ensures that in such cases, there is a better matching between deductions for the borrower and the imposition of NRWT on the lender.

However, the NRFAI definition looks at when expenditure is incurred, rather than when it is deductible. This means that where a deduction for expenditure is denied or deferred under the hybrid rules, that denial or deferral is not taken into account, for the purposes of the NRFAI definition, because it does not affect the time when the expenditure is incurred. This is not appropriate. For example, suppose interest expense is incurred in a year, but the deduction for the expense is deferred under section FH 5. In that case there can be no deferral between the allowing of a deduction and the payment of NRWT until the deduction is allowed by the hybrid rules.

Summary of legislative response

The formula for determining whether a financial arrangement gives rise to non-resident financial arrangement income (NRFAI) in section RF 2C has been amended. It is intended to ensure that expenditure for which a deduction is denied or deferred under the hybrid rules is not taken into account in determining whether a loan gives rise to non-resident financial arrangement income.

Application date

The amendment applies for income years beginning on or after 1 July 2018.

Detailed analysis

Subsection RF 2C(4) has been amended to reduce the amount of the denominator in the formula used to determine whether a loan gives rise to NRFAI.

The accumulated accruals in the denominator is now reduced by the amount of deductions which have been denied under the hybrid rules in subpart FH (referred to as "hybrid deductions").

Example 41: NRFAI, NRWT and hybrids counteraction under FH 5

Toucan Co, a foreign company resident in Tropicana (a foreign jurisdiction) owns one hundred percent of Takahē Co, an unlimited liability company resident in New Zealand. The taxation law of Tropicana disregards Takahē Co such that its income and expenditure is attributed to its owner Toucan Co. In order to fund domestic operations in New Zealand, Toucan Co provides Takahē Co with a $1000 loan for five years under which $250 of interest is payable at the end of the term.

New Zealand's financial arrangement rules spread the interest expenditure across the five-year term of the loan for tax purposes. For simplicity, assume that these rules result in Takahē Co being entitled to a deduction of $50 each year.

Under section FH 5, Takahē Co is denied deductions for its incurred expenditure on the five-year loan. See example 22 ("Disregarded hybrid payment mismatch") for an example with a similar structure that specifically deals with this deduction denial treatment.

Section RF 2C determines whether Toucan Co has non-residential financial arrangement income (NRFAI). (Note that this example ignores the de minimis in section RF 2C(3).) Takahē Co will have to withhold non-resident withholding tax in respect of any of Toucan Co's NRFAI. If the percentage calculated using deferral calculation in section RF 2C(4) is less than 90%, Toucan Co will have to apply the NRFAI rules for the remaining years of its loan with Takahē Co. As stated above, this calculation formula has been amended to take into account expenditure that is denied a deduction under subpart FH. Assuming Takahē Co has no surplus assessable income except for $100 in year three and $500 in year six (after the loan matures), the treatment of Takahē Co's deductions and the NRFAI and NRWT for Toucan Co will be as follows:

Year	1	2	3	4	5	6
Cumulative interest expenditure	$50	$100	$150	$200	$250	-
Cumulative interest paid	-	-	-	-	$250	-
Cumulative surplus assessable income			$100	$100	$100	$600
Cumulative amount of deductions denied (mismatch amounts from FH 5)	$50	$100	$50	$100	$150	-
Cumulative deduction allowed	-	-	$100	$100	$100	$250
Current year NRFAI	-	-	-	$200	$50	-
Current year NRWT @10%	-	-	-	$20	$5	-

In year one, the deferral calculation answer is treated as more than 90% because accumulated accruals is equal to zero, since there is no expenditure is incurred before year 1. This position holds for years 1-3 since Takahē Co incurred expenditure in years one and two but is denied deductions for that expenditure under section FH 5.

In year three, Takahē Co derives $100 of operating income that qualifies as surplus assessable income for the purposes of section FH 12. This means Takahē Co can offset $100 of its mismatch amounts against the surplus assessable income for a deduction of $100. Toucan Co will have NRFAI in year four because of this deduction. Toucan Co's NRFAI in year four will be $200 as that is the amount of expenditure that would have accumulated as NRFAI across the four years had Toucan Co had NRFAI each year (see section RF 12F). Toucan Co will be liable for $20 of NRWT as a result (assuming an NRWT rate of 10% on interest).

At the end of year five, the loan matures. $250 of interest is paid by Takahē Co to Toucan Co in that year. Toucan Co will have NRFAI for the year five expenditure of $50, even though the hybrid rules have denied Takahē Co a deduction for that amount. Takahē Co will be liable to collect $5 of NRWT in relation to Toucan Co's NRFAI. In year six, Takahē Co derives $500 of operating income that qualifies as surplus assessable income for the purposes of section FH 12. Takahē Co can offset this amount against its remaining mismatch amounts for a deduction of $150.

THIN CAPITALISATION CHANGES CONSEQUENT UPON HYBRID RULES

Section FE 6(2), FE 6(3)(a), FE 6(3)(aba), FE 7(3)(b), FE 15(1)(a), FE 21(3), and FE 23

Background

The thin capitalisation rules prevent a multinational group taking deductions for interest expense in New Zealand to the extent that it is excessively highly leveraged. Leverage is determined by comparing debt with assets less non-debt liabilities.

If a deduction is permanently denied for interest under the hybrid rules, it is not appropriate for that amount to be treated as interest under the thin capitalisation rules. Such treatment could result in that amount being subject (effectively) to an additional denial of deduction. It is also not appropriate for the debt giving rise to that interest to be treated as interest-bearing debt. It should be treated as either equity or a non-debt liability.

If a deduction is denied under section FH 5, FH 6 or FH 8 to FH 10, there is a possibility that a deduction will subsequently be allowed, by reason of being offset against surplus assessable income under new section FH 12. Application of the thin capitalisation rules to such interest should depend on the position of the New Zealand borrower and its worldwide group at the time the interest is incurred. Accordingly, no amendment to the current thin capitalisation rules is required in respect of such interest.

Separate thin capitalisation rules apply to registered banks controlled by a single non-resident. Changes have been made to these rules for the same reason as for the generic thin capitalisation rules.

Summary of legislative response

Sections FE 6, FE 7, FE 15, FE 21, and FE 23 have been amended to ensure that interest for which deductions are permanently denied under the hybrid rules do not give rise to additional income under the thin capitalisation rules (including the bank thin capitalisation rules), and that the debt associated with such interest is not treated as debt under those rules.

Application date

The amendment applies for income years beginning on or after 1 July 2018.

Detailed analysis

General thin capitalisation rules

Section FE 6 provides that an entity subject to the thin capitalisation regime has income equal to, broadly speaking, that portion of its interest deductions that is equal to the extent to which its New Zealand debt/assets percentage exceeds the greater of sixty percent and one hundred and ten percent of its worldwide debt/assets percentage for inbound investment (the respective percentages are seventy five percent and one hundred and ten percent for outbound investment).

Section FE 6 has been amended so that the formula in subsection (2) does not include, in the amount of interest which can give rise to such income under the thin capitalisation rules, the amount of interest for which a deduction is permanently denied under the hybrid rules. This is achieved through the following amendments:

- The formula in subsection (2) has been amended so that the interest deductions are reduced by a new term "mismatch";
- "Mismatch" is defined in new paragraph (3)(aba) as the total of the amounts denied as deductions under section FH 3, and as interest under sections FH 7 and FH 11. These three sections contain the hybrid rules where the denied deduction is not a mismatch amount that can be reversed to the extent there is surplus assessable income under section FH 12; and
- The definition of "total deduction" in paragraph (3)(a) has been amended so that it includes the interest deductions that would be allowed in the absence of the hybrid rules in subpart FH. This is to reflect the intent that interest deductions that are potentially only deferred (rather than permanently denied) under the hybrid rules should remain subject to the thin capitalisation rules.

Section FE 15 outlines how total group debt should be calculated under the thin capitalisation rules for a New Zealand group. Subsection (1) has been amended to exclude from the definition of total group debt the amount of financial arrangements that give rise to interest for which a deduction is permanently denied under the hybrid rules (that is, where the deduction is denied under section FH 3, FH 7 or FH 11).

Bank thin capitalisation rules

Section FE 7 has been amended so that a reporting bank's interest expenditure does not include interest for which a deduction is denied under sections FH 3 (for character mismatches only), FH 7, or FH 11 (those being the hybrid rules that permanently deny deductions).

Section FE 21 has been amended such that interest expenditure denied under sections FH 3 (for character mismatches only), FH 7, or FH 11 gives rise to additional financial value for the purposes of calculating equity value for a banking group. Correspondingly, Section FE 23 has been amended such that a banking group's funding debt does not include debt under which a deduction has been denied under sections FH 3 (for character mismatches only), FH 7, or FH 11.

HYBRID MISMATCH RULE FOR NRWT

Sections BH 1(4), RF 11C

New section RF 11C inserts a new hybrid mismatch rule allowing New Zealand to charge NRWT on payments under certain cross border hybrid financing instruments if New Zealand treats the payment as interest. This rule overrides our double tax agreements (DTAs).

Background

The Government has identified a hybrid mismatch issue that arises in the following circumstances.

The New Zealand branch of a non-resident company borrows money from another non-resident in the same overseas country as the borrowing company. The borrowing is under a hybrid instrument which New Zealand treats as debt but the other country treats as shares.

Under our DTAs, New Zealand is able to charge NRWT on interest payments made by a non-resident's New Zealand branch to another non-resident. However, New Zealand is not able to charge NRWT on dividends paid by one non-resident company to another (regardless of whether the dividends are connected with a branch in New Zealand). This means that whether New Zealand can charge NRWT on payments under a hybrid financial instrument where the borrower is a New Zealand branch of a non-resident and the lender is a resident of the same country depends on whether the payments are classified as interest or dividends for DTA purposes.

If the payments are dividends for DTA purposes, and New Zealand was not able to impose NRWT on them, then the branch would be entitled to an interest deduction in New Zealand for the payments but the payments would not be subject to NRWT. This would be contrary to the intent of the relevant DTA provisions.

Australia already has a rule effectively providing that outgoing payments are not dividends for DTA purposes (and so are subject to Australian NRWT) if they are treated as interest under Australia's domestic law.[7]

Application date

New section RF 11C applies retrospectively from 1 April 2008. Where taxpayers have already adopted the position that NRWT or AIL is not payable in respect of such cross border interest payments made prior to the introduction of the Bill (6 December 2017), a savings provision is available.

Detailed analysis

The Act inserts a new section RF 11C. Section RF 11C(1) provides that the section applies to a payment of interest (as defined in section YA 1) by a company that is resident outside New Zealand under an applicable DTA to another person who is also resident outside New Zealand under that DTA, if the payment has a New Zealand source under the Income Tax Act. Section RF 11C(2) then provides that the payment is treated as interest under the NRWT rules and the DTA, notwithstanding anything to the contrary in the DTA. The Act also amends section BH 1(4) to make it clear that section RF 11C overrides the applicable DTA.

The combined effect of the legislation is that New Zealand may withhold NRWT from a cross border payment that is New Zealand source interest under the Act, regardless of whether it is treated as a dividend under the applicable DTA.

Example 42: Hybrid mismatch in DTA/NRWT context

A foreign group in the business of bridge building consists of two consolidated foreign companies resident in Greenwich (a foreign country), Simon Co and Garfunkel Co. Simon Co has a New Zealand branch and Garfunkel Co issues a convertible note to Simon Co to assist with its troubled New Zealand operations. (Assume for the purposes of this example that New Zealand and Greenwich have a DTA in force that is consistent with the commentary above.)

Simon Co must make annual payments to Garfunkel Co under the note and these payments are treated as interest under New Zealand domestic law, but as dividends in Greenwich. RF 11C(2) will ensure that the payment is subject to NRWT, regardless of its treatment in Greenwich or under the DTA.

HYBRIDS COMPLIANCE AND DISCLOSURE

As with all other provisions of the law, self-assessment requires taxpayers to determine their taxable income considering the potential application of the hybrid provisions. The following table should assist taxpayers to determine whether or not they are likely to need to consider the application of the hybrid provisions. The table also contains a reference to the relevant section, and some comments to assist in determining whether or not the section will in fact give rise to denial of a deduction or additional income. The last column identifies which item in the BEPS disclosure form the taxpayer should tick if the relevant section does in fact apply to them.. Like the rest of this commentary, these questions do not replace the law, and cannot be relied on to identify every hybrid mismatch situation.

[7] Section 3(2A) of Australia's International Tax Agreements Act 1953.

<table>
<tr><th colspan="4">HYBRIDS GUIDANCE AND DISCLOSURE QUESTIONS</th></tr>
<tr><th></th><th>Guidance Question</th><th>Comment</th><th>Disclosure question</th></tr>
<tr><td>1.</td><td>Are you claiming a deduction under a financial instrument for a payment to a related non-resident, where either:
the payment was not taxable income for the non-resident in another country in an accounting period beginning within 24 months of the end of the income year in which you are claiming a deduction; or
you do not know whether (or when) the payment was taxable income in another country.
FH 3 – deductions on hybrid financial instrument rules</td><td>Any time you claim a deduction under a financial instrument (generally this will be a loan, derivative, or other financial arrangement, but for this purpose the definition is slightly broader) where the payee is non-resident and related to you, you should check the foreign tax treatment of the payment. Is the related party including the payment in its taxable income as interest, or as income taxable at the same rate as interest? If it is, is that inclusion expected to occur in an accounting period beginning within 24 months of the end of the income year in which you are claiming a deduction for the payment? If the answer to either question is no, you need to consider sections FH 3 of the hybrid rules before claiming a deduction.
The definitions of "financial instrument" and "related" are in section FH 15.</td><td>Hybrid payment disclosure</td></tr>
<tr><td>2.</td><td>Do you hold shares in a foreign company where you have treated the dividend on those shares as exempt income, and either:
the payment was deductible to the payer in another country, or otherwise gave rise to some form of tax relief; or
you do not know how the payment was treated by the payer.
CW 9(3) – deductible dividends</td><td>A dividend from a foreign country is not exempt from tax under section CW 9(1) if the payment is deductible to the payer or otherwise meets the definition of a "deductible foreign equity distribution" in section YA 1.</td><td>Hybrid receipt disclosure</td></tr>
<tr><td>3.</td><td>Have you received a payment under a financial instrument with a non-resident related person where either:
that person is entitled to a deduction or equivalent tax relief for payments under the arrangement in tax periods that end more than two years before the beginning of the income year in which you expect to recognise the income from those payments; or
that person is entitled to a deduction or equivalent tax relief for payments under the arrangement which will not be included in your income
you do not know whether or not that is the case.
FH 4 –income on hybrid financial instruments rule</td><td>If a non-resident is entitled to a deduction (or equivalent tax relief) for a payment to a New Zealand related party in relation to a financial instrument in a tax period ending more than 24 months before the beginning of the income year in you treat the payment is treated as income in New Zealand, or you do not treat the payment as income at all, you must recognise the income at the same time it is deducted by the payer, under section FH 4.</td><td>Hybrid receipt disclosure</td></tr>
</table>

NEW LEGISLATION

4.	Are you claiming a deduction for a payment to a non-resident member of your *control group* where any of the following applies: A. under a foreign tax law, the payment is not taxed because you and the payee are treated as the same person; B. the payee is treated as transparent by the tax law of the country where it is formed; or C. the payee is not taxable on the income because it is treated by the payee as received in a country where the payee is not resident. D. you do not know the answer to any of questions A to C. **FH 5 hybrid entities primary and FH 7 reverse hybrids**	Any time you make a payment to a non-resident member of your *control group*, you need to consider whether or not the payee is treating you as a separate entity for purposes of its tax law. For example, it may not be treating you as a separate entity if you and the payee are members of the same consolidated group in that country. If it is not treating you as a separate entity, you need to consider section FH 5 before deducting any expenditure you have incurred. You also need to consider whether the payee is not taxed on the amount because: - it is fiscally transparent in the country where it is formed or operates; or - one country (generally the country where the payee is tax resident) exempts the income because it is treated as referable to activities in a third country, but the third country does not tax the income because it does not treat it as referable to such activities. In these two cases, you need to consider section FH 7 before deducting any expenditure you have incurred. "Control group" is defined in section FH 15.	A & D Hybrid entity/Branch/Dual resident disclosure and Hybrid payment disclosure B-D. Hybrid payment disclosure
5.	Are you a branch of a non-resident, and claiming a deduction in relation to activities occurring outside New Zealand ("head office activities")? **FH 5 branches primary**	If you are entitled to a deduction in New Zealand for amounts reflecting activities occurring outside New Zealand, and those amounts are more than an allocation of third party costs (eg they reflect a profit margin for the offshore activity), you need to consider section FH 5 of the Act before taking a deduction for those amounts. Generally, section FH 5 denies a deduction if the same profit margin is not income in the other country.	Hybrid entity/ Branch/Dual resident disclosure **and** Hybrid Payment disclosure
6.	Are you a member of a tax consolidated group who has received a payment from another member of the group that relates to the offshore activities of the payer. **FH 6 hybrid entities defensive**	If yes, has the payer claimed a deduction in the other country for that payment? If yes, you are likely to be required by section FH 6 of the hybrid rules to include the payment in income. If the other country has hybrid rules, it should deny a deduction for the payment, so section FH 6 will not apply.	Hybrid receipt disclosure
7.	Do you have a foreign branch which is entitled under the tax law where it operates to a deduction for activities carried on by you in New Zealand. **FH 6 branches defensive**	If yes, is the deduction in the other country more than an allocation of your New Zealand costs (ie it reflects a profit margin for New Zealand)? If yes, you need to consider whether section FH 6 requires you to include the additional amount deducted in your New Zealand income (if you are not already doing so). If the other country has hybrid rules that apply to the payment, it should deny a deduction for any mismatch amount, so section FH 6 will not apply.	Hybrid receipt disclosure
8.	Do you have a foreign branch, or an interest in an entity in another country which is *related* to you and which you treat as fiscally transparent for New Zealand tax (for example a foreign partnership). **FH 8 – double deduction primary rule**	If the answer is yes, you need to determine whether there is another person in that country who for foreign tax purposes is able to offset your share of any branch or entity loss against its income. If there is, you need to consider whether section FH 8 denies you a deduction for the expenditure incurred through the branch or by the entity.	Double deduction disclosure
9.	Are you a branch of a non-resident, or is there a non-resident entity in your *control group*: • who is treated under a foreign tax law as paying a pro rata portion of the amounts paid by you? • whose foreign tax law treatment of your expenditure you are not aware of? **FH 9 – double deduction defensive rule**	If you are a non-resident who is entitled to a tax deduction in New Zealand for some of your expenditure, that expenditure may be deductible in two (or more) countries. Similarly if you are a resident who is fiscally transparent under the tax law applying to any of your owners. If the other country does not have a hybrid rule that denies a deduction in the other country (that is, a rule equivalent to section FH 8) you need to consider section FH 9 before deducting any expenditure you have incurred.	Hybrid entity/ Branch/Dual resident disclosure **and** Double deduction disclosure

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10.	Are you a dual resident company? **FH 10**	If yes, as well as not being able to group any loss with the income of another company (section IC 7(2)), you need to consider section FH 10 of the hybrid rules before deducting any expenditure you have incurred. Note that dual residence can arise very easily and can be unintended. For example, a company that is incorporated in New Zealand and managed and controlled in another country may be dual resident.	Hybrid entity/ Branch/Dual resident disclosure
11.	Are you claiming a deduction for a payment to a member of your *control group* in a country without hybrid rules? **FH 11**	If yes, is that payment part of an arrangement or flow of funds that involves a hybrid mismatch within your *control group*. The payment will be part of such an arrangement or flow of funds for these purposes if it funds, directly or indirectly, a hybrid mismatch within your *control group*. There is no need for any connection between the payment and the hybrid mismatch. You need to take into account all information within your possession in making this determination. Where the deduction is material, you should make enquiry of your group tax function as to whether the payment is part of a hybrid mismatch arrangement. If there is not a clear "no", given on the basis of reasonable enquiry, then no deduction should be claimed.	Imported mismatch disclosure
12.	Are you claiming a deduction for a payment under an arrangement, other than those identified above, where there are any indications that the arrangement has been undertaken on the basis that it will produce a deduction/no inclusion outcome that would give rise to counteraction under the hybrid rules if the arrangement were entered into with a related party or a control group member. **FH 3 – FH 7 and FH 11**	Taxpayers are expected to consider all information within their knowledge and control in order to determine whether a payment is made under a *structured arrangement* as defined in section FH 15. If you are making a payment under a *structured arrangement*, you need to consider the possible application to payments under that arrangement of all of sections FH 3 to FH 7 and FH 11 of the hybrid rules.	As applicable, depending on the nature of the mismatch.

BEPS - Interest limitation rules

RESTRICTED TRANSFER PRICING FOR CROSS-BORDER RELATED BORROWING

Sections GC 6, GC 15 to GC 19 and YA 1 (cross-border related borrowing, and related-party debt) of the Income Tax Act 2007

New rules have been introduced requiring related-party loans between a non-resident lender and a New Zealand-resident borrower to be priced using a restricted transfer pricing approach. Under these rules, specific rules and parameters are applied to certain inbound related-party loans to:

- determine the credit rating of New Zealand borrowers at a high risk of BEPS; and
- remove any features not typically found in third party debt in order to calculate (in combination with the credit rating rule) the appropriate amount of interest that is deductible on the debt.

Separate rules apply to financial institutions such as banks and insurance companies.

Application date

The amendments apply to income years starting on or after 1 July 2018. The amendments will not apply to an arrangement that complies with an advance pricing agreement issued by the Commissioner before 1 July 2018.

Key features

Amendments to section GC 6, including the introduction of subsections GC 6(3B) to (3E), provide for the rules to restrict interest deductions on cross-border related borrowing.

The rules, where they apply, alter the terms and conditions of a borrower and/or an instrument considered before applying the general transfer pricing rules, including the amendments to transfer pricing also amended by the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 and discussed elsewhere in this special report.

The rules are contained in sections GC 15 to GC 19:

- Section GC 15 sets out how the rules operate and also defines an "insuring or lending person" as the rules operate differently for these persons.
- Section GC 16 calculates how the credit rating of a borrower, other than an insuring or lending person, may be adjusted.
- Section GC 17 calculates how the credit rating of an insuring or lending person may be adjusted.
- Section GC 18 disregards certain features of a financial arrangement for the purpose of calculating an interest rate.
- Section GC 19 confirms that for arrangements existing before the new rules apply the loan must be repriced at the last day before the new rules apply that the loan was priced or repriced.

Background

New Zealand's thin capitalisation rules limit the amount of deductible debt a company can have, rather than directly limiting interest deductions. For the rules to be effective at actually limiting interest deductions in New Zealand to an appropriate level, allowable interest rates on debt also need to be limited.

Historically this limitation has been achieved through transfer pricing. However, this approach has not been wholly effective.

The transfer pricing rules require taxpayers to adjust the payments for cross-border related party transactions, so they align with the arm's length conditions that would be agreed to by a third party in a comparable transaction. The arm's length interest rate on a debt is affected by several factors including its term, level of subordination, whether any security is offered, and the credit rating of the borrower.

New Zealand's transfer pricing rules have been updated and strengthened by including adopting economic substance and reconstruction provisions similar to Australia's rules through the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. The amended transfer pricing rules disregard legal form if it does not align with the actual economic substance of the transaction. They also allow transactions to be reconstructed or disregarded if such arrangements are commercially irrational and would not be entered into by third parties operating at arm's length.

Even with these stronger transfer pricing rules, traditional transfer pricing is not effective to prevent profit-shifting using high-priced related party debt.

When borrowing from a third-party, commercial pressures will drive the borrower to try to obtain as low an interest rate as possible and on the best terms and conditions – for example, by providing security on a loan, and by ensuring their credit standing or rating is not adversely affected by the amount being borrowed and the borrowing rate.

These same pressures do not exist in a related-party context. A related-party interest payment, such as from the New Zealand subsidiary of a multinational to its foreign parent, is not a true expense from the perspective of the company's shareholders. Rather, it is a transfer from one group member to another. There are no commercial tensions driving interest rates to a market rate. Indeed, it can be profitable to increase the interest rate on related-party debt above a market rate – for example, if the value of the interest deduction is higher than the tax cost on the resulting interest income.

In addition, related-party transactions are fundamentally different to third-party transactions. Factors that increase the riskiness of a loan between unrelated-parties (such as whether the debt can be converted into shares or the total indebtedness of the borrower) are less relevant in a related-party context. For example, the more a third-party lends to a company, the more money is at risk if the company fails. However, the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with debt or equity.

As the foreign parent and New Zealand subsidiary are commonly controlled, in many cases the terms and conditions of any loan can be set having regard to taxation, rather than the commercial considerations that would be most important in an actual arm's length loan. Related-party loans can feature unnecessary and uncommercial terms (such as being repayable at the borrower's discretion or having an extremely long term) that are used to justify a high interest rate. Simply making the related party debt subordinated or subject to repayment optionality may also be used as justifications for a higher interest rate. In other cases, a high level of related party debt may be loaded into a New Zealand subsidiary to depress the subsidiary's creditworthiness, which also is used to justify a higher interest rate.

It can be difficult for Inland Revenue to challenge such arrangements under the transfer pricing rules as similar conditions are not generally found in arrangements entered into by third parties in comparable circumstances. With the new stronger transfer pricing rules, the taxpayer would have to provide evidence that the legal form was consistent with the economic substance and that a third party operating at arm's length would agree to enter into the arrangement. These new requirements should limit the use of artificial or commercially irrational funding arrangements. However, in isolation, they would still provide scope for taxpayers to choose to borrow from related parties using higher-priced forms of debt than they would typically choose when borrowing from third parties.

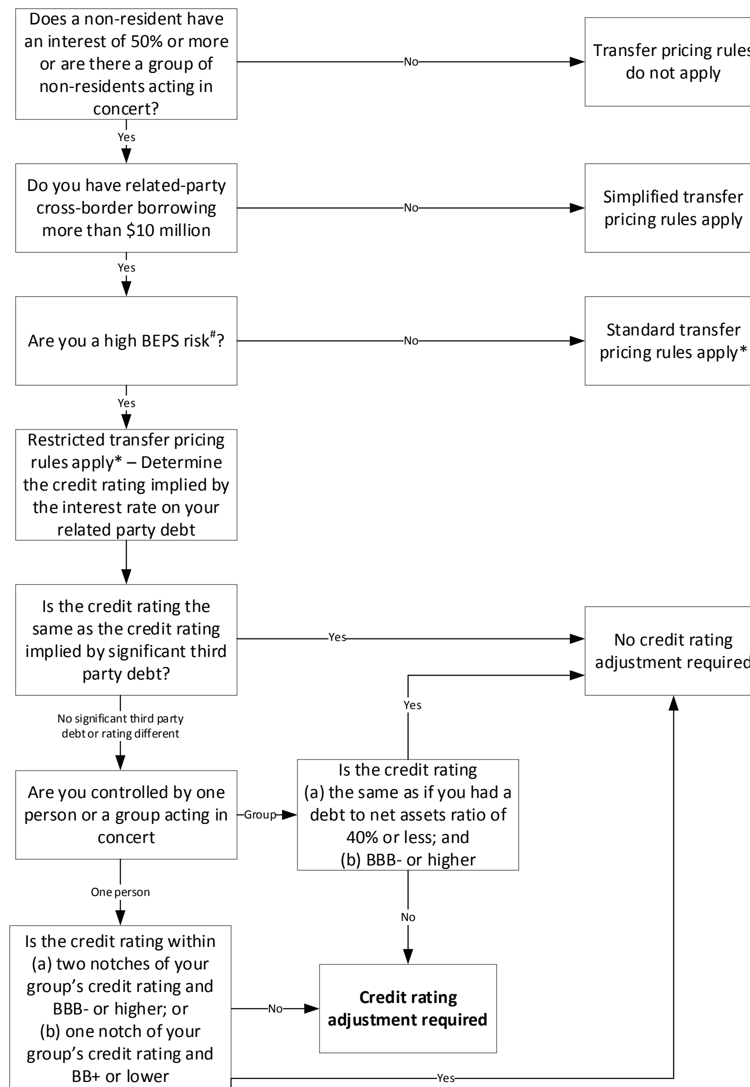
In addition, the highly fact-dependent and subjective nature of transfer pricing can make the rules complex and uncertain to apply. Assessing compliance with the arm's length principle requires very detailed and specific information and analysis of how a comparable transaction between unrelated parties would have been documented. This makes complying with the transfer pricing rules a resource-intensive exercise which can have high compliance costs and risk of errors. Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue.

New Zealand is not alone in these concerns. The OECD's final report on interest limitation rules notes that thin capitalisation rules are vulnerable to loans with excessive interest rates. This was one of the reasons behind the OECD favouring the earnings before interest, tax, depreciation and amortisation (EBITDA) approach to limit interest deductions.

Detailed analysis

The following flow chart sets out, at a high level, the steps a New Zealand borrower must go through, before determining a credit rating adjustment is required under the new rules. Further detail on each of these steps is provided below:

Flowchart 1: Process for determining NZ borrower's credit rating



From restricted transfer pricing to interest rate

The guidance in this TIB as well as the legislative restrictions imposed by the restricted transfer pricing rule focus on credit rating, and instrument terms and conditions restrictions, rather than directly determining an appropriate interest rate or margin.

For any particular credit rating, it is necessary to use this information, along with other relevant factors, to determine an appropriate interest rate using the standard transfer pricing rules in section GC 6 to GC 14. This will frequently require access to specialist information such as that provided by Bloomberg or Reuters, on comparable instruments. This approach is unchanged between the previous transfer pricing rules and the additional requirements required under the restricted transfer pricing rule.

Section GC 13, within the standard transfer pricing rules, requires accurately delineating and identifying the transaction including the conditions that independent parties after real and independent bargaining might be expected to agree upon for the identified transaction. While it would typically be expected that a transaction that had been adjusted under the restricted transfer pricing rule in GC 15 to GC 19 would not include any non-arm's length conditions there is no override of section GC 13 so a taxpayer should still consider how this section may apply.

Selection of suitable comparables and any adjustments that need to be made to them, such as converting into New Zealand Dollars, remains critical to arriving at an appropriate rate for a given transaction.

Cross-border related borrowing

Both the credit rating and disregarded features part of the restricted transfer pricing rule apply only where there is a cross-border related borrowing which is defined in section GC 6(3B). To be a cross-border related borrowing funds must have been provided to the borrower under which deductible expenditure arises and one or more of the following factors:

- the lender and borrower are associated;
- there is a person or group of persons that has an ownership right of at least 50% in the lender and the borrower;
- the funding is provided through an indirect associated funding arrangement (detailed further on); or
- the lender is part of a non-resident owning body or other group of non-residents acting in concert and that body or group has an ownership right of at least 50% in the borrower.

Provides funds

Section GC 6(3B)(a) requires that for an arrangement to be a cross-border related borrowing, a non-resident lender must provide funds to the borrower. This term has been used in the thin capitalisation rules since their inception and is also used in the non-resident financial arrangement income rules. It is explained on pages 54 and 55 of *Tax Information Bulletin* Volume 29, No 5, June 2017. It includes a finance lease, which in substance is a vendor-financed sale. It does not include an operating lease.

Expenditure arises for the borrower

Section GC 6(3B)(b) requires that for an arrangement to be a cross-border related borrowing, expenditure must arise for the borrower for which the borrower is allowed a deduction. There is no advantage in adjusting the interest on a related party loan if that interest is not deductible including under sections FH 3, FH 7 and FH 11 of the hybrid and branch mismatch rules (that is, one that is not subject to reversal under section FH 12). There is no timing restriction on this provision, so the rules continue to apply if the deduction is temporarily disallowed, for example because it is a hybrid deduction denied subject to reversal under section FH 12.

Association

The lender and borrower will be associated if they meet one or more of the existing association tests in subpart YB.

An ownership right of at least 50% in the borrower

This test is determined under sections FE 38 to FE 41. These sections provide how ownership interests in companies are determined and ensure that the restricted transfer pricing rule applies to the same groups that are covered by the thin capitalisation rules. The calculations are similar to the control interest calculations in the controlled foreign company rules.

In most cases, where rights are held in equal proportion across all (classes of) shares, having an ownership right of at least 50% will occur where two companies are associated anyway. However, this test will also include some lenders and borrower who are not associated if rights are not held in the same proportion across all (classes of) shareholders.

The test references the direct control interests in section EX 5(1) as if the borrower was a foreign company and looks at the highest interest across the following categories:

- shares in the borrower
- shareholder decision-making rights in the borrower; which are decision making concerning:
  - dividends or other distributions
  - constitution of the company
  - variation in capital
  - appointment of a director
- a right to receive income of the borrower
- a right to receive any of the value of the net assets of the borrower

As this test is based on the highest interest, it is possible for more than one person or group to have an over 50% interest. As this is not an income attribution provision, and only requires potential restrictions on the pricing of interest when a group has control or influence over the pricing of interest paid to them, this does not raise concerns.

NZ Shareholder Co has a voting interest of 51.25% so is associated with NZ Co. However, the restricted transfer pricing rule will not apply to NZ Shareholder Co as it is not a non-resident. Non-resident Shareholder Co has a voting interest of 48.75% so it is not associated with NZ Co. However, Non-resident Shareholder Co has 60% of the right to appoint directors. Any loans to NZ Co by Non-resident Shareholder Co will be subject to the restricted transfer pricing rule.

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If NZ Shareholder Co sold all its shares in NZ Co to another non-resident both the new shareholder and Non-resident Shareholder Co would be subject to the restricted transfer pricing rule as both shareholders would be non-residents with an interest of greater than 50%.

Example 1

NZ Co has two classes of shares and two shareholders; as follows:

Share class	NZ Shareholder Co	Non-resident Shareholder Co	Total
Class A	55	45	100
Class B	4	6	10

Class A shares hold all income distribution interests as well as decision making concerning distributions, the constitution of the company and variation in the capital of the company. Each class B share holds the right to appoint one director.

Voting interests are determined by the shareholder decision making rights as follows:

Decision making right	NZ Shareholder Co	Non-resident Shareholder Co	Total
Distributions	55%	45%	100%
Constitution	55%	45%	100%
Capital	55%	45%	100%
Directors	40%	60%	100%
Average	**51.25%**	**48.75%**	**100%**

NZ Shareholder Co has a voting interest of 51.25% so is associated with NZ Co. However, the restricted transfer pricing rule will not apply to NZ Shareholder Co as it is not a non-resident. Non-resident Shareholder Co has a voting interest of 48.75% so it is not associated with NZ Co. However, Non-resident Shareholder Co has 60% of the right to appoint directors. Any loans to NZ Co by Non-resident Shareholder Co will be subject to the restricted transfer pricing rule.

If NZ Shareholder Co sold all its shares in NZ Co to another non-resident both the new shareholder and Non-resident Shareholder Co would be subject to the restricted transfer pricing rule as both shareholders would be non-residents with an interest of greater than 50%.

Indirect associated funding

An indirect associated funding arrangement is defined in section GC 6(3C). It is based on the similar indirect associated funding arrangement definition in section RF 12I for the purpose of the NRWT rules. The purpose of this test is to prevent a lender from circumventing the restricted transfer pricing rule by channelling funding through an unassociated person to a New Zealand borrower where direct funding would be covered by one of the other limbs of the cross-border related borrowing definition.

Example 2

Foreign Co has a wholly owned subsidiary, NZ Co. Foreign Co has deposited NZ$20 million with Foreign Third Party Bank. Foreign Co and Foreign Third Party Bank have agreed that Foreign Third Party Bank will pay 9.7% interest to Foreign Co on the deposit and will also lend NZ$20 million to NZ Co at a rate of 10%. If Foreign Third Party Bank had lent NZ$20 million directly to NZ Co without this arrangement the interest rate would have been 7%.

If Foreign Third Party Bank had simply lent money to NZ Co, the restricted transfer pricing rule would not apply as Foreign Third Party Bank does not have any interest in NZ Co. However, as the loan is indirect associated funding, it is covered by the restricted transfer pricing rule.

Whether a cash pooling arrangement is classified as indirect associated funding was covered on page 68 of *Tax Information Bulletin* Volume 29, No 5, June 2017 when this term was introduced for the non-resident financial arrangement income rules. In short, indirect associated funding:

- includes an arrangement entered into with the purpose or effect of avoiding the restricted transfer pricing rule; and
- does not include commercial cash pooling arrangements such as those set up with a fluctuating debit and credit balance to cover working capital requirements.

Acting in concert

This test covers borrowers that have at least 50% of their rights held by a group of non-residents that act in concert to control the borrower. This overlays the 50% ownership right test described above with the existing non-resident owning body and acting in concert tests that already apply for thin capitalisation and NRWT.

In section GC 16(3), such a group is referred to as a co-ordinated group and a borrower from a co-ordinated group is referred to in this report as not having an identifiable parent. Each of these terms can be used interchangeably. There are two exceptions to this general treatment:

- If the borrower is owned by a single non-resident with no other business activity, and that non-resident is itself controlled by a co-ordinated group, the New Zealand borrower will be treated as controlled by a co-ordinated group. This is because the New Zealand borrower will be in the same situation as if the direct non-resident did not exist and the New Zealand borrower was owned directly by each of the members of the co-ordinated group.
- If the borrower is controlled by a co-ordinated group but one of the members of that co-ordinated group meets the 50% ownership interest test by themselves the New Zealand borrower is treated as not controlled by a co-ordinated group. This is because the restricted transfer pricing rules apply without the need to consider the existence or otherwise of a co-ordinated group.

Exclusion of certain preference shares

Section GC 6(3E) excludes ownership interests arising from certain preference shares from the cross-border related borrowing test. To meet this exclusion the preference shares must be:

- held by a person not associated with the issuer; and
- issued with the intention of satisfying or replacing debt previously provided by the preference shareholder to the issuer in the ordinary course of business.

The purpose of this exclusion is to cater for certain situations where a non-resident, in the business of lending to third parties, lends money to a New Zealand borrower who gets into financial difficulty. In such cases, rather than a portion of the debt being cancelled, the borrower may issue the lender preference shares. In this circumstance the lender, has an ownership right in the borrower, subject to the terms and conditions of the preference share. However, it clearly would not be appropriate to require the interest rate on the remaining debt to be determined having regard to the group credit rating of the preference shareholder.

This exclusion will not apply if the preference shares are issued to a person who is already associated with the borrower, or if the preference shares are sold or transferred to a third party. These restrictions are designed to prevent investors using this exclusion to take or extend an equity-like interest without this being included in determining ownership for purposes of the restricted transfer pricing rules.

Credit rating adjustments

A borrower that is subject to the new rules will follow the process set out in Flowchart 2, to arrive at one of the following issuer credit ratings:

- Default credit rating – the borrower's own rating.
- Restricted credit rating – the higher of (i) the borrower's own rating if their debt/assets percentage is no higher than 40% debt and (ii) BBB-.
- Group credit rating – the higher of the group borrower's credit rating minus one or two notches and the borrower's own rating (the group borrower is the group company with the highest amount of unsecured long term borrowing).
- Optional credit rating – the credit rating implied from significant third-party debt.

None of the credit rating methods is intended to require a borrower or another entity in the worldwide group to obtain a credit rating if it does not already have one. Instead a credit rating, subject to any restrictions imposed by the methods, can continue to be implied based on an analysis of current and historical information to form a business risk profile that considers competitive position, managerial conduct and intent, industry and country risk and a financial risk profile based on cash flow and leverage. This forms the basis of the borrower's stand-alone position which may be influenced by other factors including group or governmental support to form the issuer credit rating.

Default credit rating

The default credit rating in section GC 16(2) and (8) is the borrower's rating including any implicit parental support. This is the rate that applies under the rules outside of the restricted transfer pricing rule. It will continue to apply where the borrower is a low BEPS risk. This is also the rating that applies when a borrower has less than $10 million of cross-border related borrowings.

The Commissioner has previously issued administrative guidance for transfer pricing of loans with a total principal up to $10 million in order to minimise compliance costs. The availability of the administrative approach is not intended to be affected by the new restricted transfer pricing rule and a loan priced under this approach is intended to be compatible with the default credit rating. To make this clear, loans where the borrower has less than $10 million of cross-border related borrowings have been carved out of the restricted credit ratings and group credit rating methods discussed below.

Further detail on the administrative approach is available at:

www.ird.govt.nz/international/business/transfer-pricing/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html

Restricted credit rating

The restricted credit rating in section GC 16(3) and (9) will apply where the borrower does not have an identifiable parent, and either is a high BEPS risk or chooses to use it to reduce compliance costs. It is based on the borrower's standalone rating but adjusted to reduce its debt level to 40% if it is above this and is subject to a to a minimum rating of BBB-, or equivalent given by a rating agency approved by the Reserve Bank.

The Reserve Bank approves rating agencies for their non-bank deposit taker rules which are published at:

www.rbnz.govt.nz/regulation-and-supervision/non-bank-deposit-takers/requirements/credit-ratings

There are four rating agencies currently approved by the Reserve Bank. BBB- is the lowest investment grade credit rating assigned to a party by Standard & Poor's, Fitch and Equifax Australasia and is equivalent to a Baa3 Moody's rating.

If a New Zealand borrower is controlled by a non-resident and that non-resident has no other business activity and itself has no identifiable parent, the New Zealand borrower will be treated for the purpose of determining its credit rating as having no identifiable parent rather than the direct non-resident being its parent. The consequence of this is the New Zealand borrower will need to consider whether the restricted credit rating applies rather than the group credit rating.

Group credit rating

The group credit rating in section GC 16(4) and (10) will apply where the borrower has an identifiable parent and either represents a high BEPS risk (discussed below) or chooses to use it to reduce compliance costs. A New Zealand borrower's rating, in comparison with the group borrower's rating, is reduced by two notches if the parent's rating is BBB+ or above and one notch if it is below this. A notch is referred to in the legislation as the smallest division within the credit rating categories (for example from AA to AA- or AA- to A+). This distinction is made as a two-notch difference is only available where the New Zealand borrower would not end up below BBB-. BBB- is the lowest credit rating that is still investment grade. A one notch movement at a rating below investment grade would be expected to have a larger impact on the interest rate than a one notch movement at a rating above investment grade.

As with the equivalent terminology in the restricted credit rating, the reference to BBB+ uses the rating scale used by Standard & Poor's and other agencies. An equivalent rating by a different rating agency (such as a Baa1 Moody's rating) would also be acceptable.

The following table sets out the lowest available credit rating for a high BEPS risk borrower with an identifiable parent for certain credit ratings:

Group borrower credit rating	Maximum spread	New Zealand borrower credit rating
A	2 notches	BBB+
A-	2 notches	BBB
BBB+	2 notches	BBB-
BBB	1 notch	BBB-
BBB-	1 notch	BB+
BB+	1 notch	BB

Optional credit rating

The optional credit rating in section GC 16(5) and (11) allows a New Zealand borrower to apply a credit rating to an amount of their related party borrowing that is the same as that implied from significant[1] third party borrowing by a member of their New Zealand group. For a borrower that could use the default credit rating the optional credit rating would be consistent with this; however, this option is available for all borrowers, including insuring or lending persons, with cross-border related borrowing and third party debt.

[1] "Significant" is not a term used in the legislation, but is discussed in the next paragraph.

NEW LEGISLATION

The optional credit rating allows the credit rating of a cross-border related borrowing to be set under the same credit rating that can be implied from third party long-term senior debt. This is based on the same principle as the third-party exceptions used for disregarded features and described below. As with the disregarded features exception the optional credit rating can be used for cross-border related borrowing with a principal of up to four times the third-party debt – this restriction is to prevent a borrower using a small amount of expensive third party debt to justify a full deduction for the interest on a large amount of expensive related party debt.

Usually a well secured loan will have an interest rate that implies a higher credit rating than that of the lower ranking debt of the entity, such as subordinated or even unsecured debt. Where a borrower has both secured and unsecured third party borrowing it would be appropriate for the optional credit rating to be based on the lower credit rating implied by the unsecured debt up to the four times limit.

If this limit was reached and the borrower had no unsecured debt or chose not to base the optional credit rating on its unsecured debt, it could also calculate the optional credit rating based on the rating implied from secured debt.

Choosing to use the restricted, group or optional credit rating

As referred to above, a borrower can choose to apply the restricted credit rating, group credit rating or optional credit rating in certain circumstances (see section GC 16(2)(a)). Where this is available, no election notice is required. The method is chosen by calculating a deduction under the method and including this in the income tax return that first includes this arrangement. Once a borrower chooses a method for a particular arrangement in their first income tax return they cannot change to a different method in a subsequent return.

What is a high BEPS risk?

A borrower will generally be unable to use its standalone credit rating (default credit rating) and required to use the group or restricted credit rating options when it is a high BEPS risk, and the optional credit rating does not apply. This will occur when at least one of two factors are present:

High New Zealand group debt percentage

A borrower with an identifiable parent has a high New Zealand group debt percentage if its debt percentage is greater than 40%, unless its ratio is within 110% of its worldwide group (section GC 16(4)(b)). Where there is no identifiable parent, the 110% safe harbour cannot apply, and the equivalent relevant test is in section GC 16(3)(c).

In calculating the debt percentage for the purpose of this test, the borrower should use the same methodology and arrive at the same result as for their overall thin capitalisation calculation. This would include, for example, adjusting for non-debt liabilities and (if applicable) utilising the on-lending concession in section FE 13.

Borrowing from a low tax rate jurisdiction different from the ultimate parent

Borrowing from a low tax jurisdiction is borrowing from a lender resident in a country where the interest is subject to a lower than 15% tax rate. This factor is in section GC 16(3)(c)(i) and (ii), and GC 16(4)(b)(i) and (ii) for borrowers without and with an identifiable parent respectively. This factor does not apply if the ultimate owner of that lender is also resident in that jurisdiction. This factor is intended to apply to lending routed through a low tax country, which may be structured to achieve a tax advantage. It should not apply simply because a lender group is based in a low tax country. This factor does not apply to entities that are subject to lower, or no, tax due to a policy decision such as exempt sovereign wealth funds. This is achieved, by looking at both the lender's own tax rate and the tax rate that would apply to a company with the usual tax status of a company. This test considers the jurisdiction of each lender when a loan is provided by more than one person. If any of the lenders of a specific loan fail this test the borrower will be a high BEPS risk for that entire loan rather than just the portion provided by the lender in the low tax jurisdiction.

Calculation dates

The high BEPS risk tests are calculated on the latest calculation date provided by section GC 16(6).

For a loan that is entered into, renewed or renegotiated after the new rules apply, the calculation date will be the day the loan is entered into (under paragraph (6)(b)) or the day it is renewed or renegotiated (under paragraph (6)(c)). The calculation dates for other loans is covered separately below.

The calculation date may not be on a thin capitalisation measurement date[2]. To reduce compliance costs of a borrower determining whether it exceeds the 40% threshold on that date, section GC 16(7) allows the borrower to estimate their debt percentage by making appropriate adjustments to the thin capitalisation calculations done on the most recent measurement date rather than having to re-do the entire calculation. While "appropriate adjustments" is not defined this is intended to include the effect of the new loan as well as any actions related to that wider arrangement such as using the loan to repay an existing loan or purchase a new asset.

De minimis

A de minimis has been included in section GC 16(3)(b) and GC 16(4)(a) to minimise compliance costs of borrowers with smaller amounts of related party cross-border loans. A borrower with less than $10 million of cross-border related borrowing will not have to consider the credit rating adjustment part of the rules and will apply the default credit rating as they do now. The optional credit rating will continue to be available for a borrower with less than $10 million of cross-border related borrowing who chooses to use it.

The de minimis continues to apply to a loan in future years even if the de minimis is not satisfied in those future years, unless the loan is renewed, extended or renegotiated. The borrower will have to consider whether the de minimis applies each time they enter into a new cross-border related borrowing.

An equivalent de minimis also applies in sections GC 17(b) and GC 18(1)(a) which are discussed elsewhere in this report.

Implicit parental support

A borrower must include any implicit support arising because it is a member of the foreign parent's worldwide group when determining its default credit rating in section GC 16(8) or group credit rating in section GC 16(10)(b). This is consistent with the OECD transfer pricing guidelines[3], in particular paragraphs 1.157 and 1.164 to 1.167 of those guidelines, reproduced below:

> 1.157 Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors…

Example 1

1.164 P is the parent company of an MNE group engaging in a financial services business. The strength of the group's consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, i.e. a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

1.165 Assume that S borrows EUR 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows EUR 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender (i.e. an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S's other borrowings including the simultaneous loan to S from T.

1.166 Under these circumstances the interest rate charged on the loan by T to S is an arm's length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from S's group membership alone and not from any deliberate concerted action of members of the MNE group.

[2] Taxpayers are only required to calculate whether they comply with thin capitalisation on their measurement dates which, under section FE 8, can be daily, 3-monthly or annually. Most taxpayers choose to have an annual measurement date.

[3] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2017.

Example 2

1.167 The facts relating to S's credit standing and borrowing power are identical to those in the preceding example. S borrows EUR 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA. The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

We note that some of the OECD guidelines, including those quoted above, use the Moody's rating scale. The rest of this document uses the Standard & Poor's rating scale which is more common in New Zealand. A rating of Baa3 in the Moody's scale is equivalent to BBB- in Standard & Poor's.

Group Borrower's credit rating

For simplicity, the term 'group borrower's credit rating' is used in a number of places in this TIB; however, this term is not used in the legislation. Instead section GC 16(10)(a) refers to "the credit rating for debt that is long-term senior unsecured debt and not related-party debt or between associated non-residents, of the member of the borrower's worldwide group under subpart FE, that has the most such debt".

It is not appropriate to always base the parent's credit rating on the credit rating of the ultimate parent of a group as in some instances this company will not be the highest rated member of the group. For example, where the ultimate parent is a non-operating holding company. This entity would not be the one providing implicit support to the New Zealand borrower and it would instead be more appropriate to base the implicit support on the credit rating of a higher rated member of the group.

The group borrower's credit rating is used because it should be easier for the New Zealand borrower to identify this entity without having to obtain the credit rating of all group members including those that may not have a published credit rating.

In most instances the group borrower will be either the main operating entity of the worldwide group or a separate treasury entity that funds the group. Multinationals have a commercial incentive to ensure that the credit rating of the largest group borrower from third parties is as high, and therefore the interest rate is as low, as possible. Accordingly, the credit rating of the member with most long-term senior unsecured third-party debt is expected to reasonably reflect the credit of the worldwide group.

The members of the worldwide group are identified using the existing rules in section FE 17 which is based on entities that are consolidated under generally accepted accounting practice. Where an entity is part of the group but not wholly-owned or does not have exactly the same shareholding as other members of the group this will not exclude that entity from being considered the group borrower for the purpose of these rules. The amount of long-term senior unsubordinated debt is not apportioned to reflect different shareholdings. For example, if a group only has two entities with long-term senior unsecured debt – a 100% owned entity with $400m of debt and a 60% owned entity with $500m of debt – the 60% owned entity would be treated as having debt of $500m rather than $300m and therefore would be the group borrower for the purpose of determining the group credit rating.

Long term senior unsecured debt

The legislation does not define 'long term', as this is a commonly used and understood term. Typically long term refers to debt with a term when issued of at least one year. In many circumstances a borrower determining which entity in their group has the highest level of long term senior unsecured debt will be able to consider non-current liabilities on each member's balance sheet. However, this distinction may not be sufficient to differentiate between long-term senior unsecured debt and other instruments such as subordinated or secured debt or where debt that has been issued with a term of more than one year is nearing maturity.

The purpose of this part of the rules is to provide a cost-effective measure for determining what an appropriate credit rating for the group is. It will typically not be necessary to identify and classify all debt within an entity or group as it is only necessary to determine which is the entity with the most senior unsecured debt rather than the absolute amount of such debt

The reason for choosing unsecured debt only is that it more accurately reflects the credit risk of the entity or group rather than the specific security provided. The exclusion of secured debt may also exclude special purpose vehicles (SPVs) set up for a specific project, such as an infrastructure investment.

Where a group has no long-term senior unsecured third-party debt

In a limited number of situations, a group may have no long-term senior unsecured third-party debt, in which case the standard test will not be able to identify which entity to base the group borrower's credit rating on. Sections GC 16(10)(ab) and GC 17(ab) allow the group to determine the credit rating based on the member of the worldwide group with the highest credit rating. To reduce compliance costs, the group does not have to determine or consider the credit rating of any group member that could be reasonably considered to be unlikely to have the highest credit rating. Officials expect the member with the highest rating would typically be the one that may be expected to support the New Zealand borrower if needed, such as a main trading entity or entity with the largest balance sheet. A group would typically not be expected to consider the credit rating of entities within the group operating in countries outside the chain of ownership to the ultimate parent unless these entities were sufficiently large relative to other members of the group that they could reasonably be expected to have a higher credit rating.

Application to existing arrangements

The restricted transfer pricing rule applies to cross-border related borrowing for income years beginning on and after 1 July 2018. This includes existing arrangements entered into before this date in which case, under section GC 19, the interest rate will be calculated at the date the loan was entered into (or renewed, extended or renegotiated if this resulted in the interest rate being reset) with application to income years starting on or after 1 July 2018.

The high BEPS risk tests for an existing arrangement can be calculated at either of the following dates:

- The last day before the new rules apply – GC 16(6)(a).
- When the loan was last repriced before the new rules apply – GC 16(6)(d).

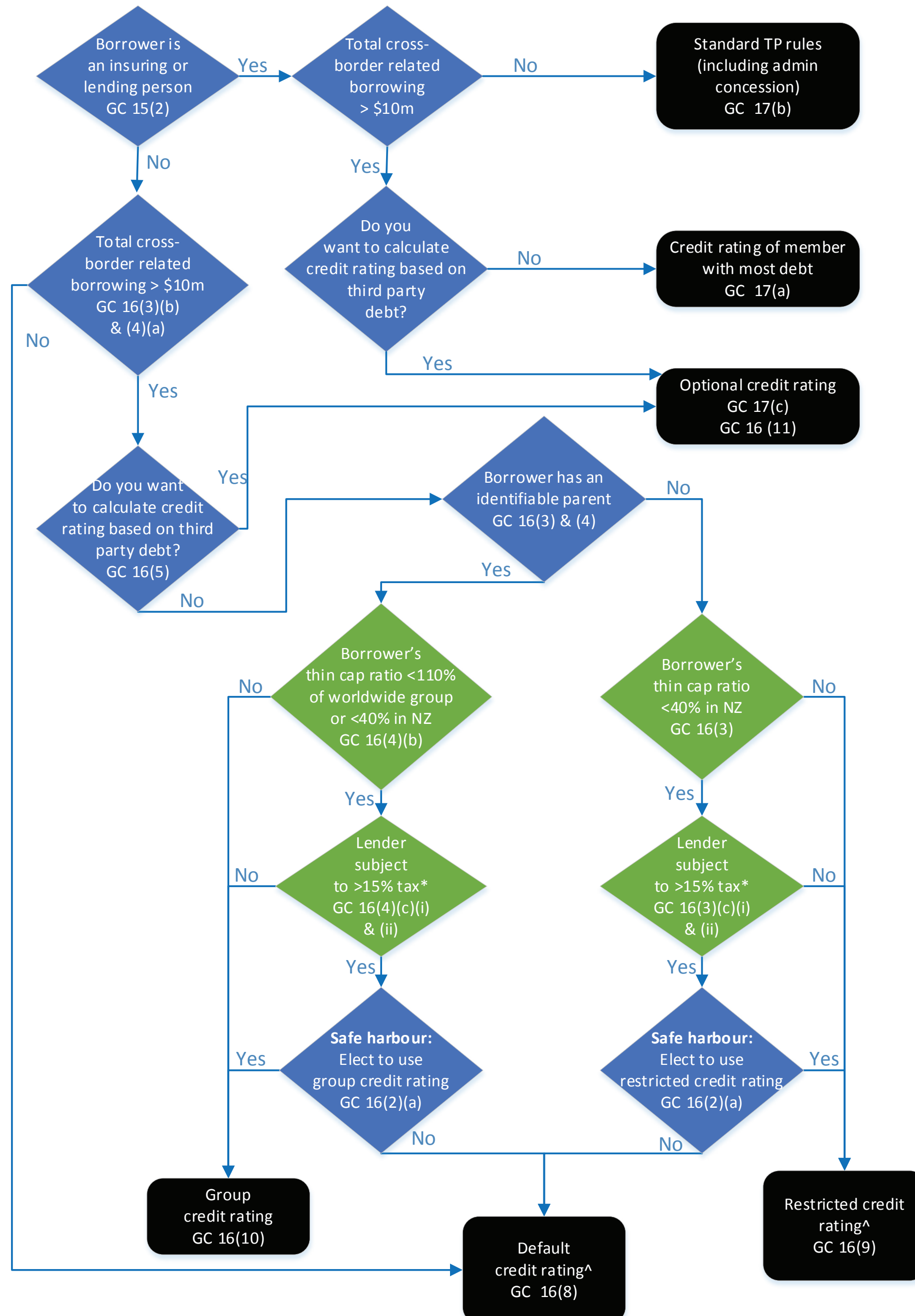
No separate election is required for this choice; however, the borrower should document this choice in the records used to support their tax return calculations. In this way a borrower who is a low BEPS risk at either of these two dates will not have to calculate the credit rating adjustment for existing arrangements. They may still have to calculate the impact of the disregarded features (discussed below).

A borrower calculating their debt percentage on the date the existing arrangement was last repriced before the new rules apply will be required to apply the calculation as it applied before the amendments in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. This means the debt percentage calculation will not be required to adjust for non-debt liabilities as discussed elsewhere in this TIB.

When the new rules mean that a portion of the interest payments under an existing loan is non-deductible, the parties may want to reduce the amount of the payments so there is no non-deductible portion. Inland Revenue accepts that such a reduction will not, on its own, require any amendment to the amount of the interest payments which is deductible under the new rules.

The restricted transfer pricing rule will not apply to arrangements that comply with an advance pricing agreement issued by the Commissioner before 1 July 2018.

Flowchart 2: Determining the credit rating to use for restricted transfer pricing



Mutual Agreement Procedure

Double Tax Agreements often contain a mutual agreement procedure (MAP) provision, which can be invoked when a taxpayer considers the actions of one of the contracting states will result in taxation not in accordance with the agreement.

A lender may wish to invoke MAP if it considers that the deductible amount in New Zealand under the restricted transfer pricing rules is less than the lender's jurisdiction will require to be returned as income, applying an arm's length standard. This will require the presentation of a case to the lender jurisdiction's Competent Authority or, depending on the provision, the New Zealand Competent Authority. Borrowers are not entitled to determine their deductible interest on the basis that the restricted transfer pricing rules are over-ridden by a double tax agreement unless they have first been through the MAP process. This guidance does not consider the substantive issues raised by such an application

Further guidance is available on MAP on Inland Revenue's website at:

www.ird.govt.nz/international/business/international-obligations/mutual-agreement-procedure/mutual-agreement-procedure-guidance.html

Effect of paying non-deductible amounts

If a borrower pays an amount of interest in excess of the amount which is deductible under the restricted transfer pricing rule, that payment will give rise to a dividend under subpart CD. This will not affect the borrower's obligation to apply the withholding tax rules applicable to interest payments to the excess amount, unless the lender applies to the Commissioner under section GC 11. See example 1 on page 4 of TIB Vol 11 No 7 (March 1996)).

Guarantee fees

The restricted transfer pricing rule does not explicitly refer to guarantee fees. The OECD is currently developing guidance on how guarantee fees should be priced. IR officials will continue to monitor this situation including whether future legislative change may be required.

No fee is appropriate for a guarantee of debt between parties who are commonly owned.

Payment of a guarantee fee to a non-resident related party may be appropriate if it guarantees third party debt. However, this would have to be considered on a case-by-case basis and would not be expected to materially exceed the cost of a non-resident group member borrowing from a third party and on-lending to the New Zealand borrower with the New Zealand borrower's interest deduction calculated under the restricted transfer pricing rule.

Example 3

NZ Sub is 100% owned by Foreign Parent and is a high BEPS risk as it has a debt percentage of 50%. Foreign Parent has an AA credit rating. Under a traditional transfer pricing analysis, NZ Sub would be rated BB+; however, the restricted transfer pricing rule requires related party debt borrowed by NZ Sub to have a credit rating of A+.

If Foreign Parent borrowed $100 million from third party bank and on lent this to NZ Sub the cost to the group would be based on Foreign Parent's AA credit rating and the cost to NZ Sub would be based on its A+ credit rating with Foreign Parent profiting on the margin difference between AA and A+.

If, instead, NZ Sub borrowed directly from third party bank with a guarantee from Foreign Parent the cost to NZ Sub would be based on Foreign Parent's AA credit rating. If NZ Sub paid a guarantee fee to Foreign Parent equal to the margin difference between AA and A+ the transaction would be equivalent to the related party lending example above, if the fee was greater than this NZ Sub would make a smaller profit and Foreign Parent would make a greater profit on what is economically an equivalent transaction. The guarantee fee in this case would have a high risk of being challenged.

Ignoring surrounding circumstances, terms, and conditions

Another way related party interest rates can be inflated is by using borrower friendly loan terms. To mitigate this risk the following features will be disregarded or adjusted for when considering the pricing of a particular instrument, subject to certain exemptions:

The term of the loan being greater than 5 years

Almost all NZ$ bank debt owed by New Zealand borrowers, and the majority of third-party bond issues, are for a term of 5 years or less. Due to a (generally) positive sloping yield curve and the lack of comparables with terms of over 5 years, debt with very long duration can be priced higher than equivalent shorter terms. If the term of cross-border related borrowing is more than 5 years section GC 18(4) and (8)(b) will price it as if its term is 5 years unless an exception applies. This pricing should apply for the term of the loan. Further detail is provided on this provision below.

Subordination

Subordination is where an instrument ranks behind other instruments in the event of default. This reduces the chance of the creditor receiving all their money back in the event the borrower runs into financial difficulty and can be used to justify a higher interest rate. Often in a related party context any subordination will not affect the amount the parent (or other lender within the group) would receive in the event the subsidiary failed. Arrangements with subordination will have that subordination disregarded by section GC 18(3)(g) for the purpose of calculating the interest rate.

Exotic features

Exotic features are those generally not seen with third-party lending. Section GC 18(3) provides a list of features that will be disregarded in determining the transfer price for cross border related borrowing, which include:

- payment other than in money (for example, repaying a loan by issuing shares)
- interest payment deferral beyond 12 months;

- options which give rise to premiums on interest rates (for example, on early repayment by the borrower);
- promissory notes or other instruments which do not provide rights to foreclose/accelerate repayment in the event of borrower default;
- contingencies (for example, where interest is repaid only under certain conditions).

Deferral beyond 12 months

Any increased interest rate that arises where payment of interest is made less than annually to the extent that increase is due to the increased risk of default due to interest being deferred beyond 12 months is disregarded. This provision will not apply where the increase in interest reflects the loss of the ability to reinvest the deferred interest so that the effective rate of return is the same as if the interest was not deferred.

Example 4

The arm's length rate if a borrower borrows $100 with annual interest is 5%. If instead, the borrower issues a zero-coupon bond for $100 with a $127.63 redemption payment in 5 years' time section GC 18(3)(b) will not apply as this bond has the same 5% interest rate. Any higher interest rate, for example to compensate for the higher credit risk from longer exposure to the borrower, will be disregarded.

Third party features

While generally the above features will be disregarded under the new rules for cross-border related borrowing, they will be taken into account under section GC 18(9) if the borrower (or its worldwide group, if it is part of one) has a significant amount of third-party debt with that feature.

The extent to which disregarded features can be taken into account depends on the structure of either the borrower's (or its worldwide group's) third-party debt. That is:

- the borrower's related-party debt can have a disregarded feature in proportion to its third-party debt. For example, if the borrower has $100m of senior third-party debt and $50m of subordinated third-party debt, related-party debt that is 2:1 senior:subordinated would be allowable; or
- the character of debt owed by the borrower matches the character of the borrower's group's third-party debt provided that type of debt is commercially appropriate in the New Zealand context. For example, say on a worldwide consolidated basis the borrower's group has $200m of ordinary debt and $50m of convertible notes. If the borrower has $40m of ordinary related-party debt, this means that up to $10m of convertible related-party debt would be allowable (as this means the borrower's debt character – a 4:1 mix of ordinary and convertible debt – would match that of its group).

In order for the borrower to use its own third-party debt to justify an otherwise disregarded feature, that third-party debt must be significant. That is the related-party debt with a feature cannot be more than 4 times the third-party debt with that feature. This is to prevent taxpayers agreeing to small amounts of expensive third-party debt in order to justify expensive related-party debt.

Terms greater than 5 years

Section GC 18(4) to (8) determines whether a term greater than 5 years is disregarded for the purposes of calculating the interest rate.

Section GC 18(4) includes that the 5-year term restriction does not apply to instruments that qualify as regulatory capital under section GC 18(10). This is explained further in the insuring or lending persons section below.

For New Zealand borrowers that are not an "insuring or lending person" whether a term of over 5 years can be included in calculating an interest rate is determined under a similar process to the general third-party features test above. The rules are necessarily more complicated for the over 5 years terms exclusion as not all loan terms can be treated equally; for example, a 6-year term third party loan could not be used to justify a 30-year term related party loan.

The third-party exception can either be (at the option of the taxpayer) based on third party debt of the worldwide group or third-party debt of the New Zealand group. Due to minor differences in terminology this decision affects which subparagraphs of sections GC 16(4) to (8) apply. This choice is also consistent with the choice available for other disregarded features in section GC 18(9)(a).

The threshold term is calculated at the date the loan was entered into renewed or extended rather than the remaining term.

The following table sets out the steps a taxpayer must go through to if they seek to apply the third-party exception to a loan with a term over 5 years:

Step	Reference if using worldwide group third party debt	Reference if using New Zealand third party debt
1. Choose whether the calculation is based on worldwide or NZ third party debt	GC 18(5)(a)(i)	GC 18(5)(a)(ii)
2. Calculate the threshold term – weighted average term of third-party debt with a term over 5 years	GC 18(6) using GC 18(7)(a), (b) and (c)(i)	GC 18(6) using GC 18(7)(a), (b) and (c)(ii)
3. Calculate the threshold fraction – proportion of third-party debt with a term over 5 years	GC 18(5)(b)(i)	GC 18(5)(b)(ii)
4. No adjustment is required if: • the related party term is less than (or equal to) the threshold term; and • the proportion of related party debt with a term over 5 years is less than (or equal to) the threshold fraction	GC 18(5)(a)(i) and (b)(i)	GC 18(5)(a)(ii) and (b)(ii)
5. Term is adjusted to the threshold term if: • the related party term is greater than the threshold term; • the proportion of related party debt with a term over 5 years is less than (or equal to) the threshold fraction; and • related party debt with a term over 5 years is less than 4 times third party debt with a term over 5 years.	GC 18(8)(a)(i), (a)(ii) and (b)(ii)	GC 18(8)(a)(i), (a)(ii) and (b)(iii)
6. Term is adjusted to 5 years if: • the proportion of related party debt with a term over 5 years is greater than the threshold fraction; or • related party debt with a term over 5 years is (equal to or) more than 4 times third party debt with a term over 5 years	GC 18(8)(b)(i) or (b)(ii)	GC 18(8)(b)(i) or (b)(iii)

Example 5

Foreign Parent Ltd has debt from third parties of the following amounts and terms:

Loan	Principal	Original term at issue
#1	$70 million	Less than 5 years
#2	$10 million	7 years
#3	$10 million	9 years
#4	$10 million	11 years
Total	$100 million	

The threshold term under section GC 18(5)(a)(i) is 9 years, which is calculated under section GC 18(6) as:

Loan	Term	Term Debt	Long-term Debt	Threshold Term
#2	7 years	$10 million	$30 million	2.3 years
#3	9 years	$10 million	$30 million	3.0 years
#4	11 years	$10 million	$30 million	3.7 years
Total				9 years

The threshold fraction under section GC 18(5)(b)(i) is $30 million/$100 million or 3/10.

NZ Subsidiary Ltd[4] has existing loans of $700,000 from Foreign Parent with a term of less than 5 years. It enters into three further loans with Foreign Parent with terms over 5 years on successive days and needs to consider what term will be included for setting the interest rate.

[4] For simplicity for the purpose of this example disregard the $10 million de minimis in GC 18(2)(a).

Loan 1

A $50,000 loan with a term of 7 years.

- Section GC 18(8)(a) does not apply as the term of the loan (7 years) does not exceed the threshold term (9 years).
- Section GC 18(8)(b)(i) does not apply as related party loans having a term of more than 5 years ($50,000) as a proportion of total related party loans ($700,000 + $50,000 = 750,000) is 6.7% which is less than the threshold fraction of 30%.
- Section GC 18(8)(b)(ii) does not apply as related party loans having a term of more than 5 years ($50,000) is less than 4 times the value of worldwide loans with this feature (4 × $30,000,000).
- Section GC 18(8)(b)(iii) does not apply as the threshold fraction was not determined under subsection (5)(b)(ii).

Therefore the 7-year term is not adjusted and is included in calculating the interest rate.

Loan 2

A $100,000 loan with a term of 11 years.

- Section GC 18(8)(a)(i) applies as the term of the loan (11 years) exceeds the threshold term (9 years).
- Section GC 18(8)(a)(ii) applies as related party loans having a term of more than 5 years ($50,000 + $100,000 = $150,000) as a proportion of total related party loans ($750,000 + $100,000 = $850,000) is 17.6% which is less than the threshold fraction of 30%.

Therefore the 11-year term is adjusted to the threshold term of 9 year for the purpose of calculating the interest rate.

Loan 3

A $200,000 loan with a term of 9 years.

- Section GC 18(8)(a) does not apply as the term of the loan (9 years) does not exceed the threshold term (9 years).
- Section GC 18(8)(b)(i) applies as related party loans having a term of more than 5 years ($150,000 + $200,000 = $350,000) as a proportion of total related party loans ($850,000 + $200,000 = $1,050,000) is 33.3% which exceeds the threshold fraction of 30%.

Therefore the 9-year term is adjusted to 5 years for the purpose of calculating the interest rate.

Example 6

Foreign Co has three senior unsecured loans from third parties. These are each for US$100 million and had terms at issue of 5 years, 10 years and 15 years respectively, so the average maturity of their long-term senior unsecured debt is 10 years.

NZ Co, a wholly owned subsidiary of Foreign Co, has a loan from Foreign Co for NZ$20 million with a term of 10 years.

The threshold term is 12.5 years (as the 5-year loan is not included in the calculation). The threshold fraction is US$200 million/US$300 million or 2/3. NZ Co's related party debt with a term of more than five years as a fraction of total related party debt is NZ$20 million/NZ$20 million or 1/1. This exceeds the threshold fraction. So, for the purposes of calculating the deductible interest on the related party loan, the term of the loan from Foreign Co would be adjusted to 5 years.

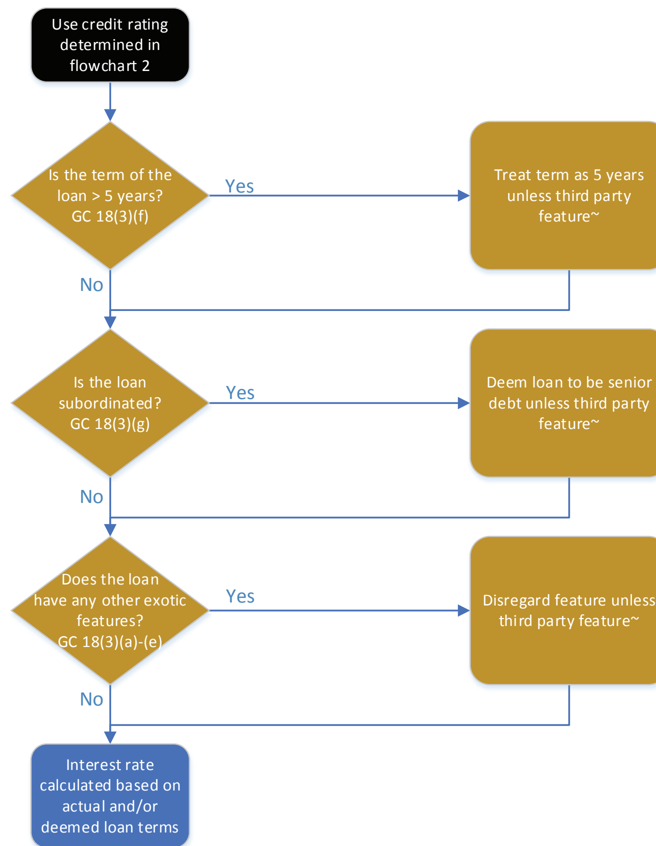
Suppose Foreign Co chooses to restructure its loan to NZ Co by lending NZ$10 million for 5 years and NZ$10 million for 12.5 years and using this to repay the original NZ$20 million loan. NZ Co's average term of related party debt greater than 5 years is now 12.5 years and its related party debt with a term of more than five years as a fraction of total debt is NZ$10 million/NZ$20 million or 1/2. These amounts are less than or equal to the threshold term and fraction, so no adjustment is made to the term of the 12.5-year loan under the restricted transfer pricing rule.

Example 7

NZ Co has a $100 million 30-year loan from its parent, Foreign Co and no third-party debt. The interest rate on this loan is reset on 1 January each year. Foreign Co has an embedded call option whereby it can demand repayment on the reset date provided it gives 30 days prior notice. Foreign Co does not face any more risk than if they provided a one-year loan that was rolled over each year.

The term of this loan would be required to be adjusted to 5 years, but the annual interest rate reset, and embedded call option would continue to be included in the pricing so it is unlikely any adjustment would be required to the amount of deductible interest.

Flowchart 3: Determining the interest rate on a particular instrument – not for insuring or lending persons



Key

~ A significant amount of long-term senior unsecured third party debt has feature, or feature is present in worldwide group, and feature in related party debt is in overall proportion with feature in third party debt.

Credit ratings of insuring or lending persons

Financial institutions (referred to in the legislation as an "insuring or lending person") are generally required to use the credit rating of the member of the group with the highest amount of debt rather than the default credit rating, restricted credit rating or group credit rating discussed above. There are two reasons for this:

- Financial institutions are more integral to their worldwide group in that a default is more likely to affect the risk perception of the worldwide group. This results in a higher level of implicit support.
- Financial institutions apply a different funding model from most other businesses, with much higher levels of leverage and, as interest is their main income source, calculating their debt percentage under the standard thin capitalisation rules is not appropriate.

An "insuring or lending person" is defined in section GC 15(2) to include the following persons:

- Banks, insurance companies and non-bank deposit takers regulated by the Reserve Bank of New Zealand.
- A member of a group or subgroup not regulated by the Reserve Bank of New Zealand whose main business is lending to third parties.
- An individual entity in the business of lending to third parties.

These last two bullet points are dealt with by section GC 15(2)(d) and (e) respectively.

An example of the last category is where a motor vehicle importer is a member of a group which also has a finance company to assist its customers to lease their vehicles. This will essentially require the group to be split into two for the purpose of applying the rules with the finance company subsidiary having a credit rating under section GC 17 and the motor vehicle importer applying section GC 16. If importing motor vehicles and operating a finance company was undertaken in a single company, the company would need to determine its main business activity so that it is treated for purposes of transfer pricing its debt as either an insuring or lending person or not.

Credit ratings

The default credit rating for insuring or lending persons is the group borrower's credit rating in section GC 17(a). Unlike the approach for non-insuring or lending persons there is no high-BEPS risk test and there is no difference between the group borrower's rating and the New Zealand borrower's rating. In many instances, including the majority of the banking industry on their current ratings, this should not provide a practical restriction as the New Zealand rating is already the same as the group borrower's. Even if the group borrower and New Zealand subsidiary ratings diverge in the future this may not impose a restriction in practice due to the availability of the optional credit rating – which is explained further below.

Although the credit rating must be the same as the group borrower's, this does not require the interest rates on identical debt to also be identical. If there is market observable data that a New Zealand financial institution with the same credit rating as its group borrower pays a higher or lower interest rate for an equivalent instrument, then the new rules will not prevent that differential also applying in the determination of interest rates on cross-border related borrowing.

One notable example that has been identified is the credit rating of certain insurance companies. Many insurance companies, either internationally or in New Zealand, will have a high credit rating but little or no debt compared with another entity in the group that will have a slightly lower credit rating but the majority of borrowing for the group. As noted above, the group borrower's credit rating is based on the entity in the group with the highest amount of long-term senior unsecured debt. Therefore, the credit rating of the insurance group will be based on the credit rating of the entity that borrows externally which will be lower than the credit rating of the insurance company. This lower rating should more accurately reflect the actual borrowing costs of the group.

There are two alternative methods of determining the credit rating. The first is a $10 million de minimis in section GC 17(b). This is consistent with the $10 million de minimis for non-insuring or lending persons and allows an insuring or lending person with less than $10 million of cross-border related borrowing to apply the credit rating that would apply under the standard transfer pricing rules in the absence of the restricted transfer pricing rule.

The second alternative method is the optional credit rating in GC 17(c). This follows the same methodology as the optional credit rating for non-insuring or lending persons. The borrower can use the credit rating implied from this debt for up to four times the value of the third-party debt. Further detail on this method is provided in the non-insuring or lending person section above.

Regulatory capital of banks, insurers and non-bank deposit takers

The Reserve Bank requires banks, insurance companies and non-bank deposit takers to hold certain levels of capital to support their operations. Some of this regulatory capital can take the form of debt with deductible interest for tax purposes.

There are legitimate commercial reasons why multinational banking and insurance groups often issue regulatory capital in their home country, and then invest some of that regulatory capital down into other countries where they operate. Where this capital is passed down to New Zealand, it would not necessarily satisfy the general third-party exception as:

- the foreign parent will often be subject to different regulatory requirements in its home jurisdiction so will have issued instruments with different features; or
- the worldwide group may have a more comprehensive range of activities in its home jurisdiction. An example is a group that operates a bank and an insurance company internationally but only operates as an insurance company in New Zealand.

It is important that the tax rules do not discourage the existence of regulatory capital as that increases the risk of that business being unable to meet its obligations to depositors, policy holders or other creditors.

For banks, insurance companies, and non-bank deposit takers, the third-party test is replaced with a regulatory capital test in section GC 18(10). This test allows a bank, insurance company or non-bank deposit taker to include features in pricing related party debt if that feature was required for the instrument to be recognised by the Reserve Bank as regulatory capital or solvency capital, even where those features would otherwise have to be disregarded under the restricted transfer pricing rules.

There are four further areas of detail on this regulatory capital test which are:

- minimum standards;
- terms;
- disqualification; and
- back-to-back loans.

Minimum standards

Banks, insurance companies and non-bank deposit takers usually maintain regulatory capital above the minimum standards, primarily so they can remain above the standards if a future event, including losses and payments of dividends, causes their regulatory capital to drop. Banks can also issue different levels of capital depending on what features it has. Potential loss of interest deductions should not discourage this behaviour. Any features that are required to meet the Reserve Bank requirements should be included in pricing even where the regulatory capital is over the minimum standard or where the entity issues a type of capital that has a greater risk than another type of capital.

Terms

Under the current regulatory framework, banks can issue Tier 2 capital which, amongst other requirements, must have a minimum original maturity of at least five years. However, when such an instrument has less than five years to maturity, the amount that is recognised as regulatory capital is amortised on a straight-line basis at a rate of 20% per annum as follows:

Years to maturity	Amount recognised
More than 4	100%
Less than and including 4 but more than 3	80%
Less than and including 3 but more than 2	60%
Less than and including 2 but more than 1	40%
Less than and including 1	20%

Due to this amortisation, banks are incentivised to issue Tier 2 capital for terms exceeding the minimum 5 years. Section GC 18(4) recognises this by allowing any term of greater than 5 years to be included in pricing on any instrument that is recognised as regulatory capital, even though that longer term is not required in order for the instrument to qualify as regulatory capital.

Section GC 13(1)(b) still requires identifying conditions that independent parties after real and independent bargaining might be expected to agree upon for the comparable transactions. This means terms would not be expected to be significantly longer than the term of equivalent Tier 2 capital issued to third parties, or where there is no such capital what would be expected to be agreed by a New Zealand borrower who was issuing Tier 2 capital to third parties.

Disqualification

From time to time, the Reserve Bank changes the regulatory capital requirements. For example, it is currently consulting on removing the requirement for regulatory capital to convert to common equity in certain circumstances. Where there is a regulatory change there will often be a transitional period where a former regulatory capital instrument will only be partially recognised and will eventually cease to qualify as regulatory capital. Where this occurs, the bank or insurance company will not necessarily repay the instrument as there may be other commercial reasons to retain it (such as meeting the expectations of external investors). The features that formerly qualified it as regulatory capital will still be present, even where it ceases to qualify as regulatory capital. In these circumstances, these features will still be included in the pricing, so the test is based on the instrument qualifying as regulatory capital when it was entered into rather than any subsequent changes.

Officials will monitor the use of this provision and would not expect an insuring or lending person to maintain high priced related party debt that no longer qualifies as regulatory capital when there is no commercial reason to do so other than to obtain a higher tax deduction than on a new instrument, especially when equivalent third-party instruments have been repaid.

Back-to-back loans

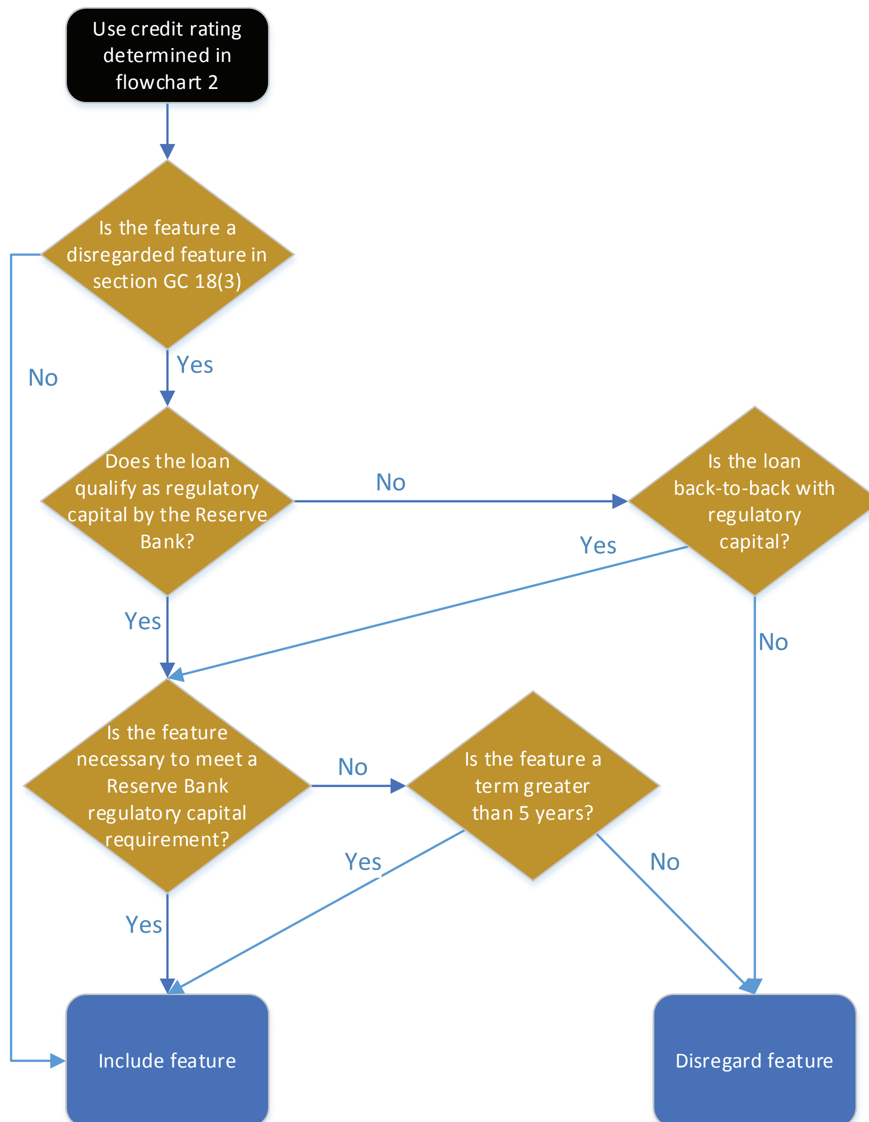
Some banks, insurance companies and non-bank deposit takers have an entity, such as a New Zealand holding company or a New Zealand branch of the foreign parent, which is not itself regulated by the Reserve Bank but raises funds from the worldwide group to on-lend to the regulated entity. A consequence of this is a New Zealand taxpayer may receive high priced debt with features that provide no direct benefit to it as a stand-alone entity but will match the instrument/funding on-lent to a group member which is regulated and therefore the group is provided with a regulatory benefit.

Any features included in an instrument issued by a non-regulated entity that would be necessary for it to qualify as regulatory capital (refer to the tests discussed above) if the entity was a regulated entity will be included in pricing provided that instrument is part of a back-to-back loan to the regulated entity/group. These two instruments are referred to in the legislation as the funding arrangement and the funded arrangement.

This is achieved in section GC 18(10)(b), (d) and (f) by requiring that the feature "reflects" a feature of regulatory or solvency capital. This term is not intended to require perfect mirroring between features of the funding and funded arrangements, but this should not provide the opportunity for inclusion of any features in the funding arrangement under the pretext of imperfect mirroring. The inclusion or non-inclusion of a feature in the funding or funded arrangement should not prevent that instrument qualifying in respect of other features. Where more judgement is required is where a different feature is included in the funding arrangement than in the funded arrangement. An appropriate approach would be to include a feature in a funding arrangement, which does not exactly match a feature in a funded arrangement, only if the feature provides protection to the banking/insuring/deposit taker associate in a similar circumstance to that faced under the funding arrangement. Furthermore, the increase in price due to the feature in the funding arrangement should not exceed the increase in price due to the feature in the funded arrangement.

Not all regulatory capital will be a financial arrangement as a bank may also issue preference shares which are an excepted financial arrangement. The rules also allow the funded arrangement to be an excepted financial arrangement while the funding arrangement is a financial arrangement. In this instance, it is expected that the terms of both arrangements will less perfectly mirror each other than where the funded arrangement is a financial arrangement; however, the paragraph above that discusses the limits on features of the funding arrangement will continue to be relevant.

Flowchart 4: Determining whether a feature can be included in pricing for banks, insurance companies and non-bank deposit takers



THIN CAPITALISATION

Sections EX 20D, EX 20E, FE 5, FE 6, FE 8, FE 10 – FE 12, FE 14 – FE 16B, FE 18, FZ 8, GB 51B, and YA 1 (total group non-debt liabilities) of the Income Tax Act 2007

Debt percentages determined under the thin capitalisation rules have historically been based on an entity's debt relative to its gross assets. The thin capitalisation rules in subpart FE have been amended so that debt percentages will now be based on an entity's assets net of its "non-debt liabilities".

A number of other changes have been made to strengthen the thin capitalisation rules. These are:

- a de minimis in the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;
- new rules for when a company can use an asset valuation for thin capitalisation purposes that is different from what is used for financial reporting purposes;
- an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of a year to circumvent the thin capitalisation rules; and
- a minor remedial to clarify how the owner-linked debt rules apply when the borrower is a trust.

Application date

These amendments apply to income years starting on or after 1 July 2018. Grandparenting for five years has been included for the 110 percent debt threshold for non-residents acting together, which is set out in more detail below.

Key features

The thin capitalisation rules in subpart FE have been amended so that the debt percentages are based on an entity's assets net of its non-debt liabilities. This applies to both inbound and outbound thin capitalisation.

There are consequential amendments to the Controlled Foreign Company (CFC) rules in subpart EX of the Act to ensure the non-debt liabilities adjustment applies in relation to the CFC rules where relevant.

A number of other changes have also been made to the thin capitalisation rules. These changes have:

- extended the **de minimis** in section FE 6 of the outbound thin capitalisation rules (New Zealand companies with foreign subsidiaries) to the inbound thin capitalisation rules (foreign controlled New Zealand companies);
- reduced the 110 percent worldwide debt threshold to 100 percent for a NZ group controlled by a group of **non-residents acting together** for the purposes of the interest apportionment rule in section FE 6;
- strengthened the integrity of the rules that allow taxpayers to **value assets** using values not reported in their financial accounts for the purposes of determining total group assets under section FE 16;
- introduced an **anti-avoidance rule** in new section GB 51B to prevent taxpayers circumventing the thin capitalisation rules by repaying a loan just before a measurement date; and
- amended the owner-linked debt provisions in section FE 18(3B) to ensure they operate correctly for trusts.

Background to non-debt liabilities

The thin capitalisation rules form part of New Zealand's international tax rules and are designed to protect our tax base. Like many countries, New Zealand has been reviewing its thin capitalisation/interest limitation rules in light of the OECD's 2015 Final Report, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, on Action 4 of the BEPS Action Plan. This review identified aspects of New Zealand's thin capitalisation rules that could be strengthened, and these aspects were subject to public consultation that followed the release of the Government discussion document, *BEPS – Strengthening our interest limitation rules*, in March 2017.

New Zealand's thin capitalisation rules are based on the principle that a multinational group should not have significantly less capital in New Zealand, relative to the size of its New Zealand business, than it has on a worldwide basis, unless it has no more than a 60% debt/assets ratio. Historically this comparison has been made by comparing the ratio of debt to assets for the New Zealand group with the same ratio for the worldwide group. This measure did not deal well with companies with non-debt liabilities. When a New Zealand group has significant non-debt liabilities, its debt/assets ratio can appear relatively low, even though it has very little equity contributed by its owners. The thin capitalisation rules in subpart FE have been amended to prevent this, by excluding non-debt liabilities from the definition of assets.

The non-debt liabilities change better aligns New Zealand's thin capitalisation regime with its core objectives and with other countries' thin capitalisation rules.

Detailed analysis

Non-debt liabilities adjustment

Section FE 12 has been amended so that in calculating its New Zealand group debt percentage, an entity will be required to measure its assets net of its non-debt liabilities, as defined in section FE 16B.

In addition, there are consequential amendments to sections EX 20D and EX 20E to ensure the non-debt liabilities adjustment also applies in relation to the CFC rules where relevant.

Section FE 16B has separate, albeit similar, definitions for non-debt liabilities, depending on whether they are being calculated for the New Zealand group (section FE 16B(1)) or the worldwide group (section FE 16B(2)).

Non-debt liabilities for New Zealand group – section FE 16B(1)

For a New Zealand group, non-debt liabilities are all liabilities shown in the entity or group's financial statements, except for:

- liabilities that are debt under section FE 15;
- certain interest-free loans from shareholders;
- certain shares held by shareholders;
- provisions for dividends; and
- certain deferred tax liabilities.

This effectively means that non-debt liabilities comprise the liabilities that are not debt, nor shareholder funding that is akin to group equity, and certain deferred tax liabilities. This represents a broad range of liabilities that include, but are not limited to:

- trade credits;
- GST payable;
- provisions and accruals for employee benefits such as wages, bonuses, redundancy and holiday pay and long service leave;
- financial liabilities from derivatives such as interest rate swaps and foreign exchange contracts; and
- current and deferred tax liabilities.

The exclusions in paragraphs FE 16B(1)(a) to (c) are covered in more detail below.

Debt liabilities

Paragraph (a) excludes from non-debt liabilities any liabilities that are counted as debt under section FE 15. This includes, but is not limited to, financial arrangements that provide funds to the entity and give rise to deductions for the entity. Financial arrangements that provide funds include finance leases and some credit sales. This is discussed in the definition of "cross-border related borrowing" above.

The primary example of debt liabilities under section FE 15 is interest-bearing debt.

Interest-free loans from shareholders

Paragraph (b) excludes from non-debt liabilities any financial arrangements providing funding to the entity if either:

- the funding is advanced pro rata with shareholding; and/or
- the shareholder (along with any associated persons) holds 10 percent or more of the voting interests in the company.

This is because such loans are akin to group equity if they are held pro rata with shareholding, or by a substantial shareholder.

This exclusion is targeted at interest-free loans from shareholders.

The exclusion does not include related-party agreements for the sale and purchase of property or services (defined in section YA 1 and colloquially known as trade credits), which will therefore be treated in the same way as other non-debt liabilities. Trade credits are treated this way because the price payable for the corresponding goods or services is generally increased by an implicit interest charge for the deferral of payment, and therefore it is not appropriate to treat them as non-interest bearing.

As drafted, the exclusion only applies to a loan from a shareholder.

Example 8

A Co is owned by two non-resident shareholders in the following proportions: B Co (80%) and C Co (20%). B Co and C Co provide a combination of interest-bearing and interest-free loans in proportion to their shareholdings.

The interest-bearing loans are debt under section FE 15 and therefore are not non-debt liabilities under section FE 16B(1)(a).

The interest-free loans are not debt under section FE 15 but also are not non-debt liabilities under section FE 16B(1)(b) as the loans are advanced in proportion to shareholding.

Therefore, neither the interest-bearing nor interest free loans should be treated as non-debt liabilities for thin capitalisation purposes.

This means the interest-bearing loans will have the same effect on A Co's thin capitalisation calculation as any other third party loan, while the interest free loans will have the same effect as shareholder equity.

This exclusion (like those in paragraphs (c) and (d) of section FE 16B(1)), does not apply funding to a trust, other than a unit trust.

Preference shares

Shares can be treated as liabilities for accounting purposes in some circumstances (for example, if the shares are redeemable at the holder's option or on a specific date).

Paragraph (c) excludes shares held by a shareholder from the definition of a non-debt liability if either:

- the funding is advanced pro rata with shareholding; and/or
- the shareholder (along with any associated persons) holds 10 percent or more of the voting interests in the company.

Similar to the exclusion targeted at interest-free loans in paragraph (b) such shares are akin to group equity if they are held pro rata with shareholding, or by a substantial shareholder. Otherwise it is appropriate for them to be excluded in determining the extent of equity funding in a New Zealand group. They are commercially more in the nature of third-party funding, rather than equity.

Provisions for dividends

Paragraph (d) excludes a provision for dividends from the definition of a non-debt liability. This is because it is similar in substance to an interest-free loan from shareholders.

Deferred tax liabilities

Paragraph (e) excludes a deferred tax liability from the definition of a non-debt liability if it satisfies three requirements. The general purpose of these requirements is to exclude a deferred tax liability only if it has in effect already been taken into account in the valuation of the relevant asset. The three requirements are as follows:

- It arises as a result of the difference between the value of an asset in the financial statements and the amount which remains depreciable or deductible for tax purposes.
- It reflects an amount of tax that would not arise if the relevant asset were sold for the value in the financial statement.
- The value of the relevant asset in the financial statements takes into account the deduction or depreciation actually available for tax purposes in relation to the asset (rather than the deduction or depreciation recorded in the financial statements), or on the basis that the asset is non-depreciable or depreciable at a rate of zero.

The first limb will be met relatively often, due to either a difference between accounting and tax depreciation rates, or asset revaluations. For example, suppose a building acquired in 2011 for $10m. The building is revalued in the 2018 financial statements to $15m. This gives rise to a deferred tax liability of $1.4m. The liability arises as a result of the difference between the building's value in the financial accounts ($15m) and the depreciable amount for tax purposes ($0). It therefore comes within the first limb of section FE 16B(1)(e).

The second limb means that a deferred tax liability relating to a depreciable asset can only be excluded from being a non-debt liability to the extent that it is higher than the tax that would be payable if the asset was sold for its accounting value. This means that a deferred tax liability should be taken into account to the extent it reflects tax that would be paid on depreciation recovery income if the asset was disposed of.

The third limb reflects the "no double-counting" purpose of the exclusion. If the valuation of an asset already reflects the limited amount of depreciation available for tax purposes, it is not appropriate for the difference between accounting and tax depreciation to be taken into account again by way of the reduction in the thin capitalisation denominator for non-debt liabilities. For instance, in the case of a building which is revalued after buildings became depreciable at a rate of 0% (i.e. the 2011-12 income year), the accounting value of the building would be expected to recognise there are no depreciation deductions. This means the debt percentage calculation takes into account, through the calculation of the asset amount, the non-depreciable nature of the building for tax purposes. It is not then appropriate to make a further reduction in the debt percentage calculation. Any valuation based on the market value of the building after the 2011-12 tax year would be expected to reflect its non-depreciability, and therefore to mean that section GC 16(1)(e)(iii) is met with respect to any deferred tax liability in respect of that asset. However, a valuation based on the net present value of future cash flows might not take non-depreciability into account, in which case those requirements would not be met.

For the avoidance of doubt, the third limb should not exclude a deferred tax liability relating to a building which was acquired before buildings became depreciable at a rate of 0% (i.e. the 2011-12 income year), if the building has not been revalued in the financial statements since that time. In that case, the value (say, the original cost) of the building in the financial statements reflects an assumption of depreciability, so it is reasonable that the deferred tax liability does reduce the thin capitalisation denominator.

Example 9

D Co is currently recognising a deferred tax liability on its buildings of $4.2m calculated as follows:

Accounting Base	Tax Base	Temporary Difference	Tax Rate	DTA/(DTL)
15m	0	15m	28%	(4.2m)

D Co purchased the building in 1995 for $20m. It claimed tax depreciation of $8m on the building until the depreciation rate was reduced to 0% from the 2011-12 income year. The building has not been revalued for accounting purposes since that time although accounting depreciation continues to reduce its carrying value which is currently $15m. Because the building is held for use rather than sale, this results in a deferred tax liability of $4.2m which is recognised in the financial statements.

Question

Can any of the deferred tax liability be excluded from being a non-debt liability under section FE 16B(1)(e)?

Answer

No. The accounting value of $15m has not been revalued to take into account the 0% depreciation on the building for tax purposes. Therefore, the third limb of section FE 16B(1)(e) is not met.

Example 10

The facts are the same as above, except that the building has been revalued for accounting purposes post-the 2011-12 income year to $30m. The revaluation was undertaken on a discounted cash flow basis that reflects that there is no tax depreciation shield from the building.

Accounting Base	Tax Base	Temporary Difference	Tax Rate	DTA/(DTL)
30m	0	30m	28%	(8.4m)

Can any of the deferred tax liability be excluded from being a non-debt liability under section FE 16B(1)(e)?

Yes. The first limb is met. The second limb is met to the extent that the deferred tax liability exceeds the tax liability that would arise if if the building was sold for $30m.If the building were sold for $30m, D Co would have a tax liability of $2.24m, being $8m of depreciation recapture income x 28%. The amount of the DTL that is within paragraph (ii) is therefore $8.4m - $2.24m = $6.16m. The third limb is met as the $30m valuation takes into account that tax depreciation on buildings is 0%.

This means that $2.8m of the DTL of $6.16m will be excluded from being a non-debt liability under section FE 16B(1)(e).

Example 11

Y Co's balance sheet is as follows:

Assets	200
Interest-bearing debt	50
Deferred tax liability*	30
Provision for dividends	15
Equity	10

*The deferred tax liability may be split into $10 that meets criteria of section FE 16B(1)(e) and $20 that does not. The $10 deferred tax liability may reflect that the accounting value recognised in the financial statements for a particular class of assets already takes into account the level of tax depreciation shield available for those assets.

Z Co's debt for the purposes of the thin capitalisation rules is $50. Its total liabilities are $95, but $15 of this is a provision for dividend and $10 of the deferred tax liability meets the criteria of section FE 16B(1)(e). Both of these are excluded from being non-debt liabilities. Its non-debt liabilities are $20 (the non-excluded portion of the deferred tax liability) and its thin capitalisation percentage under section FE 12 is 50 ÷ (200 – 20) = 27.8%.

Note that Z Co may not wish to consider whether any component of its deferred tax liability meets the criteria of section FE 16B(1)(e). In such a case, it treats the full quantum of the deferred tax liability as a non-debt liability and it would calculate its thin capitalisation percentage under section FE 12 to be 50 ÷ (200 – 30) = 29.4%.

Example 12

Z Co's balance sheet is as follows:

Assets	100
Interest-bearing debt	20
Non-debt liability – trade credits	10
Interest free loan from parent	20
Equity	50

Z Co's debt for the purposes of the thin capitalisation rules is $20. Its total liabilities are $50, but $20 of this is an interest-free loan from Z Co's parent company and $20 is debt, which are both excluded from being non-debt liabilities. Its non-debt liabilities are therefore $10 (trade credits) and its thin capitalisation debt percentage under section FE 12 is 20 ÷ (100 – 10) = 22.2 percent.

Non-debt liabilities for worldwide group – sections FE 16B(2) and FE 18

For a worldwide group, non-debt liabilities means:

- all liabilities (as shown in the entity's financial statements) that are not counted as debt under section FE 18; less
- any owner-linked debt that is excluded under section FE 18(3B), as such debt is treated as equity for the purposes of the worldwide group debt test.

This is similar to the definition of non-debt liabilities for a New Zealand group, although there are fewer exclusions.

Consequential amendments to the CFC rules – sections EX 20D and 20E

In calculating the net attributing CFC income or loss for a CFC, sections EX 20D and EX 20E outline rules to help determine the deductibility of interest expenditure for excessively-debt funded CFCs. The test for whether a CFC is considered to be excessively debt-funded is whether it has a debt-asset ratio, determined under section EX 20D(4), of more than 75 percent and also has a relative debt-asset ratio, determined under section EX 20E, of more than 110 percent.

Similar to the changes to the thin capitalisation rules in subpart FE, sections EX 20D and EX 20E have been amended to reflect that non-debt liabilities should be deducted from the denominator of the formula in calculating the CFC's debt-asset ratio and the CFC's relative debt-asset ratio. The meaning of non-debt liabilities for the purposes of these calculations is the total value of the non-debt liabilities determined under generally accepted accounting practice for the CFC and group respectively, as provided in sections EX 20D(8B) and (6B) respectively.

De minimis for inbound thin cap

Section FE 6(3)(ac)(i) provides a de minimis which means that a person subject to the outbound thin capitalisation rules does not derive an amount of income (equivalent to any disallowed interest) if they have a group finance cost for a year of less than $1 million. The de minimis reduces between $1 million to $2 million of group finance cost.

This is achieved by section FE 6(ac)(ii) or (iii), which reduce the amount of income derived by an excess debt entity, but only where paragraph (i) does not apply.

Amendments to section FE 6(3)(ac) have extended this de minimis to a person subject to the inbound thin capitalisation rules unless they have owner-linked debt – that is debt from a person with an ownership interest in the entity – under section FE 18(3B).

This change is intended to reduce compliance costs for smaller firms.

Worldwide debt test for non-residents acting together

The inbound thin capitalisation rules were extended with application from the 2015-16 tax year to include New Zealand entities owned by non-residents that act together as a group in relation to the way they fund a New Zealand investment and own 50 percent or more of that entity (we refer to these New Zealand entities as "group controlled").

The 2015-16 changes also tightened what is known as the "110 percent worldwide debt test" in the inbound rules, which compares the amount of debt in a group's worldwide operations to the debt in their New Zealand operations. The effect of section FE 18(3B) is that owner-linked debt (as discussed above) is excluded when calculating the worldwide debt percentage.

A New Zealand group's allowable debt percentage under section FE 5(1)(a) is the greater of 60 percent of its assets and 110 percent of its worldwide debt percentage. For a group controlled New Zealand entity, the worldwide group is the New Zealand group itself under section FE 31D, as a company owned or controlled by a group of non-residents acting together has no identifiable parent. As such, the 110 percent worldwide debt test is effectively a measure of the New Zealand group's total debt relative to its third-party debt.

This means that shareholders of group controlled entities with high levels of third-party debt were able to invest in New Zealand predominantly through owner-linked debt. For example, a project funded 90 percent with third-party debt could have 9 percent shareholder debt and only 1 percent equity without breaching the thin capitalisation limit.

Sections FE 5(1)(ab) and FE 6(3)(e)(iii) require that when a taxpayer has a worldwide group given by section FE 31D, interest deductions will be denied if the entity has any owner-linked debt and its total debt level exceeds 60 percent. In effect, this means that its allowable debt level is the greater of 60 percent and 100 percent of its third-party debt rather than the greater of 60 percent and 110 percent of its third-party debt as was previously the case.

Grandparenting

For relevant entities that are above 60 percent total debt and 100 percent of their third-party debt, transitional provisions have been included in section FZ 8. In determining its allowable debt level, A group-controlled entity can continue using its current percentage of its worldwide group debt percentage up to the 110 percent threshold for up to five years from the rules applying. The borrower's current percentage of third-party debt can be calculated at either the date of introduction of the Taxation (Neutralising Base Erosion and Profit Shifting) Bill (6 December 2017) or the thin capitalisation measurement date immediately prior to this.

Example 13

On 30 June 2018, NZ Co's worldwide group debt percentage is 70% and its debt percentage is 76.3% which is 109% of its worldwide debt percentage. NZ Co enters into a new loan with a third party in 2019. As a result, its debt percentage as a percentage of its worldwide group debt percentage drops to 105% (because NZ Co's related-party debt level has not changed since year 2018). NZ Co's allowable debt level under the transitional provisions will stay at 109% of its worldwide group debt percentage.

In 2020, NZ Co repays a number of large loans and, as a result, the debt percentage of its New Zealand group drops to 55%. NZ Co does not need to rely on its grandparented 109% of worldwide debt anymore, but is still covered by the grandparenting provisions for the remainder of the five-year period. This means that NZ Co will not be denied interest deductions if its debt percentage exceeds 60% in 2021 unless its debt percentage also exceeds 109% of its worldwide debt percentage.

NEW LEGISLATION

Asset valuation

In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative provided that would be allowable under generally accepted accounting principles.

Asset valuations reported in financial statements are subject to a higher level of scrutiny than asset valuations that are adopted solely for thin capitalisation purposes. Moreover, there was a concern that taxpayers may be valuing assets for thin capitalisation purposes without seeking an independent valuation.

New section FE 16(1BAA) provides that taxpayers can only use the net current value of an asset if they have received a valuation from an independent valuer or the valuation methodology, assumptions and data have been approved by an independent valuer.

This provision does not provide guidance on how frequently such a valuation must be undertaken. It would not be practical to expect a valuation to be undertaken for each period; however, times when a valuation may be necessary include where there is an impairment event for financial reporting purposes or if the taxpayer is seeking to increase the value.

Anti-avoidance rule around measurement dates

Section FE 8 provides a taxpayer's assets and liabilities can be valued for thin capitalisation purposes on a daily, 3 monthly, or annual basis. An annual measurement date is the simplest and most widely-used of these approaches.

Annual valuation means taxpayers can use the annual measurement date to effectively breach the thin capitalisation debt limits for up to one year without facing any interest denial, by partly repaying a loan or converting it to equity on or before their balance date.

Previously, section FE 11 prevented taxpayers from benefitting from temporary increases or decreases in values if the change had a purpose or effect of defeating the intent and application of the thin capitalisation rules. However, this section only applied to changes between measurement dates and did not cover the initial year when an arrangement was entered into.

Section FE 11 has been amended and new section GB 51B reconstructs certain situations, transactions or arrangements where a taxpayer subject to the thin capitalisation rules substantially repays a loan or, more generally, enters into a transaction near a measurement date with the purpose or effect of manipulating the thin capitalisation rules.

Owner-linked debt when the borrower is a trust

To reduce compliance costs, the owner-linked debt provisions in section FE 18(3B) only count debt as owner-linked if the owner has an ownership interest in a member of the group of companies of 5 percent or more. This test worked correctly when the entity was a company but not if it was a trust as settlements on a trust do not convey ownership interests.

Amendments to section FE 18(3B) now count debt as owner-linked if the owner:

- has a direct ownership interests in a member of the group of 5 percent or more; or
- has made 5 percent or more (by value) of the settlements on the trust.

Worldwide group debt percentage and the on-lending concession

Existing section FE 13 allows the debt percentage of a New Zealand group and a worldwide group to be reduced to the extent a person subject to thin capitalisation:

- has provided funds to an unrelated party or a related party outside the lender's NZ group; or
- is a trust with no property other than financial arrangements and incidental property.

This is known as the on-lending concession.

If a person (or group) who can rely on the on-lending concession has a mixture of funding from related and unrelated parties there was previously no guidance on which debt was reduced or how the reduction was allocated between the two sources of debt. This becomes a problem when the person is controlled by a non-resident owning body or trustee under section FE 31D so that the New Zealand group is the worldwide group.

New section FE 18(3B) confirms that when a person applies the on-lending concession the proportion of related and unrelated party debt remains the same as prior to the on-lending concession being applied.

INFRASTRUCTURE PROJECT FINANCE

Sections CH 10B, FE 4B, FE 7B and YA 1 of the Income Tax Act 2007

Amendments have been made that will provide entities carrying out eligible infrastructure projects a limited exemption from the thin capitalisation rules by allowing them to claim deductions on debt that exceeds the thresholds set out in section FE 5(1).

The debt that is allowed to exceed the ordinary thin capitalisation thresholds under this rule is limited to third-party debt (or debt that is from an investor but is made in the capacity of a third-party lender) that only has recourse against the assets associated with the infrastructure project and the income arising from those assets.

Background

This measure is intended to deepen the market and improve the competitiveness in the bidding process for eligible infrastructure projects by ensuring that investors are subject to similar levels of thin capitalisation restrictions.

New Zealand-owned entities have no thin capitalisation restriction on the level of third-party debt they can take on. Similarly, New Zealand entities owned by a group of non-residents (none of which have a controlling interest in their own right) are unrestricted in how much third-party debt they can take on (provided that debt is not guaranteed by the owners). The amendment effectively provides other entities (i.e. New Zealand entities controlled by a single non-resident) involved in eligible infrastructure projects with an exemption from the thin capitalisation rules if they only have third party debt.

Key features

The thin capitalisation rules have been amended to provide entities carrying out eligible infrastructure projects a limited exemption from the thin capitalisation rules by allowing them to claim deductions on debt that exceed the thresholds in section FE 5(1).

The debt that can exceed the ordinary thin capitalisation thresholds under the exemption is limited to third-party debt (or debt that is from an investor but is made in the capacity of a third-party lender) that only has recourse against the assets associated with the infrastructure project and the income arising from those assets.

Application date

The amendments apply to income years starting on or after 1 July 2018.

Detailed analysis

Public project assets

This exemption will apply only to debt that relates to public project assets – defined in section FE 4B(1), which are assets arising from a project performed under a contract that meets the following criteria:

- The project is established at the request of the New Zealand Government or a public authority.
- The project is to provide, upgrade, or create assets in New Zealand and to operate or maintain those assets.
- The contract is for a period of at least 10 years.
- The public funding relating to the contract is approved by the Minister of Finance.
- The contract provides that the assets are owned by the New Zealand Government or the public authority after the completion of the contract.

Public project debt

The exemption will apply only to public project debt – defined in section FE 4B(2). This debt must meet the following criteria:

- The debt is applied to:
  - a project in order to give rise to public project assets, or income derived from public project assets; or
  - refinance a loan that was public project debt, including previous refinances of public project debt.
- The debt must not be on-lent to a party that is not associated with the performance of the project, unless the on-lending is minor or incidental and the funds are still expected to be applied to the project. This is discussed further below under the heading on-lent funds.
- The debt must give rise to interest expenditure that is incurred in New Zealand.

Threshold debt amount

The threshold debt amount is the amount of debt that an entity carrying on an eligible infrastructure project could have without being required to apportion its interest expenditure under section FE 6. It is calculated by multiplying the value of the public project assets and assets used in performing the project by the threshold debt percentage given by FE 5(1). If the amount of public project debt is less than this amount, all interest on the public project debt will continue to be deductible, even if the debt is of a type that is not intended to receive the benefit of this exemption (public project participant debt and unrestricted debt). If the amount of public project debt exceeds this amount, only interest on debt that is intended to receive the benefit of the exemption will be deductible.

Public project participant debt

Public project participant debt, defined in section FE 4B(3) and used to define the item "member debt" in the formula in section FE 7B(4)(f), is public project debt issued by a participant in the infrastructure project that is made under an arrangement that has the purpose or effect of funding the project with debt equal to each participant's interest in the project.

Public project participant debt is not intended to get the benefit of the exemption. If this form of debt was able to get the benefit of the exemption, it could result in some private investors being able to allocate more debt to the infrastructure project than is appropriate.

Example 14 is an example of where the partners in a partnership that is performing an eligible infrastructure project contract partially fund the project using debt in a way in which the debt is effectively a substitute for equity.

Example 14

A Co, B Co and C Co, all of which are foreign companies, entered into a partnership called ABC Partnership. ABC Partnership entered into a contract with the New Zealand government to provide and maintain an asset for a 20-year period. All three partners have permanent establishments in New Zealand due to the activities of ABC Partnership.

In order to carry out the project, ABC Partnership required $100 million. All three partners contributed $5 million of capital contribution. In addition, ABC Partnership received a loan from Bank Co of $70 million at an interest rate of 10% p.a.

The final $15 million is provided in equal proportions by A Co, B Co and C Co by way of loans to ABC Partnership at a rate of 10% p.a.

All of the $70 million debt from Bank Ltd will be considered public project debt. All of the $15 million from the three partners will also be considered public project debt. However, it will also be considered to be public project participant debt, because it was advanced under an arrangement between the three partners in a way that allowed them to fund the partnership in proportion to their interest in the partnership.

Funding that is provided by a participant will not automatically be considered funding that is under an arrangement with a purpose or effect of allowing the participants to fund the project equal to their own ownership interests in the project. Examples 15 and 16 provide two types of situations in which debt from an investor in a project will not be public project participant debt.

Example 15

A Co, B Co and C Co, all of which are foreign companies, entered into a partnership called ABC Partnership. ABC Partnership entered into a contract with the New Zealand Government to provide and maintain an asset for a 20 year period. All three partners have permanent establishments in New Zealand due to the activities of ABC Partnership.

In addition to being a direct investor in infrastructure projects in New Zealand, C Co is also in the business of providing debt funding to a variety of New Zealand based projects. As a part of ABC Partnership's process of procuring adequate debt funding for the project, it was decided that a combination of debt facilities from Bank Ltd and C Co was the best available funding option.

Therefore, ABC Partnership obtained debt from Bank Ltd of $60 million at the beginning of the project at a rate of 10% p.a., with terms that gave Bank Ltd recourse solely to assets and income derived from the project. ABC Partnership also obtained debt from C Co of $15 million on the same terms as the debt facility from Bank Ltd.

The funds provided under the debt facility from C Co are applied by ABC Partnership to give rise to public project assets, which means that the debt will be public project debt. However, it will not be considered public project participant debt. This is because the debt facility was only provided by one of the three partners (C Co).

In addition, there is no evidence that this loan was made with the intent of being a substitute for C Co's capital contribution to the project.

NEW LEGISLATION

Example 16

A Co, B Co and C Co, all of which are foreign companies, entered in a partnership called ABC Partnership. ABC Partnership entered into a contract with the New Zealand government to provide and maintain an asset for a 20-year period. All three partners have permanent establishments in New Zealand due to the activities of ABC Partnership.

The partners agreed that capital contributions would be made once construction of the asset was complete.

ABC Partnership obtained debt from Bank Ltd of $60 million at the beginning of the project at a rate of 10% p.a., with terms that gave Bank Ltd recourse solely to assets and income derived from the project.

Before Bank Co would provide its debt facility, it required recourse to the capital contributions that all three of the partners would provide as a part of the project contract. Bank Ltd agreed that to secure this, each partner could provide a letter of credit, or provide the funds to ABC Partnership through a convertible debt instrument.

At the beginning of the project, B Co and C Co provided letters of credit for the amount of their capital contribution. A Co decided to provide debt funding to ABC Partnership using a convertible debt instrument. That instrument provided for a fixed rate of return at an arm's length price, and converted into A Co's partnership interest at the same time that B Co and C Co put in their capital contribution.

The convertible debt instrument is an arrangement that provides funding to the project, but it only provides funding from one of the partners (A Co). There is no evidence that the arrangement was designed with the purpose of allowing all of the participants to provide funding in proportion to their interests in the project. Further, rather than being a substitute for partnership interest, the convertible debt instrument is a substitute for the letters of credit provided by the other parties. As such, the convertible debt will not be public project participant debt.

On-lent funds

A loan will not be considered public project debt if it is on-lent to a third party, unless that on-lending is simply due to a delay in the application of the funds to the project. This is to prevent an excess debt entity that has an interest in an eligible infrastructure project from taking on more debt than is necessary for the project and applying that debt to a separate project, while still getting the benefit of these measures.

Depositing funds from a loan with a financial institution will generally be a delay in the application of funds to a project, unless it is intended that those funds will not be applied to the project.

Unrestricted debt

Unrestricted debt, defined in section FE 7B(4)(c), is public project debt that does not meet the definition of "public project participant debt" that is made on terms that give the creditor recourse that is not limited to the project. Recourse over public project assets, income derived from those assets and ownership interests in entities that are only involved in the infrastructure project will be recourse that is limited to the project. Unrestricted debt is not intended to receive the benefit of this concessionary rule.

"Public project participant debt" is excluded from this definition to ensure that debt that meets both definitions does not have its interest deductions denied twice, as well as ensuring that an excess debt entity is still allowed an amount of debt that meets the threshold debt amount provided by the ordinary thin capitalisation rules. This principle is illustrated in Example 17.

Example 17

X Co, Y Co and Z Co are all foreign companies and are the only shareholders in XYZ Co, a company incorporated in New Zealand. X Co is a majority shareholder with 60% ownership interest, while Y Co and Z Co each have a 20% ownership interest. XYZ Co entered into a contract with the New Zealand Government to provide and maintain an asset for a 20-year period.

To carry out the project, XYZ Co required $100 million. All three partners contributed $5 million of equity. XYZ Co also secured a loan from Bank Co of $50 million with an interest rate of 10% p.a. This loan only has recourse against assets and income associated with the project.

XYZ Co also secured a separate loan from Bank Co of $20 million with an interest rate of 5% p.a. This loan had a lower interest rate because it was on terms that gave Bank Co recourse over specific assets held by the shareholders of XYZ Co. As this item of debt gave Bank Co recourse that was not limited to the project, it will meet the definition of unrestricted debt.

The final $15 million is provided by X Co, Y Co and Z Co in proportion to their ownership interest by way of loans to XYZ Co with an interest rate of 15% p.a. These loans meet the definition of public project participant debt.

Over the course of the first year of the project, XYZ Co spends all of the $100 million on constructing the asset for the New Zealand Government. XYZ Co has a $110 million asset in its financial statements, which incorporates the present value of the expected payments from the New Zealand government over the next 20 years.

For the purpose of section FE 7B, XYZ Co has a debt percentage of 77% (85 ÷ 110), assuming no non-debt liabilities for simplicity. In addition, XYZ Co has a worldwide group debt percentage of 50%. This means that it will have to apply the apportionment formula in section FE 7B(3).

For the purpose of the apportionment formula, the value of public project participant (member) debt is $15 million and member interest is $2.25 million. Member excess is $15 million, because the amount of public project debt that is not public project participant debt is $70 million and the threshold debt amount is $66 million ($110 million × 60%).

Unrestricted debt is $20 million and unrestricted interest on this debt is $1 million. Unrestricted excess will not be the whole amount of the unrestricted debt however, as the amount of public project debt that is not either public project participant debt or recourse debt is $50 million, which is less than the threshold debt amount of $66 million. The amount of unrestricted excess is instead $4 million, which is the amount that the public project debt that is not public project participant debt ($70 million) exceeds the threshold debt amount.

The result of the formula will be ($1 million × $4 million ÷ $20 million) + ($ 2.25 million × $15 million ÷ $15 million) = $2.45 million of income derived by XYZ Co.

Disposing of interest

Section FE 4B(1)(b) provides that public project assets cannot be disposed of within 10 years from the beginning of the contract, unless it is to the Crown, a public authority, or another person performing the contract. By allowing public project assets to be disposed of to "another person performing the project", it is intended that an investor in an eligible infrastructure project will be able to dispose of their investment to a separate investor who will step into their shoes.

The intent of this provision is to ensure that the concessionary rules will only apply to projects that cannot be abandoned at the discretion of the private investor(s). It is not intended to prevent an investor from disposing of its interest in the project to a third party that intends to carry on the original investor's obligations under the project contract.

Scope of exemption

Section FE 7B(1) provides that this exemption will only apply to entities controlled by a single non-resident, partnerships, and New Zealand resident entities subject to the outbound thin capitalisation rules. A similar exemption already applies (in effect) where a separate entity is controlled by a group of non-residents.

Where a person has an interest in more than one eligible infrastructure project, each project will be treated separately under section FE 7B(5). This bifurcation will prevent the debt that is related to one infrastructure project that is denied a deduction from mixing with a low debt project.

Option of applying the rule

Each excess debt entity that is required to apply the thin capitalisation rules in relation to public project debt has the choice of whether to apply the ordinary thin capitalisation rules, or to apply the special rules for eligible infrastructure projects.

Section FE 7B(1)(c) allows an excess debt entity to choose whether or not they want to apply the concessionary rule. An election to apply the concessionary rule must be made at the time that the excess debt entity is first able to apply the concessionary rule to public project debt associated with the project.

Once an election is made to apply the concessionary rule to a project, the excess debt entity must continue to use that approach for the life of the project. If an excess debt entity applies the ordinary thin capitalisation rules to the first calculation for public project debt that relates to the project, then that entity will be unable to utilise the concessionary rule. However, if the concessionary rule was not in place before the first time in which the thin capitalisation rules are applied to the project, then the concessionary rule can still be applied to the project after the application date for the rule.

Each excess debt entity that is applying the thin capitalisation rules for a specific infrastructure project will be able to make its own election. In addition, if an excess debt entity disposes of its interest in an eligible infrastructure project to a new investor, that new investor will have the opportunity to make an election at the time in which it is first required to make a thin capitalisation calculation that relates to the project.

ORDER IN COUNCIL

Tax Administration (Direct Credit of Income Tax and Gaming Machine Duty Refunds) Order 2019

Sections 184A and 184B of the Tax Administration Act 1994

An Order in Council has been made to include income tax and gaming machine duty as tax types refundable by direct credit under section 184A of the Tax Administration Act 1994 (the TAA).

The provisions in sections 184A and 184B require tax refunds to be paid via direct credit to a bank account nominated by the taxpayer and were introduced to benefit taxpayers by eliminating time delays associated with the postal system and costs related to cheques.

The Tax Administration (Direct Credit of Income Tax and Gaming Machine Duty Refunds) Order 2019 mandates the direct credit of refunds for excess payments of income tax and gaming machine duty. Income tax means tax imposed under section BB 1 of the Income Tax Act 2007 and includes ancillary tax such as PAYE and FBT. Gaming machine duty refunds are reimbursements of duty paid by gaming machine operators under Part 2A of the Gaming Duties Act 1971. Section 184A of the TAA still allows the Commissioner to provide an exemption when direct crediting would cause undue hardship or is impracticable.

The Order in Council comes into effect on 1 April 2019.

Background

Compulsory direct crediting for goods and services tax (GST) refunds was implemented when GST was moved to Inland Revenue's new technology platform (START), which modernises and improves information flows, and enables more online self-service and automated processes. The administration of income tax is to be moved to this new technology platform in the next phase of Inland Revenue's business transformation, planned for April 2019, and the administration of gaming machine duty was already moved to the new platform in April 2018.

Whilst the intent was that the Commissioner would eventually be required to direct credit all refunds of tax paid in excess, the progressive implementation for various tax types through Orders in Council was legislated for to allow Inland Revenue the necessary flexibility to choose the optimal dates to implement direct crediting of refunds for each tax type.

CRS reportable jurisdictions amendment regulations

New Zealand's list of reportable jurisdictions was updated on 25 February 2019 by the following Order in Council: the *Tax Administration (Reportable Jurisdictions for the Application of CRS Standard) Amendment Regulations 2019 (LI 2019/34).*

Reportable jurisdictions are relevant to the Common Reporting Standard (CRS rules) which was enacted in New Zealand in 2017 as part of New Zealand's implementation of the G20/OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters, or AEOI. Reportable jurisdictions are territories to which Inland Revenue (IRD) will provide certain information on non-residents that is reported to IRD by financial institutions in accordance with the CRS rules.

Pursuant to section 226D of the Tax Administration Act 1994 (the Act), additions and deletions to the list must be made by Order in Council. The T*ax Administration (Reportable Jurisdictions for the Application of CRS Standard) Amendment Regulations 2019* add the following 30 jurisdictions to New Zealand's existing list of 60 reportable jurisdictions:

Antigua and Barbuda	Aruba	Azerbaijan	Barbados	Belize	Brunei Darussalam
Cook Islands	Costa Rica	Curacao	Cyprus	Dominica	Ghana
Grenada	Lebanon	Macao	Montserrat	Nigeria	Niue
Pakistan	Panama	Romania	Saint Kitts and Nevis	Saint Lucia	Saint Vincent and the Grenadines
Samoa	Sint Maarten	Switzerland	Trinidad and Tobago	Turkey	Vanuatu

A full listing of reportable jurisdictions can be found on the IRD website and the Order in Council can be found at **legislation.govt.nz**

Application date

The additional 30 jurisdictions are reportable jurisdictions for reporting periods beginning on or after 1 April 2018. Section 226D(2) of the Act allows for the retroactive application of these regulations.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

Product Ruling – BR Prd 19/01

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Milldale Infrastructure LP.

Taxation Laws

Legislative references are to the Income Tax Act 2007 (ITA) and the Goods and Services Tax Act 1985 (GSTA).

This Ruling applies in respect of:

- Sections DA 1, DA 2, DB 6, DB 7, EW 3, EW 5, EW 14, EW 15, EW 29 and EW 31, and subpart RE of the ITA.
- Sections 8 and 10 of the GSTA.

The Arrangement to which this Ruling applies

The Arrangement is a funding arrangement that includes:

- the advancement of an amount by Milldale Infrastructure LP (the Applicant) to the Developer for the Bulk Infrastructure required for a proposed housing development in Milldale (the Developer Loan);
- the satisfaction of the Developer's obligation to repay part of the Developer Loan by registration of an encumbrance (the Final Encumbrance) over each subdivided section when title is issued; and
- the payment by future landowners of amounts (Infrastructure Payments) over the term of the Final Encumbrance.

Further details of the Arrangement are set out in the paragraphs below.

Background

1. The Developer (and its associated companies) are, or will be, the registered proprietors of land in Milldale, Wainui, Auckland, which will be subdivided to deliver approximately 3,860 new build houses, apartments and commercial premises. As part of the development of that land, the Developer is responsible for building bulk infrastructure (including storm water, drinking water, waste water and roading) (Bulk Infrastructure). The Bulk Infrastructure will be owned, operated and maintained by the local Council or other appropriate entity.
2. The Arrangement relates to a portion of the overall funding of the Bulk Infrastructure, and involves the recovery of amounts from the Developer and future landowners of the subdivided sections (the Landowners) as repayment of the funding.
3. The relevant funding (the Developer Loan) was provided to the Developer by the Applicant on the terms and conditions set out in the Developer Project Agreement. The Developer is using the funding to assist the build of the Bulk Infrastructure required for the development. The Developer Loan is secured by way of a first ranking mortgage over all the land in the development (the Developer Mortgage).

The Final Encumbrance

4. As titles are issued in respect of the subdivided sections the Developer will be treated as having repaid part of the Developer Loan by registering an encumbrance against the title of each subdivided section (the Final Encumbrance). The Background to the Final Encumbrance states:
    - A. The Encumbrancee has helped fund bulk infrastructure projects (roading and wastewater) in the Wainui East area necessary to enable housing in the area to proceed including within the Milldale development.
    - B. A portion of the overall bulk infrastructure project costs are to be recovered from the benefiting land owners as the repayment of, and return on, funding that related to the construction of the bulk infrastructure projects referred to above.

BINDING RULINGS

C. As a condition of the Encumbrancee funding the bulk infrastructure projects described above the Encumbrancer or, from the time of sale, any subsequent purchaser of the Land is bound to pay the Infrastructure Payments to the Encumbrancee on the terms set out in this Encumbrance.

5. The Developer will sell the subdivided sections to third party purchasers (the Landowners). The titles will be transferred subject to the Final Encumbrance, such that the new Landowners will take on the obligation to make payments under the Final Encumbrance. No consideration will be paid for the transfer of the Final Encumbrance (clause 17 of the Final Encumbrance).
6. The Final Encumbrance requires the owner of each subdivided section (the Landowner) to make payments (Infrastructure Payments) to the Applicant over the term of the Final Encumbrance (30 years). Each Infrastructure Payment will fall due for payment in four equal quarterly instalments (clause 2 of the Final Encumbrance), on the same payment dates that apply for Auckland Council general rates. The payments under the Final Encumbrance will be made by Landowners to the Council as collection agent on behalf of the Applicant.
7. The full amount of Infrastructure Payments owing or that would become owing under a Final Encumbrance can be prepaid by a Landowner in a single lump sum payment (clause 7 of the Final Encumbrance). A Landowner is not entitled to make a partial prepayment of Infrastructure Payments (clause 8).
8. Once the final Infrastructure Payment has been made in relation to a specific section (and no arrears or enforcement costs are outstanding), the Applicant will remove the Final Encumbrance from the title.

Future sales of the sections

9. Any future sale of the subdivided sections will also be subject to the Final Encumbrance until all of the required payments have been made and the Final Encumbrance has been removed from the title. Any subsequent purchaser is also a Landowner for the purposes of this Ruling. No consideration will be paid for the transfer of the Final Encumbrance to any subsequent purchaser of the land (clause 17 of the Final Encumbrance).
10. Where an Infrastructure Payment has accrued for a period but is not yet due on the date that a section is sold, the Vendor may pay an amount as 'outgoings' to the purchaser on settlement for their share of the Infrastructure Payment. Similarly, if the Vendor has prepaid an amount of Infrastructure Payment for a period, the purchaser may pay an amount of 'outgoings' to the Vendor for their share of the Infrastructure Payment for the period.
11. The following example demonstrates the apportionment referred to above:

Example

A GST registered Landowner owns a section with a Final Encumbrance attached. Infrastructure Payments are $300 per quarter and are due for payment on the same payment dates that apply for quarterly payments of Auckland Council general rates, being:

- 31 August, for the period 1 July - 30 September
- 30 November, for the period 1 October - 31 December
- 28 February, for the period 1 January - 31 March
- 31 May, for the period 1 April - 30 June

The Landowner sells the property for $500,000 plus GST, with settlement on 31 July. The Landowner has not paid the Infrastructure Payment for the period 1 July - 30 September.

On settlement, there will be an apportionment of the accrued but unpaid Infrastructure Payment on settlement date, calculated on a number of days basis:

31 days / 92 days in the quarter * $300 = $101.10

The 'outgoings' adjustment on settlement that the vendor will pay the purchaser for their apportioned share of the accrued but unpaid Infrastructure Payments will not be subject to GST.

The settlement statement on 31 July will include:

Purchase price as per Agreement for Sale and Purchase	$500,000.00	Plus GST
Less: credit for vendor's proportion of Infrastructure Payments from 1 July to 31 July (31 days) at $300 per quarter	($101.10)	GST exempt
GST (15% × $500,000.00)	$75,000.00	
Amount required to complete settlement as at 31 July	**$574,898.90**	

BINDING RULINGS

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

a) This Ruling does not apply to:
   - The Developer;
   - Any Landowner who holds the property for private purposes and to whom the private limitation in s DA 2(2) applies;
   - Any Landowner who holds the property for the purposes of deriving exempt income, and to whom the exempt income limitation in s DA 2(3) applies; or
   - A non-resident, unless the Landowner carries on business through a "fixed establishment" (as defined in s YA 1) in New Zealand and the property is used as part of carrying on that business.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any condition stated above, the Taxation Laws apply to the Arrangement as follows:

ITA

a) The Final Encumbrance is a "financial arrangement" under s EW 3 and not an "excepted financial arrangement" under s EW 5.

b) For the purposes of ss EW 15(1) and EW 31(7), the only amounts that are "consideration" under the Final Encumbrance are:
   - The Infrastructure Payments (including any lump sum prepayment of the amounts owing); and
   - Any amount paid to or by the Landowner as an adjustment of the purchase price for the accrued or prepaid portion of the Infrastructure Payment when a section is purchased or sold.

c) Provided that the Landowner applies *Determination S62* (which applies to allocate the consideration under the Final Encumbrance to an income year), the amounts allocated will be expenditure incurred by the person under s EW 14(3).

d) Provided that the Landowner applies *Determination S62*, when the property is sold, or the final Infrastructure Payment is made, the Landowner will be required to calculate a base price adjustment (BPA) under s EW 29. The BPA calculation under s EW 31(5) must:
   - Add the aggregate of all Infrastructure Payments made over the period for which they held the property;
   - Add or subtract (as relevant) any adjustment made to the purchase price for the accrued or prepaid portion of the Infrastructure Payments when the property was purchased (the adjustments);
   - Add or subtract (as relevant) any adjustment made to the sale price for the accrued or prepaid portion of the Infrastructure Payments when the property was sold (the adjustments);
   - Subtract the aggregate of all Infrastructure Payments (plus or minus any adjustments) made over the period for which they held the property where a deduction was taken under subpart D.

   The BPA amount will equal the total Infrastructure Payments made in the BPA year (plus or minus any adjustments) and will be a negative amount.

e) Expenditure incurred by Landowners under the financial arrangements rules (including the amount determined under *Determination S62* and calculated under the BPA) will be deductible under ss DA 1 and DB 6 or DB 7, provided that no provision in subparts DB to DZ applies to deny a deduction. None of the general limitations in s DA 2 apply in respect of the expenditure.

f) Provided that the Applicant holds a valid RWT exemption certificate under s RE 27, any Infrastructure Payment made by a Landowner under the Final Encumbrance (including any lump sum prepayment of the amount owing) will not be subject to resident withholding tax under subpart RE.

GSTA

g) Where a section is sold by a GST registered vendor as part of their "taxable activity" (as defined in s 6), the "value of the supply" (under s 10) is equal to the amount paid for the land as set out in the sale and purchase agreement for the property. The value under s 10 does not include any non-cash consideration for the transfer of the Final Encumbrance.

h) Infrastructure Payments made by a landowner under the Final Encumbrance (including any lump sum prepayment of the amount owing) will not be subject to GST under s 8.

i) On the sale and purchase of property, where the Infrastructure Payment for the period is prepaid beyond the date of settlement of the transaction, the payment by the purchaser for their apportioned share of the prepaid Infrastructure Payments is not subject to GST under s 8.

j) On the sale and purchase of property, where the Infrastructure Payment for the period is accrued but unpaid on the settlement date, the credit allowed by the vendor for their apportioned share of the accrued but unpaid Infrastructure Payments is not subject to GST under s 8.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 October 2018 and ending on 30 June 2056.

This Ruling is signed by me on the 7th day of March 2019.

Howard Davis
Director (Taxpayer Rulings)

INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 19/01: Income tax – application of schedular payment rules to non-resident directors' fees

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the appendix to this Interpretation Statement.

Summary

1. This Interpretation Statement follows the Commissioner's earlier guidance on directors' fees in:
   - "IS 17/06: Income tax – application of schedular payment rules to directors' fees" *Tax Information Bulletin* Vol 29, No 8 (September 2017): 7; and
   - "BR Pub 15/10: Goods and services tax – directors' fees" *Tax Information Bulletin* Vol 27, No 7 (August 2015): 3.
2. This Interpretation Statement provides further guidance on directors' fees by explaining when you must withhold tax from directors' fees paid to non-residents, and how much you must withhold if you are required to do so.
3. If you pay directors' fees to a non-resident director, you may be making a "schedular payment". If you make a schedular payment, you must withhold tax from that payment and pay the tax you withhold to Inland Revenue. If you make a payment of directors' fees that is not a schedular payment, then you are not required to withhold tax from that payment.
4. Payments of directors' fees to resident and non-resident directors have two main differences. The first difference is that directors' fees paid to non-residents might be non-residents' foreign-sourced income. If the income is non-residents' foreign-sourced income, it is not subject to tax in New Zealand and you are not required to withhold tax from it. The second difference is that the non-resident contractor regime might apply. Some payments to non-resident contractors are excluded from being schedular payments. This means you do not need to withhold tax from these payments.
5. Whether a payment of directors' fees is a schedular payment largely depends on who you contracted with to provide directorship services and, in some cases, where those services are performed.

Identifying who you contracted with

6. Both non-resident individuals and non-resident entities, such as companies or partnerships, can provide directorship services to New Zealand companies. While the Companies Act 1993 requires the person holding the office of director to be a natural person, this does not mean contracts for directorship services must be with an individual director. Non-resident entities can contract to provide the services of a non-resident individual as a director, for example, an employee of a non-resident company or a partner in an overseas law firm. Therefore, the non-resident individual holding the office of director is not necessarily the person (or entity) that you contracted with to provide the directorship services.
7. Knowing whether you have contracted with a non-resident individual or a non-resident entity is important for working out whether the directors' fees you are paying for any directorship services have a New Zealand source. It is also important in the case of New Zealand–sourced directors' fees when determining whether any of the exclusions to the schedular payment rules apply.
8. This interpretation statement does not cover directors' fees paid to non-resident executive directors who are employed under a contract of service to perform directorship duties. These fees will be "salary or wages" or "extra pay", and will be subject to PAYE. They are excluded from the schedular payment rules under s RD 8(1)(b)(i) and (ii), respectively.

9. Note that you may be paying "directors' fees" to a person who you might not ordinarily consider to be a "director". "Director" is broadly defined under the Act and may include:
   (a) a person occupying the position of director, even if they do not have the title of "director";
   (b) a person who gives directions or instructions to a director, and that director is accustomed to act in accordance with those directions or instructions;
   (c) a person treated as being a director by any provision of the Act; and
   (d) for an entity without directors but which is treated as a company under the Act, any trustee, manager, or other person who acts like a director of a company incorporated under the Companies Act 1993 would act. Entities that are treated as a "company" under the Act include:
      (i) listed limited partnerships;
      (ii) unit trusts;
      (iii) incorporated societies; and
      (iv) other body corporates.

Determining the source of directors' fees

10. Unlike when you pay directors' fees to a New Zealand resident, when you pay directors' fees to a non-resident you first need to determine whether the directors' fees have a New Zealand source or a foreign source.

11. If the directors' fees you are paying have a New Zealand source, you need to consider whether any of the exclusions to the schedular payment rules apply to determine whether you must withhold tax from the payment. However, if you determine that the directors' fees you are paying have a foreign source, the schedular payment rules do not apply, and you can make the payment without withholding any tax. Non-residents' foreign-sourced income is generally not "assessable income". The Commissioner considers that it would be inconsistent with the purposes of the Act to require tax to be withheld from income that is not "assessable income".

12. The rules for determining the source of income – the source rules – are set out in s YD 4. The source rules relevant to directors' fees paid to non-residents are in:
   - s YD 4(2) – Business in New Zealand;
   - s YD 4(3) – Contracts made or performed in New Zealand;
   - s YD 4(4) – Personal services in New Zealand
   - s YD 4(17D) – Income taxable under double tax agreement; and
   - s YD 4(18) – Any other source in New Zealand.

13. How the source rules apply depends on the facts of each case. It is not uncommon for more than one source rule to apply to a particular amount of income. The specific source rules in s YD 4(2) to s YD 4(17D) are not "exhaustive". Even if the specific source rules do not treat an amount of income as having a New Zealand source, that income may still have a New Zealand source under the general source rule in s YD 4(18) (*Tillard v Commissioner of Taxes* [1938] NZLR 795).

14. This interpretation statement considers the source of directors' fees paid to non-resident individuals (from [15]). It then discusses the source of directors' fees paid to non-resident entities (such as companies and partnerships) (from [32]).

Directors' fees paid to non-resident individuals

15. The Commissioner considers that directors' fees a New Zealand company pays to a non-resident individual will, in most cases, have a New Zealand source, regardless of whether the directorship services are performed in New Zealand or from overseas. For clarity, a person attending a board meeting via videoconference from overseas is not considered to be performing directorship services in New Zealand.

Non-resident individuals from most double tax agreement countries

16. For non-resident individuals from most double tax agreement (DTA) countries (DTA countries) who are contracting in their personal capacity to provide directorship services to a New Zealand company, the directors' fees they receive will have a New Zealand source under s YD 4(17D) regardless of where the directorship services are performed.

17. Section YD 4(17D) provides:

    Income taxable under double tax agreement

    (17D) Income that may be taxed in New Zealand under a double tax agreement has a source in New Zealand.

18. Section YD 4(17D) was added by the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 and applies for income years beginning on or after 1 July 2018.

19. Most DTAs to which New Zealand is a party include a "directors' fees" article based on the "directors' fees" article found in the OECD Model Tax Convention (OECD directors' fees article). An OECD directors' fees article permits New Zealand to tax directors' fees that a New Zealand company pays to an individual who is resident in the other country. For example, art 16 of the Double Taxation Relief (Australia) Order 1972 (Australian–New Zealand DTA) states:

Article 16

DIRECTORS' FEES

Directors' fees and other similar payments derived by a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

20. Because art 16 of the Australian–New Zealand DTA permits New Zealand to tax directors' fees paid by New Zealand companies to Australian resident individuals, those fees have a New Zealand source under s YD 4(17D). Example 1 illustrates this. The full texts of New Zealand's DTAs can be found on Inland Revenue's tax policy website at **taxpolicy.ird.govt.nz**

Example 1: Directors' fees paid to non-resident individual from Australia

Buttercup is a professional director resident in Australia. Royal Humperdinck Ltd (a New Zealand–registered company) asks Buttercup to act as a director because of her knowledge of the Australian market. Buttercup accepts and contracts in her own name. Royal Humperdinck Ltd agrees that Buttercup can attend up to six board meetings via videoconference per year. Buttercup must attend the rest of the year's board meetings in person in New Zealand. In her first year as a director, Buttercup attends four board meetings via videoconference from Australia and attends the remaining eight board meetings in person in New Zealand. She comes to New Zealand for a total of eight days over a 12-month period, one day for each board meeting.

Because art 16 of the Australia–New Zealand DTA gives New Zealand a right to tax all the directors' fees that a New Zealand company pays to Australian resident individuals, all of the directors' fees that Royal Humperdinck Ltd pays to Buttercup have a New Zealand source under s YD 4(17D), even though some of the directors' fees were for meetings Buttercup attended via videoconference from Australia.

As a result, all directors' fees that Royal Humperdinck Ltd pays to Buttercup will be schedular payments. Therefore, Royal Humperdinck Ltd must withhold tax from these payments unless one of the exclusions to the schedular payment rules applies. This scenario is continued in example 6 at [58].

21. Although most of New Zealand's DTAs include an OECD directors' fees article, some DTAs include alternatively worded directors' fees articles that do not give New Zealand taxing rights over directors' fees paid by New Zealand companies in all situations. Other DTAs, such as the DTA between the United States (US) and New Zealand, do not include directors' fees articles at all. The US–New Zealand DTA, for example, deals with directors' fees paid by a New Zealand company to a US resident (both individuals and entities) under art 7, "Business Profits". Article 7 prevents New Zealand from taxing directors' fees that a New Zealand company pays to a US resident, except where the US resident has a "permanent establishment" in New Zealand and the directors' fees are attributable to that permanent establishment. As a result, unless a US resident individual has a permanent establishment in New Zealand, s YD 4(17D) will not apply.

22. Because of the differences between New Zealand's various DTAs, not all directors' fees paid to non-resident individuals from DTA countries will necessarily have a New Zealand source under s YD 4(17D). Directors' fees paid to non-residents individuals from countries that do not have DTAs with New Zealand (non-DTA countries), cannot have a New Zealand source under s YD 4(17D) given the absence of a DTA. In situations where s YD 4(17D) does not apply, it becomes necessary to consider other relevant source rules.

Source rules under s YD 4(4) and (18)

23. The Commissioner considers that even where s YD 4(17D) does not apply, directors' fees paid to non-resident individuals will, in most cases, have a source in New Zealand under s YD 4(4) and s YD 4(18), for example, when paid to:
    - a US-resident individual who does not have a permanent establishment in New Zealand; or
    - a resident of a non-DTA country.

    Note that for residents from DTA countries without an OECD directors' fees article, the DTA that New Zealand has with that country still governs the final New Zealand income tax result.

24. Under s YD 4(4), employment income under s CE 1, which includes directors' fees, has a New Zealand source if it is "earned" in New Zealand. Under s YD 4(18), the "catch-all" source rule, income has a New Zealand source if it is "derived", directly or indirectly, from any other source in New Zealand.

25. In several cases, when deciding the source of employment income, the courts have considered s YD 4(4) and s YD 4(18) together for the same employment income. The test that courts have applied to decide where employment or personal services income is "derived" under s YD 4(18) is essentially the same test the courts have applied when deciding where employment income has been "earned" under s YD 4(4) (*Case E46* (1982) 5 NZTC 59,277; *Case H6* (1986) 8 NZTC 153; *Case P17* (1992) 14 NZTC 4,115; and *Dow Chemical Overseas Management Co Ltd v CIR* (1994) 16 NZTC 11,143).

26. The approach used when considering issues of source, is that source is a "practical, hard matter of fact", not a question of law. The question to be posed is, "Where would a 'practical person' regard the real source of the income to be?". This question involves balancing the factors for and against each potential source of that income (*CIR v NV Philips' Gloeilampenfabrieken* [1955] NZLR 868).

27. When considering the source of employment income specifically, the New Zealand courts have referred to Australian case law, which sets out three main factors that need to be weighed to determine source, namely:
    - the place where the arrangement for the provision of the services was made;
    - the place where the services were performed; and
    - the place from which the payment was made.

    (For instance, see *C of T v CAM & Sons Ltd* (1936) 4 ATD 32; *FCT v French* (1957) 98 CLR 398; and *FCT v Mitchum* (1965) 113 CLR 401 (HCA).)

28. While all three factors are relevant, in the absence of special circumstances, the "place of performance" will likely have a stronger influence on the source of employment income than the other two factors combined. However, this is not an absolute rule, and several New Zealand cases have held that amounts of employment income have a New Zealand source under the earlier equivalents of s YD 4(4) and s YD 4(18), despite the services being performed overseas (*Case E46* and *Case H6*). The courts reached this conclusion because of additional special factors identified in each case.

29. The Commissioner considers that unlike most other roles, special factors exist for directors of New Zealand companies. Where directorship services are physically performed overseas, the following special factors diminish the importance normally given to the place of performance or strengthen the practical connection between the directors' fees and New Zealand, such that those fees will most likely be found to have been "earned" or "derived" in New Zealand under s YD 4(4) and s YD 4(18) respectively:
    - Directors are unlike "ordinary" employees in that they have a special statutory connection with New Zealand. The office of director is a statutory position provided for by the Companies Act 1993. In addition, the Companies Act 1993 sets out who is permitted to hold a directorship and requires the details of directors (including their names and addresses) to be recorded on the New Zealand Companies Register as a matter of public record.
    - The Companies Act 1993 also sets out the duties and obligations of a director. These duties and obligations are owed in New Zealand and apply for the purposes of New Zealand law.
    - The amounts paid as directors' fees are subject to certain statutory requirements under s 161 of the Companies Act 1993.
    - A director who fails to discharge their statutory duties faces the possibility of prosecution under New Zealand legislation, for example, the Companies Act 1993, Income Tax Act 2007, Tax Administration Act 1994, Financial Markets Conduct Act 2013 and Takeovers Act 1993.
    - Directors' are often engaged for their knowledge and experience, rather than for the performance of a particular task. The Commissioner considers that because directorship services can be provided without physical presence in New Zealand, the place where the directorship services are performed carries less significance than it ordinarily would (*Mitchum*).

30. Even where some or all of the directorship services are physically performed outside New Zealand, the Commissioner considers that a "practical person" would conclude that directors' fees paid by a New Zealand company to a non-resident individual have their "real" source in New Zealand because:
    - the director has a special statutory connection with New Zealand;
    - the contract is most likely formed in, and subject to, New Zealand law; and
    - payment is likely being made from New Zealand.
31. Consequently, directors' fees paid to non-resident individuals will, in most cases, have a New Zealand source under s YD 4(4) and s YD 4(18). However, because source is a question of fact and, ultimately, turns on the specific factors of each case, the Commissioner accepts that situations could arise where directors' fees paid to a non-resident individual might not be found to have been "earned" or "derived" in New Zealand under s YD 4(4) and s YD 4(18) respectively. Example 2 illustrates this "balancing of factors" approach.

Example 2: Directors' fees paid to a non-resident individual from a non–DTA country

Iocane Imports Ltd (a New Zealand company) appoints Inigo Montoya, a professional director resident in Venezuela, to be a director. Inigo has specialist knowledge of the industry and South American markets. Inigo contracts personally with Iocane Imports Ltd. The contract is formed in New Zealand, and payment is made by Iocane Imports Ltd from New Zealand. New Zealand does not have a DTA with Venezuela. Iocane Imports Ltd agrees that Inigo can attend all board meetings remotely via videoconference from Venezuela.

Because New Zealand does not have a DTA with Venezuela, s YD 4(17D) will not treat the directors' fees paid to Inigo as having a New Zealand source. However, the Commissioner considers that the directors' fees that Iocane Imports Ltd pays to Inigo will have a New Zealand source because the fees will be employment income that is both "earned" (s YD 4(4)) and "derived" (s YD 4(18)) in New Zealand. The fact the services are performed in Venezuela may initially suggest the fees have a Venezuelan source. However, on balance, the Commissioner considers that given the contract is formed in New Zealand and that payment is made from New Zealand, together with the nature of directorships and their statutory connection with New Zealand, Inigo's directors' fees have a closer practical connection with New Zealand than to Venezuela. Therefore, Iocane Imports Ltd must consider whether the schedular payment rules apply to its payments of directors' fees.

Source of directors' fees paid to non-resident entities

32. The source rules relevant to directors' fees paid to non-resident entities are in s YD 4(2), s YD 4(3) and s YD 4(17D). Directors' fees that a non-resident entity derives from a business carried on in New Zealand will have a New Zealand source if the business is wholly carried on in New Zealand (s YD 4(2)). If the business is only partly carried on in New Zealand, directors' fees will have a New Zealand source only to the extent apportioned under s YD 5. A business of providing directorship services is likely to be "carried on" in New Zealand to the extent that services are physically performed in New Zealand.
33. Similarly, directors' fees derived from a contract will have a New Zealand source to the extent they are paid for directorship services physically performed in New Zealand (s YD 4(3)) and as apportioned under s YD 5. For completeness, s YD 4(4) does not apply to directors' fees paid to non-resident entities, because only individuals can derive such fees as employment income.
34. Apportionment of directors' fees under s YD 4(2) and s YD 4(3) is determined by s YD 5(2) and (3). The directors' fees apportioned to a New Zealand source for the purposes of s YD 4(2) and s YD 4(3) is the amount that would have been paid to an independent third party for carrying out the non-resident entity's New Zealand directorship activities. This means the directors' fees apportioned to a New Zealand source under s YD 5 may differ from the amount the New Zealand company has contracted to pay the non-resident entity for directorship services to be performed in New Zealand. That said, the amount apportioned under s YD 5 cannot exceed the total directors' fees paid to the director.
35. Where directors' fees are paid as a global amount, it is necessary to identify the range of directorship services being performed. Once this has been done, the directors' fees are to be apportioned to a New Zealand source in proportion to those services physically performed in New Zealand. Appropriate records, such as timesheets, will need to be maintained to substantiate the apportionment.

36. The Commissioner considers that directors' fees paid to non-resident entities are unlikely to have a source under s YD 4(17D) because directors' fees paid to non-resident entities are not dealt with under the OECD director's fees articles found in most DTAs. This is because although a non-resident entity may contractually derive directors' fees, only individuals (natural persons) can derive directors' fees "in [their] capacity as a member of the board of directors of a company". Instead, directors' fees paid to non-resident entities are covered by the "business profits" article found in many DTAs.

37. "Business profits" articles generally prevent New Zealand from taxing the business income of a non-resident entity, except where that entity has a permanent establishment in New Zealand. If a non-resident entity has a permanent establishment in New Zealand, generally the directors' fees it receives from a New Zealand company that are attributable to the permanent establishment will all be treated as having a New Zealand source under s YD 4(17D). Practically however, this scenario is likely to be rare. In situations involving a non-resident entity from a non-DTA country with a permanent establishment in New Zealand, s YD 4(17C) would likely give rise to a similar source result as produced for a non-resident entity from a DTA country under s YD 4(17D). Example 3 illustrates the more common position for an entity from a DTA country.

38. **Example 3: Directors' fees paid to a non-resident entity**

Westley is a professional director resident in Australia. ROUS Pest Control Ltd, a New Zealand company, has approached Westley to act as a director. Westley accepts and contracts with ROUS Pest Control Ltd through his Australian-resident personal services company, DPR Services Pty Ltd, of which Westley is an employee. DPR Services Pty Ltd does not have a permanent establishment in New Zealand. Westley attends six of the 12 New Zealand board meetings in person and six via videoconference from Australia. Each meeting is five hours long. DPR Services Pty Ltd is paid $1,000 per meeting Westley attends, regardless of whether he attends in person.

Valerie, the payroll manager for ROUS Pest Control Ltd, knows that s YD 4(2) and s YD 4(3) means only the directors' fees paid to DPR Services Pty Ltd for directorship services physically performed in New Zealand have a New Zealand source to the extent apportioned under s YD 5. Valerie initially decides that because DPR Services Pty Ltd provides directorship services throughout the year, then the six days Westley spends in New Zealand attending the six board meetings represents just 6/365th of the total directorship services provided to ROUS Pest Control Ltd. On this basis, Valerie calculates that only $197.26 of the $12,000 of directors' fees should be apportioned to a New Zealand source.

Valerie decides to check with Vizzini, the company's accountant. Vizzini correctly tells Valerie the portion of the directors' fees to be apportioned to a New Zealand source is the amount that would have been paid to an independent third party for carrying out DPR Services Pty Ltd's New Zealand directorship activities (s YD 4(2), s YD 4(3), and s YD 5). Vizzini tells Valerie it would be inconceivable for an independent third-party director to receive only $197.26 for attending six board meetings in New Zealand.

Vizzini advises that on the basis that the $1,000 DPR Services Pty Ltd receives per meeting represents what an independent third-party director would also receive for the same activities, then:

- $6,000 of directors' fees paid for the six meetings Westley attends in person will have a New Zealand source; and
- $6,000 of directors' fees paid for the six meetings Westley attends from Australia via videoconference will have a foreign source.

The foreign-sourced directors' fees are not subject to the schedular payment rules and can be paid without any tax being withheld. To decide if ROUS Pest Control Ltd must withhold tax from the New Zealand–sourced directors' fees, the company needs to consider whether any of the exclusions to the schedular payment rules apply.

Alternative scenario

Vizzini asks Valerie what services the $1,000 per board meeting fee is intended to cover. Valerie confirms that the $1,000 is intended to cover time spent preparing for meetings, as well as other attendances, such as company correspondence undertaken between board meetings.

Valerie also tells Vizzini that DPR Services Pty Ltd is likely to be providing at least some directorship services from Australia. Vizzini recommends that DPR Services Pty Ltd (that is, Westley) keeps accurate records of the time spent performing directorship services for ROUS Pest Control Ltd and whether those services are performed in Australia or New Zealand. These records show that for each five-hour board meeting, DPR Services Pty Ltd spends an equivalent amount of time performing other directorship services such as meeting preparation and correspondence. These other services are all performed in Australia. Accordingly, the source of the $12,000 of directors' fees paid to DPR Services Pty Ltd over the year is apportioned as follows:

- $3,000 of the directors' fees relating to the six board meetings that Westley physically attends in New Zealand (25% of total time spent) have a New Zealand source;
- $3,000 of the directors' fees relating to the six board meetings that Westley attends via videoconference from Australia (25% of total time spent) have a foreign source; and
- $6,000 of the directors' fees relating to other non-meeting services such as preparation and company correspondence (50% of total time spent) also have a foreign source.

For the foreign-sourced amounts, no withholding is required. ROUS Pest Control Ltd may be required to withhold tax from the New Zealand–sourced directors' fees, so the company needs to consider whether any of the exclusions to the schedular payment rules apply. This is discussed further in example 4 at [53].

39. Flowchart 1 at the end of this statement summarises how the source rules apply to directors' fees paid to non-resident entities and non-resident individuals.

40. If the directors' fees you are paying have a New Zealand source, then you need to consider the schedular payment rules and whether any of the exclusions to those rules apply to the payments you are making. These exclusions are discussed next. However, if the directors' fees you are paying have a foreign source, they will not be subject to the schedular payment rules and can be paid without any tax being withheld.

How the schedular payment rules apply

41. If a payment of directors' fees to a non-resident has a New Zealand source, it will be a "schedular payment", unless one of the exclusions in s RD 8(1)(b) applies.

42. The exclusions to the definition of "schedular payment" are set out in s RD 8(1)(b):

> A **schedular payment**—
>
> …
>
> (b) does not include—
>
> (i) salary or wages; or
>
> (ii) an extra pay; or
>
> (iii) a payment for services provided by a public authority, a local authority, a Maori authority, or a company, other than a non-resident contractor, a non-resident entertainer, or an agricultural, horticultural, or viticultural company; or
>
> (iv) an exempt payment referred to in section 24H and schedule 5, part C, clause 6 of the Tax Administration Act 1994 applies[1]; or
>
> (v) a payment for services provided by a non-resident contractor who has full relief from tax under a double tax agreement, and is present in New Zealand for 92 or fewer days in a 12-month period; or
>
> (vi) a contract payment for a contract activity or service of a non-resident contractor when the total amount paid for those activities to the contractor or another person on their behalf is $15,000 or less in a 12-month period.

43. The exclusions under s RD 8(1)(b)(i) and (ii), relating to payments of "salary and wages" and "extra pay", are not covered in this item. These types of payments will arise only when a person is employed (under a contract of service) to perform directorship duties. The Commissioner considers that, in most cases, non-resident individuals who perform directorship services, do so as contractors (under contracts for service), not as employees. For further information on the exclusions under s RD 8(1)(b)(i) and (ii), see "IS 17/06: Income tax – application of schedular payment rules to directors' fees" *Tax Information Bulletin* Vol 29, No 8 (September 2017): 7.

44. The exclusions under s RD 8(1)(b)(iii), (v) and (vi), as they apply to directors' fees paid to non-residents, are discussed next. Section RD 8(1)(b)(iv), which relates to exempt payments, is discussed separately in [59]. The discussion of s RD 8(1)(b)(iii), (v), and (vi) is grouped together because each of these three exclusions refers to "non-resident contractors".

Definition of "non-resident contractor"

45. Section YA 1 defines a "non-resident contractor" as:

> **non-resident contractor**, in the PAYE rules, means a person who—
>
> (a) is not resident in New Zealand under subpart YD (Residence and source in New Zealand); and
>
> (b) undertakes under a contract, agreement, or arrangement (other than a contract of service or apprenticeship)—
>
> (i) to perform services of any kind in New Zealand:
>
> (ii) to supply the use, or right to use, in New Zealand any personal property or services of another person

[1] This wording of s RD 8(1)(b)(iv) applies from 1 April 2019. Prior to 1 April 2019, s RD 8(1)(b)(iv) read, "a payment covered by an exemption certificate provided under section 24M of the Tax Administration Act 1994; or".

46. For the purposes of considering directors' fees paid to non-residents, the main requirement for being a "non-resident contractor" is that the non-resident individual or entity **performs or provides services in New Zealand**.

Payments for services provided by a company (s RD 8(1)(b)(iii))

47. If you are paying directors' fees to a non-resident company, you need to consider the exclusion under s RD 8(1)(b)(iii), which provides:

> A **schedular payment**—
>
> …
>
> (b) does not include—
>
> …
>
> (iii) a payment for services provided by a public authority, a local authority, a Maori authority, or a company, other than a non-resident contractor, a non-resident entertainer, a company in relation to a payment described in schedule 4, part J or part W, or an agricultural, horticultural, or viticultural company; or

48. The definition of "company" is very wide and includes a variety of body corporates, such as limited liability partnerships, incorporated in New Zealand or overseas. Importantly, however, companies that are non-resident contractors are not subject to this exclusion.

49. If you pay directors' fees to a non-resident company for directorship services performed **entirely from overseas**, those fees are unlikely to have a New Zealand source, so will already be outside the scope of the schedular payment rules. In these situations, you do not need to consider the exclusion under s RD 8(1)(b)(iii).

50. If you are paying a non-resident company for directorship services performed or provided in New Zealand, that company will be a non-resident contractor. As a consequence, s RD 8(1)(b)(iii) will not apply and, unless another exclusion applies, the directors' fees you pay to that company for directorship services performed in New Zealand will be a schedular payment.

Full relief under a DTA (s RD 8(1)(b)(v))

51. As noted in [19], most DTAs permit New Zealand to tax directors' fees paid by New Zealand companies to **non-resident individuals**. As a result, s RD 8(1)(b)(v) is unlikely to apply to directors' fees you might pay to a non-resident individual. This is because, regardless of whether they are present in New Zealand for no more than 92 days, they will not be entitled to full relief on those fees under a DTA, as required by s RD 8(1)(b)(v).

52. However, if you are paying directors' fees to a **non-resident entity** from a DTA country, any New Zealand–sourced portion of those fees you pay is likely to be excluded from the schedular payment rules under s RD 8(1)(b)(v). You need to consider s RD 8(1)(b)(v) only in relation to New Zealand–sourced directors' fees (those paid for directorship services performed, entirely or in part, in New Zealand) because any foreign-sourced directors' fees paid are not subject to the schedular payment rules in any case.

53. Section RD 8(1)(b)(v) provides:

> A **schedular payment**—
>
> …
>
> (b) does not include—
>
> …
>
> (v) a payment for services provided by a non-resident contractor who has full relief from tax under a double tax agreement, and is present in New Zealand for 92 or fewer days in a 12-month period; or

54. As noted in [36], most DTAs provide that income derived by a non-resident entity has full relief from New Zealand tax so long as the non-resident entity does not have a permanent establishment in New Zealand. If the non-resident entity you are paying does not have a permanent establishment in New Zealand, you will still need to confirm that the non-resident entity has not been, and will not be, present in New Zealand for more than 92 days in a 12-month period. If a non-resident entity is entitled to full relief under a DTA but has been or will be present in New Zealand for more than 92 days, they may wish to apply to the Commissioner for an exemption for those payments (s RD 8(1)(b)(iv)), as discussed later at [59]. Entities such as companies have no "physical" presence of their own. For the purposes of s RD 8(1)(b)(v), where an individual (in most cases an employee) is physically present in New Zealand performing services on behalf of a non-resident entity, that entity will also be considered present in New Zealand. Examples 4 and 5 illustrate this.

Example 4: Exclusion as full relief under DTA – s RD 8(1)(b)(v)

In the alternative scenario of example 3, $3,000 of the $12,000 directors' fees paid to DPR Services Pty Ltd were apportioned to a New Zealand source. Therefore, ROUS Pest Control Ltd must consider whether the schedular payment rules apply to those New Zealand–sourced directors' fees.

Under s RD 8(1)(b)(v), the New Zealand–sourced portion of the directors' fees paid to DPR Services Pty Ltd is excluded from being a schedular payment because DPR Services Pty Ltd:

- is a non-resident contractor because services are performed on its behalf through its employee, Westley, in New Zealand;
- has full relief from New Zealand tax under the Australia–New Zealand DTA, since business income derived by the company in New Zealand is subject to New Zealand tax only if DPR Services Pty Ltd has a permanent establishment in New Zealand, which it does not; and
- is not in New Zealand for more than 92 days, as prescribed in s RD 8(1)(b)(v).

As a result, no tax is required to be withheld from the New Zealand–sourced portion of the directors' fees that ROUS Pest Control Ltd pays to DPR Services Pty Ltd.

Example 5: Directors' fees paid to non-resident individual from the US

Fezzik, a US tax resident, is approached by Miracle Max Healthcare Ltd, a New Zealand company, to be a director. Fezzik contracts in his own name to provide the directorship services to Miracle Max Healthcare Ltd. The contract is formed in New Zealand, and payment is made by Miracle Max Healthcare Ltd from New Zealand. Fezzik does not have a permanent establishment in New Zealand.

Fezzik physically attends half of Miracle Max Healthcare Ltd's board meetings in New Zealand and the other half via videoconference from the US. As part of physically attending board meetings in New Zealand, Fezzik spends 10 days in New Zealand.

On balance, the Commissioner considers the directors' fees Miracle Max Healthcare Ltd pays to Fezzik have a New Zealand source under s YD 4(4) and s YD 4(18) regardless of where Fezzik physically performs the directorship services. The combination of the place where the contract is formed, the place where payment is made, together with the nature of directorships and their statutory connection with New Zealand, leads to the conclusion that Fezzik's directors' fees have a closer practical connection with New Zealand than the US.

Because Fezzik performs some of his directorship services physically in New Zealand, he is a "non-resident contractor". Furthermore, because Fezzik does not have a permanent establishment in New Zealand, art 7 of the US–New Zealand DTA provides that New Zealand is not permitted to tax Fezzik's directors' fees.

Therefore, the directors' fees that Miracle Max Healthcare Ltd pays to Fezzik are excluded from the schedular payment rules under s RD 8(1)(b)(v) because Fezzik is:

- a non-resident contractor;
- entitled to full DTA relief from New Zealand tax on his directors' fees; and
- is present in New Zealand for 92 days or fewer in a 12-month period.

Accordingly, Miracle Max Healthcare Ltd pays Fezzik his directors' fees without withholding any tax.

If Fezzik were to be present in New Zealand for more than 92 days, s RD 8(1)(b)(v) would not be satisfied. It is possible that some of Fezzik's directors' fees might be excluded from the schedular payment rules under the *de minimis* provision in s RD 8(1)(b)(vi). These exclusions are discussed from [54]. However, for all of the directors' fees paid by Miracle Max Healthcare Ltd to be excluded, Fezzik would need an exemption* from the Commissioner. Fezzik would be eligible to apply for an exemption because he is entitled to full relief under the US–New Zealand DTA (by virtue of not having a permanent establishment in New Zealand).

*Prior to 1 April 2019, this exemption would be given by the Commissioner in the form of an exemption certificate.

De minimis for non-resident contractors (s RD 8(1)(b)(vi))

55. Directors' fees that you pay to non-resident contractors (individuals or entities) for directorship services performed in New Zealand will be excluded from the schedular payment rules if the total amount of contract payments that the non-resident contractor has received, or will receive, for **any** contract services or activities performed in New Zealand do not exceed $15,000 in a 12-month period (s RD 8(1)(b)(vi)).

56. Section RD 8(1)(b)(vi) provides:

> A **schedular payment**—
>
> …
>
> (b) does not include—
>
> …
>
> (vi) a contract payment for a contract activity or service of a non-resident contractor when the total amount paid for those activities to the contractor or another person on their behalf is $15,000 or less in a 12-month period.

Contract payment for a contract activity or service

57. Section RD 8(1)(b)(vi) applies only to directors' fees that are paid for directorship services **performed in New Zealand by a non-resident contractor**. The term "contract payment" is broadly defined under s YA 1 as being any payment that is not a reimbursement of expenses or other payment types that are not relevant to directorship services. However, a "contract activity or service" is defined narrowly and limited to activities or services **performed in New Zealand**.

58. Accordingly, if you pay directors' fees to a non-resident contractor specifically for directorship services performed in New Zealand, s RD 8(1)(b)(vi) will exclude those fees from the schedular payment rules as long as "the total amount paid for those activities to the contractor or another person on their behalf is $15,000 or less in a 12-month period". This means contract payments for **all** contract activities or services are to be included in the calculation of the $15,000 cap, not just those received for directorship services and not just those you have paid to the contractor or another person on their behalf.

59. Directors' fees paid specifically for directorship services **performed from overseas** are not contract payments for a contract activity or service, so are not included in the calculation of the $15,000 cap. However, because directors' fees paid specifically for directorship services performed from overseas are not contract payments for a contract activity or service, s RD 8(1)(b)(vi) does not exclude them from the schedular payment rules. Therefore, tax will need to be withheld from such fees unless one of the other exclusions to the schedular payment rules applies. Example 6 illustrates how the exclusion for exempt payments works, under s RD 8(1)(b)(iv).

Example 6: De minimis exclusion under s RD 8(1)(b)(vi)

Following on from example 1, Royal Humperdinck Ltd pays Buttercup $18,000 for attending all 12 board meetings during the year ($1,500 per meeting). Because Buttercup has performed some services in New Zealand, she meets the definition of a non-resident contractor. In the last 12 months, Buttercup has not received (and will not receive in the next 12 months), any other contract payments for New Zealand contract activities or services.

The $12,000 of directors' fees paid to Buttercup for attending the eight meetings in New Zealand constitute contract payments of $15,000 or less in a 12-month period. Therefore, s RD 8(1)(b)(vi) excludes those fees from the schedular payment rules. Royal Humperdinck Ltd may pay those fees without withholding tax from them. The $6,000 of directors' fees paid to Buttercup for attending the four meetings from Australia are not contract payments for contract activities or services. Therefore, they do not count towards the $15,000 cap.

However, because the $6,000 of directors' fees Buttercup receives for attending the four board meetings from Australia are not contract payments for New Zealand contract activities or services, they are not excluded from the schedular payment rules under s RD 8(1)(b)(vi). Therefore, Royal Humperdinck Ltd must withhold tax from the $6,000 it pays Buttercup for attending meetings from Australia.

It is important to note that even though Royal Humperdinck Ltd is not required to withhold tax from some of the directors' fees it pays to Buttercup, Buttercup is still liable for New Zealand income tax on all the directors' fees she receives from the company (see example 1 for details). Therefore, Buttercup may wish to ask Royal Humperdinck Ltd to treat the directors' fees she is paid for attending board meetings in New Zealand as "voluntary schedular payments". If Royal Humperdinck Ltd agrees to do so, it would need to withhold tax from all directors' fees it pays to Buttercup throughout the year. This would reduce Buttercup's final New Zealand income tax liability. Voluntary schedular payments are discussed at [73].

Exempt payments (s RD 8(1)(b)(iv))

60. Generally, if a non-resident individual or entity notifies you that they have an exemption for the directors' fees you are about to pay them, you are not required to withhold any tax from those exempt payments. You do not need to include exempt payments, or the details of the person you are paying them to, as part of the employment income information you file with the Inland Revenue.

61. Prior to 1 April 2019, the non-resident individual or entity would notify you of their exemption by providing you with an "exemption certificate". Example 7 deals with exemptions.

Example 7: Directors' fees paid to non-resident individual from US

This example is a variation of Fezzik's situation discussed in example 5. Fezzik, a US tax resident, contracts in his own name to provide directorship services to Miracle Max Healthcare Ltd. The contract is formed in New Zealand and payment is made by Miracle Max Healthcare Ltd from New Zealand. Fezzik does not have a permanent establishment in New Zealand. Because Fezzik contracts in his own name, all of his directors' fees have a New Zealand source under s YD 4(4) and s YD 4(18).

Fezzik "attends" all board meetings via videoconference from overseas. By not performing any of his directorship services in New Zealand, Fezzik does not meet the definition of a "non-resident contractor". This means the exclusions under s RD 8(1)(b)(v) and (vi) do not apply. Unless Fezzik obtains an exemption and notifies Miracle Max Healthcare Ltd of it before any payment is made, Miracle Max Healthcare Ltd must withhold tax from Fezzik's directors' fees.

Alternative scenario

Fezzik applies to the Commissioner for his directors' fees to be exempt payments on the basis that under the US–New Zealand DTA, he is entitled to full relief from New Zealand tax on his directors' fees. The Commissioner allows Fezzik an exemption for the directors' fees, which Fezzik notifies Miracle Max Healthcare Ltd of before any payment is made. As a result, Fezzik's directors' fees are excluded from the schedular payment rules under s RD 8(1)(b)(iv), and Miracle Max Healthcare Ltd can pay Fezzik's directors' fees to him without withholding any tax.

62. Flowcharts 2 and 3 at the end of this item summarise how the schedular payment rules apply to directors' fees paid to non-resident individuals and non-resident entities that have contracted to provide directorship services to a New Zealand company.

Your withholding obligations from directors' fees

Withhold at the time of payment

63. If the directors' fees you are paying are schedular payments and you are required to withhold tax from them, you must withhold at the time you make the payment. You are then required to pay the tax withheld to Inland Revenue. You will also need to record details of the non-resident individual or entity you are paying, the amount of the payment, and the tax withheld as part of the employment income information you file with Inland Revenue. For further information about your PAYE record-keeping, payday filing and withholding tax payment obligations, see the Inland Revenue website.

Select the correct withholding rate

64. Different withholding rates may apply depending on who you are paying and the information they give you. Therefore, it is important you determine the appropriate rate for each person or entity you pay.

65. Before you pay a schedular payment to a non-resident, they should complete a T*ax Rate Notification for Contractors form (IR330C)*. The IR330C will record the person's name and New Zealand tax number. If the non-resident you are paying wants to elect their own withholding rate, they also need to record this in the IR330C. Elected rates are discussed in [67] and [68]. If a non-resident has been given a prescribed rate or additional deduction rate by the Commissioner, they must notify you of this in their IR330C. Prescribed rates and additional deduction rates are also discussed in [71] and [72].

Default withholding rates

66. If the non-resident individual or entity (other than a non-resident company) you are about to pay has not provided you with an IR330C recording their name and New Zealand tax number, you must withhold at the default withholding rate of 45%. The default withholding rate for a non-resident company is 20%. Prior to 1 April 2019, the default withholding rate was called the "no-notification rate".

Standard withholding rate is 33%

67. If the non-resident you are about to pay provides you with an IR330C recording their name and tax number with no elected rate, and they are not subject to a prescribed rate or additional deduction rate, you must withhold tax at a rate of 33%. This is the standard withholding rate for directors' fees. Because Schedule 4 provides a specific withholding rate for directors' fees, this rate prevails over the "non-resident contractor" rate set out in Part A of Schedule 4, even though the recipient is also a "non-resident contractor".

Elected rates must be at least 15%

68. A non-resident entitled to receive a schedular payment is allowed to elect their own withholding rate. However, the elected rate for non-residents (and temporary visa holders) cannot be less than 15%. A non-resident who wants to elect their own withholding rate must do so in their IR330C. As long as the elected rate is not less than 15%, you must withhold at that elected rate.

69. A non-resident can change their elected rate. However, if that person has already elected to change the withholding rate twice in the last 12-month period, you are not required to withhold at the newly elected rate unless you agree to the change.

Special tax rates

70. You may be obliged to withhold tax at a different rate if the non-resident you are paying has received a special tax rate from the Commissioner. A non-resident can elect a withholding rate below the minimum rate of 15% only if they have been granted a corresponding special tax rate. If the non-resident you are paying directors' fees to has elected a rate less than 15%, you must deduct at that rate only if they have notified you of their corresponding special tax rate. Prior to 1 April 2019, a special tax rate was issued in the form of a "special tax rate certificate", which needed to be provided to the payer prior to payment being made.

71. Where a non-resident has a 0% special tax rate, the directors' fees you pay to them will still be schedular payments even though you will not need to withhold any tax. Because they are still schedular payments, you must record the payments, and details of the non-resident you are paying, as part of the employment income information you file with Inland Revenue.

Prescribed rates and additional deduction rates

72. Occasionally, the non-resident you are paying may have outstanding tax liabilities with Inland Revenue. In this situation, the Commissioner may have prescribed a specific withholding rate for that non-resident and may have also prescribed an additional deduction rate for you to withhold and pay to Inland Revenue. Inland Revenue applies the additional deduction rate amounts to reduce a non-resident's outstanding tax liabilities.

73. You will be notified of this type of prescribed rate or additional deduction rate by the non-resident you are paying or by Inland Revenue directly. If you are notified of a prescribed rate or an additional deduction rate, you must withhold at those rates even if the person you are paying has elected a different rate.

Voluntary schedular payments

74. If you are going to be paying directors' fees that are not schedular payments, the person or entity you are paying may nonetheless want you to withhold tax from those payments. If you agree to this, those directors' fees may be treated as "voluntary schedular payments". An agreement to treat non-schedular payments as voluntary schedular payments must be recorded in writing. If you have agreed in writing to treat certain payments of directors' fees as voluntary schedular payments, you must withhold tax from those payments and pay the tax withheld to Inland Revenue, as you would for any other schedular payments.

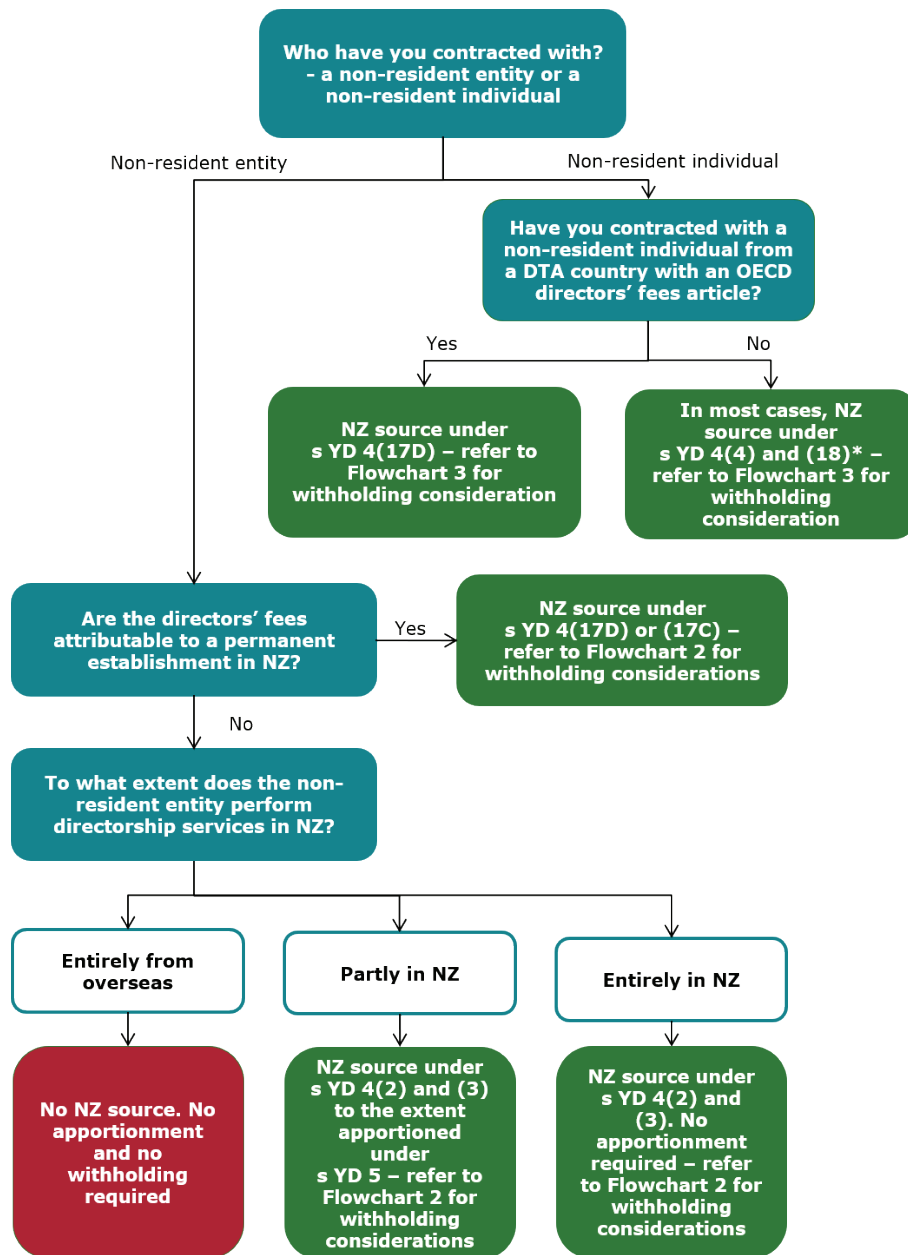
Deduct from fees net of GST and reimbursements

75. Once you have determined the appropriate withholding rate for a payment, you must then apply that rate to the total amount of the schedular payment, exclusive of any GST charged.

76. If you reimburse a non-resident for an amount they have incurred as a necessary part of performing their role as director, for example, the cost of flights to attend a board meeting, that payment is not a director's fee. Accordingly, any reimbursement amount will not be a schedular payment, so you will not need to withhold tax from it.

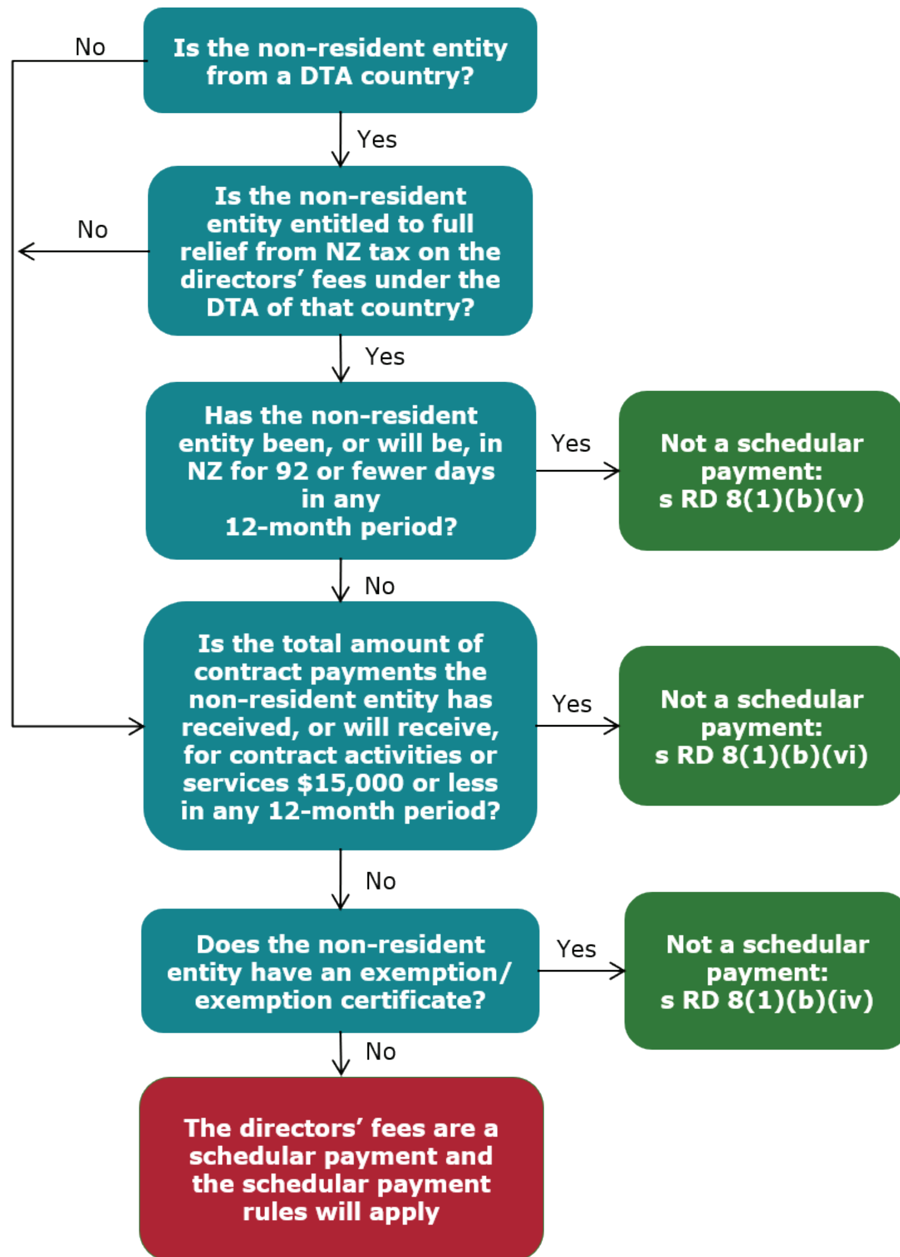
Flowcharts

Flowchart 1: Source of directors' fees paid to non-resident entities and non-resident individuals

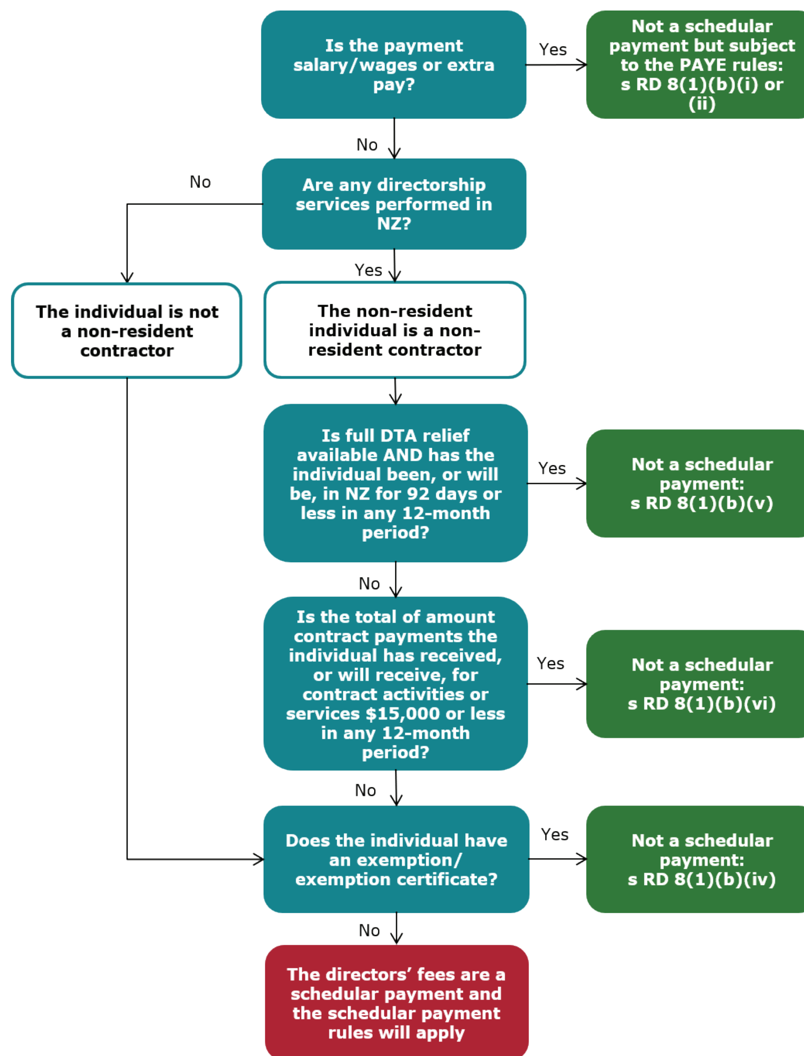


* As discussed in [23]-[31], directors' fees paid to a non-resident individual will, in most cases, have a New Zealand source under s YD 4(4) and (18). However, source under these provisions must ultimately be decided on the specific facts of each case.

Flowchart 2: Withholding from directors' fees paid to a non-resident entity – refer to Flowchart 1 to determine source



Flowchart 3: Withholding from directors' fees paid to a non-resident individual – refer to Flowchart 1 to determine source



References

Subject references

Directors' fees
Non-residents
Schedular payments
Source

Legislative references

Companies Act 1993, s 161
Double Taxation Relief (Australia) Order 1972, art 16
Financial Markets Conduct Act 2013
Income Tax Act 2007, ss CE 1, RD 8(1)(b), YA 1 ("company", "contract activity or service", "contract payment", "director", "non-resident contractor"), YD 4, YD 5, Schedule 4
Takeovers Act 1993
Tax Administration Act 1994
Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018

Case references

C of T v CAM & Sons Ltd (1936) 4 ATD 32
Case E46 (1982) 5 NZTC 59,277
Case H6 (1986) 8 NZTC 153
Case P17 (1992) 14 NZTC 4,115
CIR v NV Philips' Gloeilampenfabrieken [1955] NZLR 868
Dow Chemical Overseas Management Co Ltd v CIR (1994) 16 NZTC 11,143
FCT v French (1957) 98 CLR 398
FCT v Mitchum (1965) 113 CLR 401
Tillard v Commissioner of Taxes [1938] NZLR 795

Related rulings/statements

"BR Pub 15/10: Goods and services tax – directors' fees" *Tax Information Bulletin* Vol 27, No 7 (August 2015): 3
"IS 17/06: Income tax – application of schedular payment rules to directors' fees" *Tax Information Bulletin* Vol 29, No 8 (September 2017): 7

Appendix – Legislation

Income Tax Act 2007

1. Section CE 1(1)e provides:

CE 1 Amounts derived in connection with employment

Income

(1) The following amounts derived by a person in connection with their employment or service are income of the person:

…

(e) directors' fees:

2. Section RD 8(1) provides:

RD 8 Schedular payments

Meaning

(1) A schedular payment—

(a) means—

(i) a payment of a class set out in schedule 4 (Standard rates of tax for schedular payments); and

…

(b) does not include—

(i) salary or wages; or

(ii) an extra pay; or

(iii) a payment for services provided by a public authority, a local authority, a Maori authority, or a company, other than a non-resident contractor, a non-resident entertainer, a company in relation to a payment described in schedule 4, part J or part W, or an agricultural, horticultural, or viticultural company; or

(iv) an exempt payment referred to in section 24H and schedule 5, part C, clause 6 of the Tax Administration Act 1994 applies[2]; or

(v) a payment for services provided by a non-resident contractor who has full relief from tax under a double tax agreement, and is present in New Zealand for 92 or fewer days in a 12-month period; or

(vi) a contract payment for a contract activity or service of a non-resident contractor when the total amount paid for those activities to the contractor or another person on their behalf is $15,000 or less in a 12-month period.

3. Section YA 1 provides the following definitions:

company—

(a) means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:

(ab) does not include a partnership:

(abb) does not include a look-through company, except in the PAYE rules, the FBT rules, the NRWT rules, the RWT rules, the ESCT rules, the RSCT rules, and for the purposes of subpart FO (Amalgamation of companies):

(abc) does not include a company that is acting in the capacity of trustee:

(ac) includes a listed limited partnership:

(ad) includes a foreign corporate limited partnership:

(b) includes a unit trust:

(c) includes a trustee of a group investment fund that is not a designated group investment fund, but only to the extent to which the fund results from investments made into it that are—

(i) not from a designated source, as defined in section HR 3(5) (Definitions for section HR 2: group investment funds); and

(ii) not made before 23 June 1983, including an amount treated as invested at that date under the definition of pre-1983 investment in section HR 3(8):

(d) includes an airport operator:

(e) includes a statutory producer board:

(f) includes a society registered under the Incorporated Societies Act 1908:

(g) includes a society registered under the Industrial and Provident Societies Act 1908:

(h) includes a friendly society:

(i) includes a building society:

[2] This wording of s RD 8(1)(b)(iv) applies from 1 April 2019. Prior to 1 April 2019, s RD 8(1)(b)(iv) read, "a payment covered by an exemption certificate provided under section 24M of the Tax Administration Act 1994; or".

(j) is further defined in section EX 30(7) (Direct income interests in FIFs) for the purposes of that section:

(k) is defined in section HD 15(9) (Asset stripping of companies) for the purposes of that section

…

contract activity or service, for a non-resident contractor, means—

(a) performing any work in New Zealand:

(b) rendering a service of any kind in New Zealand:

(c) providing the use of, or right to use, in New Zealand, any personal property or services of a person other than the non-resident contractor

…

contract payment, for a non-resident contractor, means any payment other than—

(a) a royalty; or

(b) a payment made to the non-resident contractor by or on behalf of a person who is not associated with the contractor to reimburse costs incurred by the contractor; or

(c) a payment referred to in schedule 4, part E (Standard rates of tax for schedular payments)

…

director—

(a) means—

(i) a person occupying the position of director, whatever title is used:

(ii) a person in accordance with whose directions or instructions the persons occupying the position of directors of a company are accustomed to act:

(iii) a person treated as being a director by any other provision of this Act:

(iv) in the case of an entity that does not have directors and that is treated as, or assumed to be, a company by a provision of this Act, any trustee, manager, or other person who acts in relation to the entity in the same way as a director would act, or in a similar way to that in which a director would act, were the entity a company incorporated in New Zealand under the Companies Act 1993:

(b) is defined in section HD 15(9) (Asset stripping of companies) for the purposes of that section

…

non-resident contractor, in the PAYE rules, means a person who—

(a) is **not resident in New Zealand** under subpart YD (Residence and source in New Zealand); and

(b) **undertakes under a contract, agreement, or arrangement** (other than a contract of service or apprenticeship)—

(i) to perform services of any kind in New Zealand:

(ii) to supply the use, or right to use, in New Zealand any personal property **or services of another person**

4. Section YD 4(1)–(4), (17D) and (18) provide:

YD 4 Classes of income treated as having New Zealand source

What this section does

(1) This section lists the types of income that are treated as having a source in New Zealand for the purposes of this Act.

Business in New Zealand

(2) Income derived from a business has a source in New Zealand if—

(a) the business is wholly carried on in New Zealand:

(b) the business is partly carried on in New Zealand, to the extent to which the income is apportioned to a New Zealand source under section YD 5.

Contracts made or performed in New Zealand

(3) Income derived by a person from a contract has a source in New Zealand if the contract is—

(a) made in New Zealand, except to the extent to which the person wholly or partly performs the contract outside New Zealand, and the income is apportioned to a source outside New Zealand under section YD 5:

(b) made outside New Zealand but the person wholly or partly performs the contract here, to the extent to which the income is apportioned to a New Zealand source under section YD 5.

Personal services in New Zealand

(4) An amount that is income under section CE 1 (Amounts derived in connection with employment) has a source in New Zealand if the amount is earned in New Zealand, even if the employer is not a New Zealand resident.

…

Income through permanent establishment

(17C) Income attributable to a permanent establishment in New Zealand of a non-resident has a source in New Zealand, except if—

(a) subsections (15) to (17) provide otherwise:

(b) the income is a dividend from a share in a foreign company that is not revenue account property.

Income taxable under double tax agreement

(17D) Income that may be taxed in New Zealand under a double tax agreement has a source in New Zealand.

Any other source in New Zealand

(18) Income derived directly or indirectly from any other source in New Zealand has a source in New Zealand.

5. Section YD 5(1), (1B), (2) and (3) provides:

YD 5 Apportionment of income derived partly in New Zealand

When this section applies

(1) This section applies when—

(a) a person carries on business partly in New Zealand and partly outside New Zealand; or

(b) a contract is made in New Zealand and is performed, in whole or in part, by a person outside New Zealand; or

(c) a contract is made outside New Zealand and is performed, in whole or in part, by a person in New Zealand; or

(d) interest or a redemption payment is derived from money lent outside New Zealand to a New Zealand resident (the borrower) for the purposes of a business they carry on outside New Zealand through a fixed establishment outside New Zealand and through which the borrower lends money to another New Zealand resident.

Relationship with source rules

(1B) This section does not apply to limit the effect of—

(a) any of the source rules in section YD 4 other than those in section YD 4(2), (3), and (11)(b)(i); or

(b) the source rules in section YD 4(2), (3), and (11)(b)(i) to the extent to which the income referred to is also income referred to in any source rule other than those in section YD 4(2), (3), and (11)(b)(i).

Apportionment

(2) Subject to subsection (4), the amount of income derived from the business or under the contract, and the amount of expenditure incurred in deriving the income, must be apportioned between New Zealand and sources outside New Zealand to the extent necessary to achieve the result in subsection (3).

(3) The result of the apportionment, to the extent consistent with subsection (2), must be that the person's net income or net loss, in relation to the business or contract, is the same as a separate and independent person would have if they were carrying out only the person's activities in New Zealand and dealing at arm's length.

6. Schedule 4 of the Income Tax Act 2007 provides:

Part B

Payments of company directors' fees, examiners' fees, honoraria, and other payments

1 A payment of a company director's fee, or an examiner's fee, or an honorarium, has a standard rate of tax of 0.33 for each dollar of the payment.

…

Part W

Voluntary schedular payments

1 A payment to a person is treated as a schedular payment (a voluntary schedular payment) and has a standard rate of tax of 0.20 for each dollar of the payment if—

(a) there is no obligation to withhold an amount from the payment under this Act or under the Tax Administration Act 1994; and

(b) the payer and the payee have agreed that the payment is a voluntary schedular payment, and have recorded their agreement in a document.

Companies Act 1993

7. Section 161 of the Companies Act 1993 provides:

161 Remuneration and other benefits

(1) The board of a company may, subject to any restrictions contained in the constitution of the company, authorise—

(a) the payment of remuneration or the provision of other benefits by the company to a director for services as a director or in any other capacity:

…

(e) the entering into of a contract to do any of the things set out in paragraphs (a), (b), (c), and (d),—

if the board is satisfied that to do so is fair to the company.

(2) The board must ensure that forthwith after authorising the making of the payment or the provision of the benefit or … the entering into of the contract, as the case may be, particulars of the payment or benefit … or contract are entered in the interests register.

(3) The payment of remuneration or the giving of any other benefit to a director in accordance with a contract authorised under subsection (1) need not be separately authorised under that subsection.

(4) Directors who vote in favour of authorising a payment, benefit … or contract under subsection (1) must sign a certificate stating that, in their opinion, the making of the payment or the provision of the benefit … or the entering into of the contract is fair to the company, and the grounds for that opinion.

(5) Where a payment is made or other benefit provided or a guarantee is given to which subsection (1) applies and either—

(a) the provisions of subsections (1) and (4) have not been complied with; or

(b) reasonable grounds did not exist for the opinion set out in the certificate given under subsection (4),—

the director or former director to whom the payment is made or the benefit is provided … is personally liable to the company for the amount of the payment, or the monetary value of the benefit, … except to the extent to which he or she proves that the payment or benefit … was fair to the company at the time it was made, provided, or given.

Double Taxation Relief (Australia) Order 1972

8. Article 16 of the Double Taxation Relief (Australia) Order 1972 provides:

Article 16

DIRECTORS' FEES

Directors' fees and other similar payments derived by a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

SPS 19/01: Tax payments – when received in time

Introduction

Standard practice statements describe how the Commissioner of Inland Revenue (the Commissioner) will exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

This standard practice statement (this Statement) sets out the Inland Revenue's practice for accepting tax payments as having been made in time.

With the influence of technology there has been a significant shift in practice to use digital methods for making tax payments. The Commissioner encourages customers to use direct banking facilities when they make tax payments (or when refunds are issued).

Application

This Statement applies from 1 March 2019. It replaces SPS 14/01 *Tax payments – when received in time*, which was published in *Tax Information Bulletin*, Vol 26, No 8 (September 2014).

Standard practice

Summary

1. This Statement sets out when Inland Revenue would accept payments as having been received in time, including:
    - electronic payments (from New Zealand)
    - debit/credit cards
    - cash and eftpos payments
    - payments by cheque (including from overseas)
    - tax pooling
    - tax transfers
    - overseas electronic payments
    - weekends and public holidays

Detailed discussion

2. This Statement applies to all tax types, including student loan repayments and child support payments.

New Zealand electronic payments

3. Customers are encouraged to make payments electronically, including by internet banking. Payment by this method minimises delays and includes a formal notification of the date and time the payment was made to Inland Revenue. A payment will be received in time when it has been electronically paid or direct credited into an Inland Revenue account either on or before the due date. You may need to be familiar with your banks processing schedule.
4. If a customer wishes to post-date an electronic payment the "my tax payment" option is available on all major New Zealand banks' websites.
5. Customers who are registered for myIR can set up direct debits where available for certain revenue types. A direct debit payment will be received in time when it has been credited into an Inland Revenue account on or before the New Zealand due date.
6. Tax agents who are registered for myIR can set up instalment arrangements and one-off payments on behalf of their clients (who are registered for myIR) by direct debit on a condition that the client has authorised this action.

Debit/credit cards

7. Customers can make payment by debit/credit card over the phone, through the payment page on our website for all revenues, and through myIR, our secure online service.
8. A convenience fee of 1.42% is payable (charged by the banks) on all debit/credit card tax payments made within New Zealand. This fee also applies to debit/credit card tax payments from overseas, except for child support debt and student loan repayments where Inland Revenue pays the convenience fee.
9. A debit/credit card payment will be received in time when it has been paid or direct credited into an Inland Revenue account on or before the New Zealand due date.

Cash and eftpos payments

10. Payments by cash or eftpos cannot be accepted at an Inland Revenue office. Customers may make payments by cash or by eftpos at branches of Westpac. Payments made over the counter or by eftpos are received in time if they are made on or before the due date. (Note: While payment of tax may be made at Westpac branches, Westpac is not authorised to accept returns. Returns may be filed electronically, posted to Inland Revenue or delivered to an Inland Revenue office.)
11. Customers with a Westpac bank account may also make payments via Westpac ATMs, provided they have a payment slip with a bar code that has been issued by Inland Revenue.

Payments by cheque

Physical delivery to Inland Revenue offices

12. Cheque payments will be accepted as being received in time if delivered to an Inland Revenue office on or before the close of business on the due date.
13. Drop boxes are now inside Inland Revenue office reception areas and are only available during reception opening hours.

Cheques through post

14. Cheques posted to an Inland Revenue postal address, whether posted from within New Zealand or from overseas, must be received on or before the due date. Payments by post should be sent to: Inland Revenue, PO Box 39050, Wellington Mail Centre, Lower Hutt 5045.

Post-dated cheques

15. Inland Revenue will make its best efforts not to bank post-dated cheques until the specified date. A cheque that is post-dated after the due date, even though it may have been received on or before the due date, will be treated as late. This applies to cheques that are mailed or physically delivered.

Tax pooling

16. Tax pooling involves customers depositing money with a tax pooling intermediary who then deposits that money into a tax pooling account with Inland Revenue. These deposits are not tax payments at this stage.
17. It is when a payment is transferred from the tax pooling account into a taxpayer's tax account that it becomes a tax payment. The date of payment to Inland Revenue is triggered when the tax pooling deposit is transferred into a taxpayer's account. The effective date of the transfer can be no earlier than the date the tax pool deposit was received by Inland Revenue.
18. For more information on the implications of tax pooling see *Tax Information Bulletins*, Vol 15, No 5 (May 2003) pages 64 to 67, Vol 23, No 8 (October 2011) pages 35 to 55 and Vol. 29, No. 5 (June 2017) pages 148 to 149.

Overseas electronic payments

19. A payment will be received in time when it has been electronically paid or direct credited into an Inland Revenue account either on or before the New Zealand due date.
20. For more information about making payments from overseas visit **www.ird.govt.nz/makepayment/overseas/from-overseas-index.html**

Tax transfers

21. For the rules regarding the transfers of overpaid taxes refer to *Tax Information Bulletins*, Vol 14, No 11 (November 2002) pages 35 to 47, Vol 16, No 1 (February 2004) page 71 and Vol. 17, No. 1 (February 2005) pages 101 to 102.

Weekends and public holidays

22. If a due date falls on a weekend or a public holiday, then an electronic payment will be in time when it is credited into an Inland Revenue account on or before the next working day.
23. If a due date falls on a weekend or a public holiday (including a provincial anniversary day), a payment will be in time if it is received by an Inland Revenue branch office, at a Westpac branch or at an Inland Revenue postal address on the next working day. This treatment only applies to those customers who usually deliver payments to a Westpac branch or Inland Revenue drop box in the province that is celebrating its anniversary day and so are unable to access those sites on that day.

This Standard Practice Statement is signed on 19 February 2019.

Rob Wells
Manager, Technical Standards

OPERATIONAL POSITION

Operational statements set out the Commissioner's view of the law in respect of the matter discussed. They are intended to be a preliminary view in the absence of a public binding ruling or an interpretation statement on the subject

Commissioner's Operational Position on IS 19/01 – Income Tax – How schedular payment rules apply to non-resident directors' fees

The Commissioner has released Interpretation Statement 19/01 *"Income Tax – How schedular payment rules apply to non-resident directors' fees"*.

The Interpretation Statement gives guidance on when tax must be withheld from directors' fees paid to non-residents, and how much tax must be withheld when required to do so.

The view taken in IS 19/01 differs from the existing practice, which was to treat directors' fees paid to a non-resident individual as having a source in New Zealand only to the extent that the directorship services are performed in New Zealand.

The Commissioner's position now is that in most cases directors' fees a New Zealand company pays to a non-resident individual are schedular payments (subject to certain exclusions) and will have a source in New Zealand, regardless of whether the directorship services are performed in New Zealand or from overseas.

Directors' fees not subject to section YD 4(17D) of the Income Tax Act 2007

The Commissioner will apply the following operational position to directors' fees that:

- are paid by a New Zealand company to a non-resident individual; and
- do not have a New Zealand source under section YD 4(17D), because New Zealand is not entitled to tax that income under a Double Tax Agreement (DTA).

New Zealand companies and non-resident individuals who have been taking a position that is not consistent with IS 19/01 can continue to apply that position to payments of directors' fees until 31 March 2019.

From 1 April 2019, New Zealand companies and non-resident directors must apply the position as stated in IS 19/01. In most cases, directors' fees paid to non-resident individuals will have a source in New Zealand, regardless of where the directorship services are performed, and tax must be deducted from these fees.

Directors' fees subject to section YD 4(17D) of the Income Tax Act 2007

Section YD 4(17D) treats directors' fees as having a New Zealand source where:

- a New Zealand company pays directors' fees to an individual who is resident in a country that has a DTA with New Zealand; and
- that DTA permits New Zealand to tax those directors' fees.

Section YD 4(17D) applies from income years beginning on or after 1 July 2018.

For non-resident individuals with a standard balance date of 31 March, section YD 4(17D) will not apply to directors' fees paid to them before 1 April 2019, because this is the start of their next income year beginning on or after 1 July 2018.

For non-resident individuals with non-standard balance dates, section YD 4(17D) will apply to directors' fees paid to them from the beginning of their next income year on or after 1 July 2018.

For further information or advice regarding IS 19/01, please contact Inland Revenue or your tax advisor.

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

2019 International tax disclosure exemption ITR30

Introduction

Section 61 of the Tax Administration Act 1994 ("TAA") requires taxpayers to disclose interests in foreign entities.

Section 61(1) of the TAA states that a person who has a control or income interest in a foreign company or an attributing interest in a foreign investment fund ("FIF") at any time during the income year must disclose the interest held. In the case of partnerships, disclosure needs to be made by the individual partners in the partnership. The partnership itself is not required to disclose.

Section 61(2) of the TAA allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of the international tax rules (as defined in section YA 1) contained in the Income Tax Act 2007 ("the ITA").

To balance the revenue forecasting and risk assessment needs of the Commissioner with the compliance costs of taxpayers providing the information, the Commissioner has issued an international tax disclosure exemption under section 61(2) of the TAA that applies for the income year corresponding to the tax year ended 31 March 2019. This exemption may be cited as "International Tax Disclosure Exemption ITR30"("the 2019 disclosure exemption") and the full text appears at the end of this item.

Scope of exemption

The scope of the 2019 disclosure exemption is the same as the 2018 disclosure exemption.

Application date

This exemption applies for the income year corresponding to the tax year ended 31 March 2019.

Summary

In summary, the 2019 disclosure exemption **removes** the requirement of a resident to disclose:

- An interest of less than 10% in a foreign company if it is not an attributing interest in a FIF or if it falls within the $50,000 de minimis exemption (see section CQ 5(1)(d) and section DN 6(1)(d) of the ITA). The de minimis exemption does not apply to a person that has opted out of the de minimis threshold by including in the income tax return for the income year an amount of FIF income or loss.
- If the resident is not a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country or territory, and the fair dividend rate or comparative value method of calculation is used.
- If the resident is a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10% if the fair dividend rate or comparative value method is used for the interest. The resident is instead required to disclose the end-of-year New Zealand dollar market value of all such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

The 2019 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

Commentary

Generally, residents who hold an income interest or a control interest in a foreign company, or an attributing interest in a FIF are required to disclose these interests to the Commissioner. These interests are considered in further detail below.

Attributing interest in a FIF

A resident is required to disclose an attributing interest in a FIF if FIF income or a FIF loss arises through the use of one of the following calculation methods:

- attributable FIF income, deemed rate of return or cost methods; or
- fair dividend rate or comparative value methods, if the resident is a "widely-held entity" or
- fair dividend rate or comparative value methods, if the resident is not a widely-held entity and the attributing interest is incorporated or otherwise tax resident in a country or territory with which New Zealand does not have a double tax agreement in force as at 31 March 2019.

The 40 countries or territories with which New Zealand does have a double tax agreement in force as at 31 March 2019 are listed below.

Australia	France	Mexico	Spain
Austria	Germany	Netherlands	Sweden
Belgium	Hong Kong	Norway	Switzerland
Canada	India	Papua New Guinea	Taiwan
Chile	Indonesia	Philippines	Thailand
China	Ireland	Poland	Turkey
Czech Republic	Italy	Russian Federation	United Arab Emirates
Denmark	Japan	Samoa	United Kingdom
Fiji	Korea	Singapore	United States of America
Finland	Malaysia	South Africa	Viet Nam

For the avoidance of doubt, the term "double tax agreement" does not include tax information exchange agreements or collection agreements and is limited to the double tax agreements negotiated with the 40 countries or territories listed in this 2019 disclosure exemption.

No disclosure is required by non-widely-held taxpayers for attributing interests in FIFs that are income interests of less than 10% and are incorporated or otherwise tax resident in a tax treaty country or territory, if the fair dividend rate or comparative value methods of calculation are used.

A "widely-held entity" for the purposes of this disclosure is an entity which is a:

- portfolio investment entity (this includes a portfolio investment-linked life fund); or
- widely-held company; or
- widely-held superannuation fund; or
- widely-held group investment fund ("GIF").

Portfolio investment entity, widely-held company, widely-held superannuation fund and widely-held GIF are all defined in section YA 1 of the ITA.

The disclosure required, by widely-held entities, of attributing interests in FIFs which use the fair dividend rate or the comparative value method of calculation is that, for each calculation method, they disclose the end-of-year New Zealand dollar market value of investments split by the jurisdiction in which the attributing interest in a FIF is held, listed, organised or managed. In the event that tax residence is not easily determined, a further option of a split by currency in which the investment is held will also be accepted as long as it is a reasonable proxy - that is at least 90-95% accurate - for the underlying jurisdiction in which the FIF is held, listed, organised or managed. Investments denominated in euros will not be able to meet this test and so euro-based investments will need to be split into the underlying jurisdictions.

FIF interests

The types of interests that fall within the scope of section 61(1) of the TAA are:

- rights in a foreign company or anything deemed to be a company for the purposes of the ITA (eg, a unit trust)
- an entitlement to benefit from a foreign superannuation scheme, if a person acquired the interest before 1 April 2014 and treated the interest as a FIF interest in a return of income filed before 20 May 2013 and for all subsequent income years

- an entitlement to benefit from a foreign superannuation scheme, if a person's interest in the scheme was first acquired whilst the person was tax resident of New Zealand
- an entitlement to benefit from a foreign life insurance policy
- an interest in an entity specified in schedule 25, part A of the ITA.

However, the following interests are exempt (under sections EX 31 to EX 43 of the ITA) from being an attributing interest in a FIF and do not have to be disclosed:

- an income interest of 10% or more in a controlled foreign company ("CFC") (although separate disclosure is required of this as an interest in a foreign company)
- certain interests in Australian resident companies included on the official list of the Australian Stock Exchange and required to maintain a franking account (refer to Inland Revenue's website **www.ird.govt.nz** (keyword: other exemptions))
- certain interests in an Australian unit trust that has a New Zealand RWT proxy with either a high turnover or high distributions
- certain interests of 10% or more in a foreign company that is treated as resident, and subject to tax, in Australia (although separate disclosure is required of this as an interest in a foreign company)
- a beneficial interest in a foreign superannuation scheme which was first acquired whilst the person was not a tax resident of New Zealand and which has not been treated as an attributing interest in a FIF by the person
- certain foreign pensions or annuities (see Inland Revenue's guide *Overseas pensions and annuity schemes (IR257)* for more information)
- an interest in certain venture capital investments in New Zealand resident start-up companies that migrate to a grey-list country
- an interest in certain grey-list companies owning New Zealand venture capital companies
- an interest in certain grey-list companies resulting from shares acquired under a venture investment agreement
- an interest in certain grey-list companies resulting from the acquisition of shares under an employee share scheme
- certain interests held by a natural person in a foreign entity located in a country where exchange controls prevent the person deriving any profit or gain or disposing of the interest for New Zealand currency or consideration readily convertible to New Zealand currency.

De minimis

Interests in foreign entities held by a natural person not acting as a trustee also do not have to be disclosed if the total cost of the interests remains under $50,000 at all times during the income year. This disclosure exemption is made because no FIF income under section CQ 5 of the ITA or FIF loss under section DN 6 of the ITA arises in respect of these interests.

This de minimis exemption does not apply to a person who has opted out of the de minimis threshold by including in the income tax return for the year a FIF income or loss. Please note that a person opting out of the de minimis threshold is generally required to continue to apply the FIF rules in each subsequent tax year. Where a person has previously opted out of the de minimis threshold, they will be required to apply the FIF rules unless they have less than $50,000 of attributing interests in FIFs for the current year, and for each of the four previous tax years:

- the person had no attributing interests in FIFs (for example, they had no foreign shares, or only had foreign shares which were exempt from the FIF rules); and/or
- the person had more than $50,000 in attributing interests in FIFs (note that for these years they would have been required to apply the FIF rules).

Format of disclosure

The forms for the disclosure of FIF interests are as follows:

- IR443 form for the deemed rate of return method
- IR445 form for the fair dividend rate method (for widely-held entities)
- IR446 form for the comparative value method (for widely-held entities)
- IR447 form for the fair dividend rate method (for individuals or non-widely-held entities)
- IR448 form for the comparative value method (for individuals or non-widely-held entities)
- IR449 form for the cost method

- IR458 electronic form for the attributable FIF income method (this form can also be used to make electronic disclosures for all other methods).

It is now possible to download a spreadsheet as a working paper or complete the disclosures online.

If you're downloading the spreadsheet you will be able to save it as a working paper on your computer and when completed submit the form by using Inland Revenue's online services.

Alternatively, you will still be able to complete the disclosure online without downloading a spreadsheet by directly entering the disclosure online.

The IR445 and IR446 forms, which reflect the disclosure for fair dividend rate and comparative value for widely-held entities, must be filed online. As discussed above these disclosures are by country rather than by individual investment as is the general requirement of section 61 of the TAA. In order to be exempt from the general requirement, these disclosures must be made electronically.

The IR447, IR448 and IR449 forms, applying to the fair dividend rate and comparative value methods for *individuals or non widely-held entities* as well as the cost method for all taxpayers, may be completed online.

As noted above, all of the above disclosures can now be filed using the IR458 electronic disclosure (which supports the spreadsheet approach).

The online forms can be found at **www.ird.govt.nz** "Get it done online", "Foreign investment fund disclosure".

Income interest of 10% or more in a foreign company

A resident is required to disclose an income interest of 10% or more in a foreign company. This obligation to disclose applies to all foreign companies regardless of the country of residence. For this purpose, the following interests need to be considered:

a) an income interest held directly in a foreign company

b) an income interest held indirectly through any interposed foreign company

c) an income interest held by an associated person (not being a CFC) as defined by subpart YB of the ITA.

To determine whether a resident has an income interest of 10% or more for CFCs, sections EX 14 to EX 17 of the ITA should be applied. To determine whether a resident has an income interest of 10% or more in any entity that is not a CFC, for the purposes of this exemption, sections EX 14 to EX 17 should be applied to the foreign company as if it were a CFC.

Format of disclosure

Disclosure of all interests in a CFC is required using a *Controlled foreign company disclosure (IR458)* form. This form, which involves uploading a prescribed spreadsheet, can cater for up to 500 individual disclosures.

The IR458 form must be accessed online at **www.ird.govt.nz** (keyword: ir458). Please note that electronic filing is a mandatory requirement for CFC disclosure.

Overlap of interests

It is possible that a resident may be required to disclose an interest in a foreign company which also constitutes an attributing interest in a FIF. For example, a person with an income interest of 10% or greater in a foreign company that is not a CFC is strictly required to disclose both an interest held in a foreign company and an attributing interest in a FIF.

To meet disclosure requirements, only one form of disclosure is required for each interest. If the interest is an attributing interest in a FIF, then the appropriate disclosure for the calculation method, as discussed previously, must be made.

In all other cases, where the interest in a foreign company is not an attributing interest in a FIF, the IR458 for controlled foreign companies must be filed.

Interests held by non-residents and transitional residents

Interests held by non-residents and transitional residents in foreign companies and FIFs do not need to be disclosed.

This would apply for example to an overseas company operating in New Zealand (through a branch) in respect of its interests in foreign companies and FIFs; or to a transitional resident with interests in a foreign company or an attributing interest in a FIF.

Under the international tax rules, non-residents and transitional residents are not required to calculate or attribute income under either the CFC or FIF rules. Therefore disclosure of non-residents' or transitional residents' holdings in foreign companies or FIFs is not necessary for the administration of the international tax rules and so an exemption is made for this group.

Persons not required to comply with section 61 of the Tax Administration Act 1994

This exemption may be cited as "International Tax Disclosure Exemption ITR30".

1. Reference

This exemption is made under section 61(2) of the Tax Administration Act 1994 ("TAA"). It details interests in foreign companies and attributing interests in FIFs in relation to which any person is not required to comply with the requirements in section 61 of the TAA to make disclosure of their interests, for the income year ended 31 March 2019.

2. Interpretation

For the purpose of this disclosure exemption:

- to determine an income interest of 10% or more, sections EX 14 to EX 17 of the Income Tax Act 2007 ("ITA") apply for interests in CFCs. In the case of attributing interests in FIFs, those sections are to be applied as if the FIF were a CFC, and
- double tax agreement means a double tax agreement in force as at 31 March 2019 in one of the 40 countries or territories as set out in the commentary.

The relevant definition of "associated persons" is contained in subpart YB of the ITA.

Otherwise, unless the context requires, expressions used have the same meaning as in section YA 1 of the ITA.

3. Exemption

i. Any person who holds an income interest of less than 10% in a foreign company, including interests held by associated persons, that is not an attributing interest in a FIF, or that is an attributing interest in a FIF in respect of which no FIF income or loss arises due to the application of the de minimis exemption in section CQ 5(1)(d) or section DN 6(1)(d) of the ITA, is not required to comply with section 61(1) of the TAA for that interest and that income year.

ii. Any person who is a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct interest of 10% or more in a foreign company that is not a foreign PIE equivalent, and uses the fair dividend rate or comparative value calculation method for that interest, is not required to comply with section 61(1) of the TAA in respect of that interest and that income year, if the person discloses the end-of-year New Zealand dollar market value of investments, in an electronic format prescribed by the Commissioner, split by the jurisdiction in which the attributing interest in a FIF is held or listed.

iii. Any person who is not a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct income interest of 10% or more, and uses the fair dividend rate or comparative value calculation method is not required to comply with section 61(1) of the TAA in respect of that interest and that income year, to the extent that the FIF is incorporated or tax resident in a country or territory with which New Zealand has a double tax agreement in force at 31 March 2019.

iv. Any non-resident person or transitional resident who has an income interest or a control interest in a foreign company or an attributing interest in a FIF in the income year corresponding to the tax year ending 31 March 2019, is not required to comply with section 61(1) of the TAA in respect of that interest and that income year if either or both of the following apply:

    - no attributed CFC income or loss arises in respect of that interest in that foreign company under sections CQ 2(1)(d) or DN 2(1)(d) of the ITA; and/or
    - no FIF income or loss arises in respect of that interest in that FIF under sections CQ 5(1)(f) or DN 6(1)(f) of the ITA.

This exemption is made by me acting under delegated authority from the Commissioner of Inland Revenue pursuant to section 7 of the TAA.

This exemption is signed on 6 March 2019

Haydn Clark
Technical Specialist

Special Determination S61: Optional Convertible Notes with Discretionary Interest Payments

1. Explanation (which does not form part of the determination)

1.1 This determination relates to optional convertible notes (Convertible Notes) issued by the Issuer to the Holders. The Holders are different legal entities to the shareholders of the Issuer. However, they are ultimately owned and controlled by the same persons. This determination only applies to the Issuer as the Note Holders are not New Zealand residents and do not have a fixed establishment in New Zealand for the purposes of ss EW 9 and EW 10.

1.2 Under the Convertible Notes, the Holders have loaned funds to the Issuer. The Issuer, at their sole discretion, can elect to pay interest to the Holders on a quarterly basis. If no interest is paid, it does not accumulate. The interest rate is set at 250bp over the bank bill rate. No fees are payable by either the Issuer or the Holders in relation to the Convertible Notes. The Holders have the option to convert the Notes to an equivalent value of shares in the Issuer at any point during the term of the facility, but cannot demand repayment in cash until the facility maturity date. The exercise of the option to convert the debt to equity would result in no change in the ownership/voting interests in the Issuer.

1.3 A share or an option to acquire a share is an excepted financial arrangement under s EW 5(13). The Convertible Notes are a financial arrangement that include an excepted financial arrangement. In accordance with s EW 6(2), an amount that is solely attributable to an excepted financial arrangement under ss EW 5(2) to EW 5(16) is not taken into account under the financial arrangements rules.

1.4 Determination G22A: Optional Convertible Notes Denominated in New Zealand Dollars (Determination G22A) prescribes the method under the financial arrangement rules for calculating income, expenditure and the base price adjustment in relation to optional convertible notes that are denominated in New Zealand Dollars. Determination G22A does not apply to the Convertible Notes as the date and amount of all payments is not known by the first balance date. This determination applies the method and the principle from Determination G22A to the Convertible Notes.

1.5 If the Holders exercised the option and the result would be no change in the ownership of the issuer (either beneficially, voting or market value interests), no value is attributed to the Convertible Note's equity component. Therefore, all consideration paid or received under the Convertible Notes is attributed to the debt component.

1.6 As interest is discretionary, no amounts are taken into account under the financial arrangements rules, as the amount and timing of payment is not known at the first balance date. However, in the income year in which such payments are made, the amounts will be accounted for by applying Determination G25: Variations in the Terms of a Financial Arrangement.

2. Reference

This determination is made under ss 90AC(1)(bb) and 90AC(1)(h) of the Tax Administration Act 1994.

3. Scope of determination

3.1 This determination applies to the Convertible Notes issued by the Issuer to Holders on 26 February 2019.

3.2 The terms of the Convertible Notes are as follows:

- The Convertible Notes will have a face value of NZ$1.00.
- The payment of any interest is discretionary and non-cumulative.
- The interest rate will be 250bp over the bank bill rate. The Issuer's decision on whether to pay interest is made on a quarterly basis. Any interest will not be capitalised.
- The Principal is required to be repaid by the Final Repayment Date, which is 9 years and 360 days from the date of issue.
- At any point prior to the Final Repayment Date, any of the Holders may elect to convert their Convertible Notes into ordinary shares in the Issuer (subject to a 90% agreement of the Holders). No Holder can act independently, a unanimous conversion will occur so that there is no change in the ownership of the Issuer.
- The number of shares to be issued upon a conversion event will be based on the market value of the Issuer at the time of conversion.
- The right of conversion is solely held by the Holders i.e. the Issuer has no power to convert.
- The Issuer has the right to early repay a portion or all of the Convertible Notes by giving 5 days notice.
- No fees are payable by the Issuer or the Holders in relation to the Convertible Notes.

4. Principle

4.1 The Convertible Notes are a financial arrangement (as defined in s EW 3).

4.2 A share or an option to acquire a share is an excepted financial arrangement (s EW 5(13)). The Convertible Notes are therefore a financial arrangement that includes an excepted financial arrangement.

4.3 Under s EW 6(2), an amount that is solely attributable to an excepted financial arrangement under ss EW 5(2) to EW 5(16) is not taken into account under the financial arrangements rules. Any amount that is not solely attributable to an excepted financial arrangement is required to be taken into account under the financial arrangements rules and spread in accordance with those rules.

4.4 Under s EW 14(3) an amount that is allocated to an income year under a spreading method will either be expenditure incurred or income derived by the person. Any discretionary interest payments made will be expenditure incurred by the Issuer.

4.5 Determination G22A sets out a method for calculating and allocating income and expenditure for the purposes of the financial arrangement rules. In accordance with the principle in Determination G22A, none of the consideration provided or received under the Convertible Notes is attributed to the equity component of the Notes, and all consideration paid or received is attributed to the debt component. This is because:

a. The parties to the Convertible Note at the date of issue are beneficially owned and ultimately controlled by the same person; and

b. There would be no change to either the voting interests or the market value interests in the Issuer if the option to convert was exercised by the Holders.

4.6 The Issuer's discretion to elect to pay interest on a quarterly basis results in the dates and amounts of interest payments not being known by the first balance date following issue of the Convertible Notes.

4.7 Using the principle and method in Determination G22A, there will be no amounts to spread under the financial arrangement (as the subscription price for the Convertible Notes is equal to the repayment price and there are no known interest payments). In an income year in which any interest is paid, Determination G25: Variations in the Terms of a Financial Arrangement should be applied to account for those payments.

5. Interpretation

In this determination, unless the context otherwise requires:

- All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
- **Convertible Notes** means the unsecured subordinated notes, in a denomination of $1.00 issued by the Issuer to the Holders.

6. Method

6.1 The Convertible Notes have both a debt and equity component. The equity component (being the conversion option) is an excepted financial arrangement.

6.2 The amount of consideration received by the Issuer that is solely attributable to the equity component of the Convertible Note is nil.

6.3 Any early redemption of a Convertible Note for its $1 face value will be attributed to the debt component of the note.

6.4 As the issue price and redemption price of the Convertible Notes are the same, there will be no amounts of expenditure or interest to be spread in accordance with the financial arrangements rules.

6.5 Any interest payments made will not be solely attributable to an excepted financial arrangement. Under s EW 14(3) any discretionary interest payments will be expenditure incurred by the Issuer.

6.6 In the event that interest is paid, the amount of consideration paid by the Issuer must be varied using Determination G25: Variations in the terms of a financial arrangement.

7. Example

This example illustrates the application of the method set out in this determination.

On 1 April 2019, 1,000 $1 Optional Convertible Notes are issued to the Holders for a 9 year and 360 days term. The notes can be converted to shares at any time.

No interest will accrue as the interest payments are at the discretion of the Issuer. On the date of issue, as a conversion event will not trigger a change in the beneficial or ultimate owner of the Issuer, no value will be allocated to the equity component of the convertible note.

However in the 2023 income year, the Issuer exercises its discretion to pay interest for two quarters. The market interest rate is set as per the facility agreement (but for the purposes of this example we will use 5%).

The annual sum of the expenditure incurred under the financial arrangement applying the principles in Determination G25 for the period 31 March 2020 to 2024 is:

31 March 2020	Nil
31 March 2021	Nil
31 March 2022	Nil
31 March 2023	$25 (being the year in which cash interest is paid)
31 March 2024	Nil
Total Deductions	$25

This Determination is signed by me on the 6th day of March 2019.

Howard Davis
Director, Taxpayer Rulings

Special Determination S62: Spreading method to be applied by Landowners making Infrastructure Payments to fund bulk infrastructure under a Final Encumbrance

1. Explanation (which does not form part of the determination)

1.1 This Determination relates to an arrangement involving an encumbrance (the Final Encumbrance) under which a landowner (the Landowner) is required to make payments to Milldale Infrastructure LP (the LP) over a fixed period. The arrangement is described in more detail in the Product Ruling.

1.2 The LP is a vehicle that was set up to provide funding to developers to assist the build of storm water, water supply, wastewater and roading infrastructure (collectively the Bulk Infrastructure) for housing development projects. As repayment of the funding received, the developers will issue a Final Encumbrance on certain subdivided sections in the relevant subdivision, requiring Landowners to make payments to the LP (the Infrastructure Payments) attributable to that section. Each time a subdivided section is sold the Final Encumbrance will be transferred for no consideration.

1.3 The Final Encumbrance:

- Creates an obligation of the Landowner at the relevant time to pay the Infrastructure Payments attributable to that section from the relevant Infrastructure Payments commencement date and over the Infrastructure Payments term;
- Sets out the payment dates on which Infrastructure Payments are to be made by the Landowner;
- Enables the Landowner to prepay the Infrastructure Payments (in full but not in part);
- Grants the LP security over the section;
- Requires the Landowner to transfer the Final Encumbrance for no consideration when the Landowner sells a section with a Final Encumbrance; and
- Enables the Final Encumbrance to be released on the date on which all Infrastructure Payments have been paid in full.

1.4 Where a section is sold, the sale and purchase agreement may apportion an accrued or prepaid portion of the Infrastructure payment for the period in which settlement falls.

1.5 Where an Infrastructure Payment has accrued for a period but is not yet due on the date that a section is sold, the Vendor may pay an amount as 'outgoings' to the purchaser on settlement for their share of the Infrastructure Payment. Similarly, if the Vendor has prepaid an amount of Infrastructure Payment for a period, the purchaser may pay an amount of 'outgoings' to the Vendor for their share of the Infrastructure Payment for the period.

1.6 This determination prescribes the method for determining the amount of expenditure a Landowner has under the financial arrangement in each income year.

1.7 A cash basis person or an IFRS taxpayer may elect to apply the method in this determination. Subject to 3.3 below, any other taxpayer is required to apply this determination.

2. Reference

This determination is made under ss 90AC(1)(bb) and 90AC(1)(d) of the Tax Administration Act 1994.

3. Scope of determination

3.1 This determination is conditional upon the continued application of the Product Ruling.

3.2 This determination applies to the Landowner in respect of Infrastructure Payments made under the Final Encumbrance and transfers of the Final Encumbrance.

3.3 This determination does not apply to:

- The Developer;
- A Landowner who holds the property for private purposes and to whom the private limitation in s DA 2(2) applies;
- A Landowner who holds the property for the purposes of deriving exempt income, and to whom the exempt income limitation in s DA 2(3) applies;
- A non-resident, unless the Landowner carries on business through a "fixed establishment" (as defined in s YA 1) in New Zealand and the property is used as part of carrying on that business;
- A Landowner that is a cash basis person, unless they elect to apply it;

- A Landowner that is an IFRS taxpayer, unless they elect to apply it; or
- A Landowner that treats the Final Encumbrance as a hedge under IFRS.

4. Principle

4.1 The Final Encumbrance is a "financial arrangement" under s EW 3 and is not an "excepted financial arrangement" under s EW 5.

4.2 For the purposes of s EW 15 and EW 31(7), the only amounts of "consideration" under the Final Encumbrance are:

- the Infrastructure Payments made by the Landowner; and
- any adjustment made to the purchase price for the accrued or prepaid portion of the Infrastructure Payment when the section is purchased or sold.

4.3 Under s EW 12, the Landowners are required to use one of the spreading methods in s EW 14(2). Under s EW 15E(2)(d) and s EW 20, the Commissioner can determine the method to be applied. The amount allocated to an income year will be "expenditure incurred" by the Landowner, and will be deductible to them.

4.4 Under s EW 29, the Landowner is required to perform a base price adjustment (BPA) in the income year that the final Infrastructure Payment is made (including any lump sum prepayment of the amount owing) or the property is sold.

4.5 This determination specifies the method that must be applied by Landowners to allocate an amount of expenditure to an income year.

5. Interpretation

In this determination, unless the context otherwise requires:

- All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
- Capitalised terms have the same meaning as set out in the Final Encumbrance.
- **Cash basis person** has the same meaning as in s EW 54.
- **IFRS** has the same meaning as in s YA 1.
- **IFRS taxpayer** means a person who uses IFRS to prepare financial statements and to report for financial arrangements.
- **Product Ruling** means product ruling BR Prd 19/01, issued on 7 March 2019 and includes any Ruling issued to replace that Ruling provided that any change to the Ruling does not affect the application of this determination.

6. Method

6.1 The method for determining the amount of expenditure that is to be allocated to each income year is on a paid basis. That is, the amount of the Infrastructure Payment made by a Landowner in an income year is allocated to that income year as expenditure.

6.2 If a Landowner does not pay an Infrastructure Payment in an income year, no amount is allocated as expenditure in that income year.

6.3 If the property is purchased by a person in an income year:

(a) Where the Infrastructure Payment for the period is prepaid beyond the date of settlement of the transaction, the payment by the purchaser for their apportioned share of the prepaid Infrastructure Payments (covering the period from the time of settlement) will be allocated to the income year in which settlement occurred.

(b) Where the Infrastructure Payment for the period is accrued but unpaid on the settlement date, the amount owing and adjusted for on settlement by the vendor for their apportioned share of the accrued but unpaid Infrastructure Payments (covering the period up to settlement) will be allocated by the purchaser to the year that the purchaser makes a payment of its first Infrastructure Payment (i.e. the Infrastructure Payment income from settlement is netted against the next Infrastructure Payment paid by the purchaser).

7. Example

The examples below illustrate the application of the method set out in this determination.

Example 1

A Landowner purchases a subdivided section on 1 July 2019 with a Final Encumbrance attached. The Final Encumbrance requires annual Infrastructure Payments of $1,200 per year. The term of the Final Encumbrance is 30 years.

The Infrastructure Payments fall due for payment in four equal quarterly instalments on the same payment dates that apply for quarterly payments of Auckland Council general rates, being:

- 31 August, for the period 1 July - 30 September
- 30 November, for the period 1 October - 31 December
- 28 February, for the period 1 January - 31 March
- 31 May, for the period 1 April - 30 June

If the Landowner pays the Infrastructure Payments on the due dates the Landowner will have the following amounts allocated as expenditure in the income year ended 31 March 2020:

31 August 2019	$300.00
30 November 2019	$300.00
28 February 2020	$300.00
Total Interest Component	**$900.00**

Example 2

Assume the same facts as Example 1, however the Landowner elects to prepay all Infrastructure Payments on 1 July 2019.

As the financial arrangement has matured, a BPA is required and no spreading method will be applied. The full prepaid amount will be expenditure under the BPA in the income year ended 31 March 2020.

Example 3

Assume the same facts as Example 1, however the Landowner sells the section on 31 July 2029. The Final Encumbrance is transferred to the New Landowner.

On settlement, there will be an apportionment of the accrued but unpaid Infrastructure Payment on settlement date, calculated on a number of days basis:

31 days ÷ 92 days in the quarter × $300 = $101.10

If the Landowner pays the Infrastructure Payments on the due dates the Landowner will have the following amounts allocated as expenditure to the year of disposal (the income year ended 31 March 2030):

31 May 2029	$300.00
Transfer of Final Encumbrance	$101.10
Total Interest Component	**$401.10**

Example 4

Assume the same facts as Example 3, but from the purchaser's (New Landowner's) perspective.

On settlement, there will be an apportionment of the accrued but unpaid Infrastructure Payment on settlement date, calculated on a number of days basis:

31 days ÷ 92 days in the quarter × $300 = $101.10

This apportionment of outgoings will be consideration paid to the New Landowner. If the New Landowner pays the Infrastructure Payments on the due dates the New Landowner will have the following amount of expenditure allocated to the year following acquisition (the income year ended 31 March 2030):

Transfer of Final Encumbrance	($101.10)
31 August 2029	$300.00
30 November 2029	$300.00
28 February 2030	$300.00
Total Interest Component	**$798.90**

Example 5

Assume the same facts as Example 4, but the New Landowner has a 31 July non-standard balance date.

The apportionment of outgoings will be allocated to the year that the New Landowner makes a payment of its first Infrastructure Payment (i.e. the income from settlement is netted against the next Infrastructure Payment paid by the New Landowner).

For the year ended 31 July 2029, the New Landowner will have no income or expenditure under the financial arrangements rules in relation to the Final Encumbrance.

For the year ended 31 July 2030, the expenditure will be equal to the Infrastructure Payment[s] made by the New Landowner less the apportionment of outgoings.

If the New Landowner pays the Infrastructure Payments on the due dates the New Landowner will have the following amount of expenditure allocated to the year following acquisition (the income year ended 31 July 2030):

Transfer of Final Encumbrance	($101.10)
31 August 2029	$300.00
30 November 2029	$300.00
28 February 2030	$300.00
31 May 2030	$300.00
Total Interest Component	**$1,098.90**

This Determination is signed by me on the 7th day of March 2019.

Howard Davis
Director, Taxpayer Rulings

Participating jurisdictions for the CRS applied standard

Determination

New Zealand's list of participating jurisdictions for the purposes of the Common Reporting Standard (CRS rules) and requirements under Part 11B of the Tax Administration Act 1994 will be amended with effect from 1 April 2019 as follows:

Jurisdictions to be added

Antigua and Barbuda	Aruba	Azerbaijan	Bahamas
Barbados	Chile	Cook Islands	Israel
Kuwait	Lebanon	Macao	Malaysia
Nauru	Pakistan	Panama	Qatar
Saint Kitts & Nevis	Saudi Arabia	Switzerland	United Arab Emirates
Vanuatu			

Full list of participating jurisdictions from 1 April 2019

Additions are highlighted in bold italics

Anguilla	***Antigua and Barbuda***	Argentina	***Aruba***
Australia	Austria	***Azerbaijan***	***Bahamas***
Barbados	Belgium	Belize	Bermuda
Brazil	British Virgin Islands	Bulgaria	Canada
Cayman Islands	***Chile***	China	Colombia
Cook Islands	Costa Rica	Croatia	Curacao
Cyprus	Czech Republic	Denmark	Estonia
Faroe Islands	Finland	France	Germany
Gibraltar	Greece	Greenland	Grenada
Guernsey	Hong Kong	Hungary	Iceland
India	Indonesia	Ireland	Isle of Man
Israel	Italy	Japan	Jersey
Korea	***Kuwait***	Latvia	***Lebanon***
Liechtenstein	Lithuania	Luxembourg	***Macao***
Malaysia	Malta	Mauritius	Mexico
Montserrat	***Nauru***	Netherlands	New Zealand
Norway	***Pakistan***	***Panama***	Poland
Portugal	***Qatar***	Romania	Russia
Saint Kitts and Nevis	Saint Vincent and the Grenadines	Samoa	San Marino
Saudi Arabia	Seychelles	Singapore	Slovak Republic
Slovenia	South Africa	Spain	Sweden
Switzerland	Turks and Caicos Islands	***United Arab Emirates***	United Kingdom
Uruguay	***Vanuatu***		

For more information please refer to the Inland Revenue website:

www.ird.govt.nz/technical-tax/determinations/crs/aeoi-participating-jurisdictions/crs-participating-jurisdictions-index.html

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

Taxation Review Authority confirms amounts received not loan repayments, but deemed dividends

Case	*TRA 15/17* [2018] NZTRA 9
Decision date	12 December 2018
Act(s)	Income Tax Act 2007 and Tax Administration Act 1994
Keywords	"wages" "dividends" "income under ordinary concepts"

Summary

During the 2010 to 2014 tax years (disputed period), the disputant was a shareholder of or was associated with a shareholder of "GPBL", "STL" and "KMRL" (together referred to as "the Companies"). The disputant received various payments from the Companies during the disputed period and had personal expenditure paid on her behalf by STL and KMRL. The disputant filed nil returns for each of the tax years in the disputed period. The Commissioner of Inland Revenue ("the Commissioner") reassessed the disputant in respect of the amounts received from the Companies as wages and dividends or alternatively as income under ordinary concepts.

Impact

The decision applies established principles and confirms that transfers of value from a company to a person is caused by a shareholding if there is no other reasonable explanation for the payment to be made.

Facts

GPBL

The disputant's husband, Mr Smith, was the sole director and shareholder of GPBL during the disputed period. GPBL was placed in receivership in June 2013 and ceased trading.

GPBL's bank statements and bank statements for the disputant's joint account held with Mr Smith (Joint Account) showed regular and recurrent transfers from GPBL to the Joint Account during the disputed period annotated as "Repay MLS [Joint account bank number]", "MLS loan [Joint account bank number]" or similar.

The Commissioner assessed 50% of these amounts as taxable to the disputant as dividends or, alternatively, income under ordinary concepts.

STL

STL was incorporated in October 2006. The disputant and Mr Smith were appointed directors on incorporation. The disputant resigned in May 2011. The disputant was also the sole shareholder until April 2009 when all the shares in STL were transferred to GPBL. STL was placed into liquidation in July 2013.

STL's bank statements showed STL paid the disputant's and Mr Smith's personal expenses. The Commissioner assessed half of these amounts as income to the disputant for being in the nature of dividends, or alternatively as income under ordinary concepts.

STL's bank statements and the disputant's bank statements showed regular (approximately weekly) amounts of $300, $400, $500, $600 or $750 being paid by STL into one of the disputant's personal bank accounts. These amounts were annotated in the disputant's personal bank account as "Disputant STL wages" or similar wording. These amounts were assessed as income to the disputant for being in the nature of wages.

Further amounts transferred from STL into the disputant's personal bank accounts during disputed period were assessed to the disputant as dividends or, alternatively, as income under ordinary concepts.

KMRL

KMRL was incorporated in May 2011 with Mr Smith as sole director. The disputant and Mr Smith each held a third of the shares with the remaining third held by a company also owned by them. KMRL was removed from the Companies Register in October 2012.

Bank statements for one of the disputant's personal bank accounts showed regular (approximately weekly) deposits of $500 annotated as "KWA market wages". These amounts were assessed as income to the disputant for being in the nature of wages.

Bank statements for KMRL showed the disputant's and Mr Smith's personal expenses being paid from the company's bank account. The Commissioner assessed half of these amounts as income to the disputant for being in the nature of dividends, or alternatively income under ordinary concepts.

Decision

Wages

The Tax Review Authority ("the TRA") found the amounts paid to the disputant annotated as 'wages' in the bank statements was assessable income to the disputant. The coding of the payments in the bank statements as 'wages' was consistent with the payments' regularity. The disputant also said in her evidence she did do some minor work for the companies.

At the hearing, the disputant argued the amounts recorded in bank statements as "wages" had been wrongly coded as a consequence of an anomaly in the payroll software used. However, the TRA found the explanation difficult to reconcile with the fact that the disputant received amounts coded as "drawings" on the same day that she received amounts coded as "wages".

In an interview in 2015 and in a document dated 2016 the disputant stated that the amounts described as wages were coded in the Profit & Loss Statement to reflect hours spent working in the business (STL) in order to show whoever purchased the business, the amount of time that Mr Smith and the disputant had invested. That way, it was said that their accountant could reconcile the time the disputant spent on the business(es). The TRA did not find it convincing that an accountant would advise or otherwise allow a company to code amounts that were capital repayments as wages in its accounts.

Dividends

The disputant argued that the amounts paid to her or on her behalf were returns of capital amounts she had lent to the Companies prior to the disputed period. However, the disputant was unable to produce documentary evidence to prove that the amounts she received from the Companies were repayments of loan advances. Documents which could have been expected included loan agreements, minutes or resolutions, journal entries or ledgers kept by either the Companies or the disputant.

The TRA was satisfied in terms of the requirements of s CD 6(1) of the Income Tax Act 2007, that the transfers in value from the Companies to the disputant were made because of a shareholding in each of the Companies and noted that the disputant had either been a direct shareholder or associated with a shareholder of each of the Companies during the disputed period. The TRA considered that once the disputant's explanation for the nature of the payments had been discounted, there was no reason for the Companies to have made transfers of value other than because of the relevant shareholdings in the Companies.

Income under ordinary concepts

The TRA also agreed that the amounts in dispute constituted income under ordinary concepts. The amounts received by the disputant involved a regular flow of funds that had "come in" to the disputant or had been paid on her behalf. The amounts were used to meet the disputant's day to day living expenses and she had no other income to rely on during the disputed period.

Shortfall penalties

The TRA held the disputant had been grossly careless in taking nil tax positions in the disputed period and was liable for shortfall penalties under s 141C of the Tax Administration Act 1994.

High Court clarifies when payments made in support of overseas mission services qualify for tax credits

Case	*The Church of Jesus Christ of Latter-Day Saints Trust Board and Coward v Commissioner of Inland Revenue* [2019] NZHC 52
Decision date	1 February 2019
Act(s)	Income Tax Act 2007, s LD 1
Keywords	"missionary" "overseas" "donations" "donor" "gifts" "tax credits" "charitable" "public benefit"

Summary

As part of its overseas mission programme, the Church of Jesus Christ of Latter-Day Saints ("the Church") expects applicants to commit to raising a "standard amount" to go towards supporting the Church's missionary work. The Trust Board of the Church of Jesus Christ of Latter-Day Saints ("the Trust") is the Church's New Zealand-based entity which receives the "standard amount" payments for New Zealand resident applications and provides the donors (including the plaintiff in the second proceeding, Mr Coward) with deduction receipts.

The High Court had to consider whether the "standard amount" payments qualified as "gifts" under s LD 1 of the Income Tax Act 2007 ("the Act") and therefore whether tax credits could be claimed for such payments. The Court held that payments made to the Trust by a missionary, their parents, and/or grandparents were not "gifts", while payments by other relatives and friends were.

Impact

This is an important judgment that clarifies the scope of s LD 1 of the Act. The principles set out by the judge for determining whether a payment is a gift will be applicable in future cases.

Facts

The judgment addresses two proceedings, which were heard together, both involving the Commissioner of Inland Revenue ("the Commissioner") as defendant. The plaintiff in the first proceeding is the Trust. The plaintiff in the second proceeding is Mr Coward, a New Zealand tax resident and member of the Church, whose daughter was a missionary.

The Church itself is based in Salt Lake City, Utah, but has a worldwide presence, including in New Zealand. Under the Church's missionary programme, young members can apply to take part in an 18 – 24 month mission service overseas. As part of their application, a missionary is expected to commit to raising a "standard amount" to go towards supporting the Church's missionary work. This "standard amount" is not paid towards their mission overseas, but rather towards funding the expenses of other missionaries in New Zealand. The missionaries sent overseas from New Zealand have their expenses paid by the relevant Church-related entity in the country where their mission takes place.

At the time of Mr Coward's daughter's application, the "standard amount" for New Zealand was $475 per month or $5,700 per annum. At issue in Mr Coward's tax challenge were his contributions directed towards this annual amount.

Decision

The plaintiffs argued that the payments were gifts because they were gratuitous payments made by Church members to the Trust to support the Church's charitable work and were, therefore, dispositions of property without consideration.

The Commissioner argued that the payments were made to meet the essential personal expenses of the specific missionary while on a mission and not gratuitously made to the Trust. As such, the payments were not gifts.

What is a "gift"?

After having considered relevant cases from Australia, Canada, United States, and New Zealand, Hinton J adopted the following principles for determining whether a payment qualifies as a "gift":

(1) For there to be a gift, there must be a voluntary transfer of property owned by the donor to the donee.

(2) There can be no material benefit flowing to the donor as a result of the donation.

(3) However, a minor benefit or consideration will likely not be sufficient to vitiate the gift. Neither will a "purely moral" benefit.

In examining whether the donor receives a benefit, the following considerations are relevant:

(1) The benefit to the donor need not arise as a result of meeting a legal obligation.

(2) Anticipation of a benefit may be sufficient to deny a gift.

(3) There must be a connection or link between the donor's payment and the benefit.

The donor does not have to directly benefit from the donation, it is enough that the benefit is indirect, albeit it must be more than a pure moral benefit. For example, there will be a material benefit for a parent or grandparent in ensuring one's children are educated, or if one receives a contractual right to insist on the donee's performance, as a result of the payment.

Benefit or consideration to the donor

Hinton J considered that the payments were all voluntary and, as such, the case turned on whether there was any resulting benefit or consideration to the different categories of donor. To determine whether there was any benefit or consideration, Hinton J asked:

(1) Was there a sufficient link between the standard payments and the payment of a missionary's essential expenses?

(2) If so, was there a benefit to the different categories of donor as a result of the payment of those expenses?

There was a sufficient link

Hinton J considered that there was a clear link between the payments made as part of the application to be a missionary, and receipt by the missionary from the Church overseas of their essential expenses. Donors knew and anticipated that their payments to the Trust would enable the missionary (on behalf of whom they were paying) to go on their mission, and correspondingly to have their expenses paid by the Church.

Was there material benefit to each category of donor?

While Hinton J accepted that the missionary work is rigorous and conducted in very restricted conditions and circumstances, she accepted the Commissioner's argument that Ms Coward, and any other individual missionary, benefited from having their essential expenses paid.

As such, the Judge held that payments by a missionary to the Trust were not "gifts" under s LD 1.

Hinton J then considered whether payments made to the Trust by a parent (such as the payments made by Mr Coward for his daughter's application) or a grandparent were "gifts" under s LD 1. She held that because such payments provide a benefit to the child, they will generally also benefit the parent and grandparent donors who benefit by seeing their child engage in life education, being able to travel, live overseas, and experience being a missionary abroad.

As such, the Judge held that payments by parents and grandparents to the Trust were not "gifts" under s LD 1.

Hinton J considered, however, that payments made to the Trust by other relatives (including siblings, cousins, aunts, uncles, and more distant relations), as well as friends of the missionary and other members of the Church, fell into the category of pure generosity and were therefore gifts. This was because these other relatives and friends do not generally feel the same sense of obligation to assist a missionary applicant or to ensure their needs are met, and any benefit to these people is minor or immaterial and is a "pure moral benefit".

Summary of result

Hinton J held that the payments to the Trust in support of a missionary's application to participate in an overseas mission service, by the following classes of people, were not gifts under s LD 1 and, as such, the Trust was not permitted to issue donation receipts in respect of them and Mr Coward was not entitled to tax credits:

(1) missionaries called to serve the Church;

(2) a parent or legal guardian of a missionary; and

(3) a grandparent of a missionary.

However, such payments made by the following classes of people did qualify as gifts and, as such, the Trust was permitted to issue donation receipts in respect of them:

(1) a sibling of a missionary;

(2) a more distant relative of a missionary, such as a cousin, uncle or aunt; and

(3) a Church member unrelated to the missionary, such as a friend of a missionary or a member from the missionary's local ward.

High Court clarifies the meaning of "year" for calculating "ongoing daily care" for the Child Support Act 1991

Case	*P v Commissioner of Inland Revenue & Ors* [2018] NZHC 98
Decision date	07 February 2019
Act(s)	Child Support Act 1991
Keywords	"year" "ongoing daily care"

Summary

When there is change to ongoing daily care of a child which falls across two child support years (as defined) the calculation of the percentage change to ongoing daily care is not split into two separate child support years.

Impact

The judgment is an important one for the administration of child support and for changes in the ongoing daily care of a child. The judgment recognises the Commissioner of Inland Revenue's ("the Commissioner") practice when calculating whether there has been a change to the percentage of ongoing daily care (of not splitting it into child support years) is consistent with the scheme and purpose of the Child Support Act 1991 ("the Act").

Facts

This was a judicial review of a decision by the Commissioner regarding child support.

P provided ongoing daily care for her daughter. The father lived in Australia and paid child support. By agreement between P and the father, the child went to stay with the father in December 2017.

There was some disagreement between P and the father about the intended length of the child's stay. P considered the stay would be a short term one that fell over two child support years. She considered this was two short term stays split over two consecutive child support years. The father considered it would be for the long term. The child stayed with the father until July 2018.

The father advised Inland Revenue that the child was living with him. The Commissioner took the view there was a change of circumstances in the ongoing daily care of the child. The father's child support liability was adjusted to nil. P was advised she would no longer receive child support payments.

P objected on the basis the stay was a "three month per year" change using a child support year. On that basis her ongoing daily care of the child did not drop below 35% in any given child support year. The Commissioner disallowed the objection on the basis the Commissioner must give effect to any change in circumstances from the day before the date the liable parent (the father) ceases to be liable under s 25 of the Act. In this case the date P ceased to provide 35% of the ongoing daily care. The Commissioner did not consider she was constrained to using "child support year" but made the calculation commencing on the day before the day the care fell below 35% of the ongoing daily care.

Decision

Justice Palmer accepted the Commissioner's position. His Honour expressly stated:

> [2] I do not accept the child support year is the only possible basis for calculating the period over which ongoing daily care is assessed. Usually, the relevant period can be expected to be the term of the arrangement, or the period of the regular pattern, of care being assessed by the Commissioner. The Commissioner will need to assess whether short term changes to an arrangement or regular pattern change the overall relative proportions of care on the basis of the circumstances of each case. The key requirement on parents is to be clear in agreeing on their childcare arrangements and to communicate that to Inland Revenue.

His Honour noted there was neither an explicit statement specifying the period over which the costs of caring for a child are to be calculated (at [17]) nor a definition of "ongoing daily care" (at [19]).

His Honour considered the general scheme and purpose of the Act and, in particular, the purpose of amendments to the Act in 2013 to recognise changes in patterns of parenting since 1991. His Honour continued:

> [34] The legal issue in this case centres on the meaning of "ongoing daily care" and how a percentage of ongoing daily care is calculated. In particular, s 25(3)(b) provides liability ceases when the receiving carer ceases to provide "at least 35% of ongoing daily care". But 35 per cent of ongoing daily care over what period? The Act does not say. Neither does the legislative history. I have found no case law that is directly on point. The cases about who was a "principal provider of ongoing care" or "shared care" under the previous legislative regime do not assist.
>
> [35] I do not accept Ps' submission that the child support year is the only possible basis for calculating the period over which ongoing daily care is assessed. That is inconsistent with the purpose of the 2013 amendments in taking into account a wider range of circumstances. Sections 79 and 80 support that by enabling the Commissioner to make an assessment on the basis of less than a year. The relative capacity of parents to provide financial support and their relative levels of care, recognised in s 4(d), must not be determined artificially or mechanistically according only to the Act's definition of a child support year. Rather, it must equitably reflect the circumstances of those involved.

Justice Palmer recognised the Commissioner's approach was pragmatic and consistent with the Act provided the Commissioner genuinely examines the circumstances of each case and does not apply her policy mechanically (at [38]).

Taxation Review Authority considers whether it has the power to approve publication of a taxpayer's affairs on application by the taxpayer

Case	*TRA 06/18* [2019] NZTRA 1
Decision date	20 February 2019
Act(s)	Taxation Review Authorities Act 1994, Taxation Review Authorities Regulations 1998
Keywords	"publication" "journalist" "taxpayer privacy" "privacy"

Summary

The Taxation Review Authority ("the TRA") had to consider whether allowing a journalist to attend the hearing of a taxpayer's dispute was permissible given the privacy restrictions on that jurisdiction. Additionally, the TRA had to consider whether anything in the Taxation Review Authorities Act 1994 ("the Act") or the Taxation Review Authorities Regulations 1998 ("the Regulations") allowed the TRA the power to grant approval to publish information provided to the director of the disputant during the course of the TRA proceedings.

Impact

This decision confirms that challenges heard in the TRA are to be conducted in private and that the reporting of decisions of the TRA is to be restricted to maintain the confidentiality of disputants and their tax affairs.

Facts

The disputant company wished to publish an expose of the activities of the Commissioner of Inland Revenue ("the Commissioner") in relation to his company's challenge and made an interlocutory application to:

(1) Publish (digitally and in print) all information its director had received during the course of the TRA proceedings.

(2) Have an employee/contractor of the company (other than the director) at the hearing to assist with information gathering to ensure the accuracy of any resulting publication (including blogs).

The disputant submitted that the s16(4) of the Act, did not preclude the publication of TRA trial matters if the disputant chooses to do so. In the absence of an express prohibition, and in the interests of transparency he argued that limitations should not be placed on the taxpayer's rights.

The disputant advised that the application was lodged specifically to prevent future 'grey areas' or disputes arising, and to prevent the company being denied natural justice.

A right of reply to any publication that the disputant proposed to make was offered to the Commissioner. This offer was not accepted and the Commissioner opposed the application. The broad grounds of her opposition were that the orders sought by the disputant were inconsistent with the scheme of the Act, and the Regulations.

Decision

The Authority dismissed the application.

Judge Sinclair concluded that the requirement in s 16(4) of the Act that a TRA proceeding, "shall not be open to the public" was mandatory.

Additionally, she found that the restrictions reg 36 of the Regulations placed on reporting on matters brought before the TRA meant that the Commissioner would not be able to respond to any material published by the disputant. She also acknowledged it was likely s 81 of the Act would likely constrain the Commissioner's ability to respond.

In her Honour's view, the Legislature clearly intended that challenge proceedings before the TRA should be conducted in private and that reporting of decisions was restricted to maintain the confidentiality of the disputants and their tax affairs.

She noted that these restrictions do not apply in the High Court. Having elected to issue the claim in the TRA the disputant is bound by the privacy restrictions of that jurisdiction and therefore the application to have a journalist present was denied.

Judge Sinclair found that she did not have the power under reg 36 of the Regulations (or otherwise) to approve unrestricted publication as sought by the disputant. Additionally, the ability to make such an order would run contrary to the confidential nature of the jurisdiction. Accordingly, the application for an order approving restricted publication was also denied.

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