NEW ZEALAND
BANKERS ASSOCIATION

Submission

to the

Finance and Expenditure Select Committee

on the

Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill

29 July 2016

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About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fifteen registered banks in New Zealand are members of NZBA:

- ANZ Bank New Zealand Limited
- ASB Bank Limited
- Bank of China (NZ) Limited
- Bank of New Zealand
- Bank of Tokyo-Mitsubishi, UFJ
- Citibank, N.A.
- The Co-operative Bank Limited
- Heartland Bank Limited
- The Hongkong and Shanghai Banking Corporation Limited
- JPMorgan Chase Bank, N.A.
- Kiwibank Limited
- Rabobank New Zealand Limited
- SBS Bank
- TSB Bank Limited
- Westpac New Zealand Limited.

Background

3. NZBA welcomes the opportunity to provide feedback on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill (**the Bill**), and commends the work that has gone into developing it.

4. NZBA would appreciate the opportunity to make an oral submission to the Finance and Expenditure Select Committee (**Committee**) on this Bill. Please contact Richard Bicknell, Government Relations Director at NZBA on 04 802 3350 regarding times for appearing before the Committee.

5. If the Committee or officials have any questions about this submission, or would like to discuss any aspect of the submission further, please contact:

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Executive Summary

6. NZBA's key submissions are:

a. NZBA does not support the proposed onshore and offshore branch rules that impose Approved Issuer Levy (**AIL**) on offshore funding costs.

b. If the onshore and offshore branch rules are to proceed, NZBA recommends that a number of drafting amendments are required to such parts of the Bill to ensure greater certainty of their application to the banking industry. We provide a high level summary of the amendments we consider are required in the Appendix to this submission. NZBA would welcome the opportunity to discuss the necessary amendments with Inland Revenue Officials prior to enactment to ensure they operate as intended.

c. NZBA does not support the proposals to impose non-resident withholding tax (**NRWT**) on back to back loans on banks as they will be impossible to apply in practice.

d. The criteria for the AIL registration rules should be expanded to ensure appropriate entities and debt issuances are not prohibited from accessing the AIL regime.

e. An additional provision should be incorporated into the Bill to provide for the 0% rate of AIL to apply to debt issued via a Limited Disclosure Process under the Financial Markets Conduct Act 2013 (**FMCA**).

f. We support the proposed changes to the bad debt deduction rules for limited recourse arrangements of securitisation vehicles.

g. We support the proposed changes to clarify the deductibility of interest where life reinsurance arrangements are involved.

7. Please see our substantive submissions below.

Substantive submissions

NZBA does not support the proposed onshore and offshore branch rules that impose AIL on offshore funding costs.

8. The cost of raising debt in the offshore wholesale markets will increase through imposing AIL. As offshore lenders will not wear this cost, the cost will be borne by the New Zealand banks raising such debt. As financial intermediaries, this increased cost will be passed on to New Zealand borrowers.

9. This additional cost to New Zealand businesses will act as a drag on the New Zealand economy at a time of limited growth. Further, it is contrary to the Government's Business Growth Agenda, which aims to lower the cost of imported capital to, amongst other things, promote investment in infrastructure.

10. NZBA understands that the current tax regime was a purposeful design to promote borrowing direct from New Zealand banks, thereby protecting the New Zealand tax collected on the margin earned by New Zealand banks. Imposing AIL on New Zealand banks' offshore wholesale funding costs will undermine this design. As the AIL cost will be passed on to New Zealand borrowers, the indirect tax impact of borrowing from New Zealand banks will be no different than the direct tax impact of borrowing from offshore banks (where AIL is imposed on such borrowing costs).

11. Key developed countries such as the United States, Britain, Australia and Canada do not impose such taxes on offshore funding costs for the very reasons highlighted above. These proposals will, therefore, disadvantage the New Zealand economy compared with other developed countries, including New Zealand's key competitors for imported capital.

12. Imposing AIL on offshore wholesale funding contravenes negotiated positions of New Zealand's double tax agreements. In summary, the double tax agreements operate so that no withholding taxes are imposed on the offshore wholesale debt which is the subject to the proposals in the Bill. This is a design to promote the free flow of capital across borders. While AIL is technically not considered a "tax", the impact of imposing AIL appears contrary to double tax agreements.

If the onshore and offshore branch rules are to proceed, NZBA recommends that a number of drafting amendments are required to such parts of the Bill to ensure greater certainty of their application to the banking industry

13. The current drafting of the Bill will create significant uncertainty as to the application of the onshore and offshore branch rules. This is due to the various drafting errors, omissions and inconsistencies between the Bill and the commentary to the Bill. Such uncertainty presents concern for the banking industry in the raising and documentation of securities in international debt markets.

Recommendation: We would appreciate the opportunity to discuss our recommended amendments with Inland Revenue Officials prior to enactment of the Bill to ensure they operate as intended and provide certainty for the New Zealand banking sector. NZBA considers this important as any remaining errors or omissions that exist post enactment can take years to be corrected.

Given the significant detail within the Bill, we summarise below, at a high level, amendments we consider are required to the Bill.

14. We understand the purpose of subpart FG is to deem interest to arise on a notional loan for the purposes of the NRWT rules, such that, ultimately AIL will be payable on the deemed interest. However, as there is no clear link between subpart FG and the deemed interest being non-resident passive income or New Zealand sourced income (which is critical for the NRWT rules to apply), the deemed interest may not become subject to AIL.

    Recommendation: The Bill is amended to clarify that the interest on a deemed notional loan (under subpart FG) is "non-resident passive income" or New Zealand sourced income.

15. It is currently unclear from the combination of subpart FG and the proposed amendment to section RF 2(1)(d) in the Bill that interest on the notional loans will be treated as non-resident passive income. This is because the exclusions from non-resident passive income within proposed section RF 2(1)(d) would appear to apply to the deemed interest on the notional loans, potentially making such interest not subject to AIL.

    Recommendation: That proposed section RF 2(1)(d) and/ or subpart FG be amended to ensure the exclusions to section RF 2(1)(d) do not apply.

16. We understand the intention is for subpart FG to apply to interest as recorded in the financial accounts of the onshore branch. We support this intention as a practical approach for calculating the interest which will be subject to AIL. However, the wording of subpart FG makes reference to both the interest recorded in the financial accounts and interest as a payment. These concepts are different: interest is recorded in financial accounts on an accrual basis; the payment of interest is, axiomatically, a payment.

    Recommendation: Proposed subpart FG is amended so that it applies consistently for AIL to apply to the accrual of interest in the financial accounts of the onshore branch and not the payment of interest.

17. In certain circumstances, proposed subpart FG will result in a double tax impact. The current tax rules already impose NRWT (or AIL where applicable) where a foreign bank borrows money from a non-resident which is used specifically for the purposes of a business carried on by the foreign bank in New Zealand through a fixed establishment in New Zealand (i.e. a New Zealand Branch). Proposed subpart FG

will also impose AIL on interest from a notional loan from the foreign bank to its New Zealand Branch, resulting in double tax on, in essence, the same debt.

Recommendation: The Bill is amended so that subpart FG will not apply where NRWT (or AIL) is already payable.

18. Proposed section FG 3 deems the interest on the notional loan to be paid on the last day of the income year, thereby triggering the timing for payment of AIL as the 20th day of the month following income year-end. As above, the interest upon which AIL will be payable is determined from the accounting records (or financial accounts) of the New Zealand Branch. However, as the financial accounts of the New Zealand Branch are unlikely to be completed within 20 days of financial year-end, it will not be possible to calculate, with accuracy, the amount of AIL payable by the 20th of the month following a financial year-end.

    Recommendation: The timeframe for triggering the AIL liability should be extended to the 20th day following 3 months after financial year-end. Such timing will align with when the financial accounting position of a New Zealand Branch should be known.

19. We understand that the transitional rules for the application of subpart FG are intended to provide a 2 year grand-parenting from AIL for transactions (or notional loans) that are in existence at the time the Bill receives Royal assent. However, the transitional rules, as currently drafted, do not provide any grand-parenting.

    The current drafting of the transitional rules (clause 83(2) of the Bill) states that subpart FG applies:

    (a) to a transaction that is recorded in the relevant accounting records on or after the date on which this Act receives the Royal assent; or
    (b) from the first day of a person's income year that starts 2 income years after the last day of the income year in which this Act receives the Royal assent, for a transaction that is recorded in the relevant accounting records before the date on which this Act receives the Royal assent.

    A transaction entered into before the date the Act receives Royal assent (which should be captured under paragraph (b) above) will also be recorded in the relevant accounting records after the date the Act receives Royal Assent. As such, paragraph (a) above would also apply resulting in the proposed grand-parenting not applying at all.

    Further clause 83(2) of the Bill refers to the existence of a "*transaction*" between the foreign bank and its New Zealand Branch. In a legal sense, no transaction exists as it is not possible to have a legal arrangement with oneself.

    Recommendation: Paragraph (a) above is amended so that it applies only to transactions "first" recorded in the relevant accounting records after the date on which the Act receives Royal Assent.

Recommendation: The reference to “transaction” is defined to be an amount made available by the foreign bank to its New Zealand Branch.

20. NZBA considers that a 5 year grand-parenting period for the onshore branch rules is more appropriate than a 2 year grand-parenting period. The inter-branch loans (or notional loans as so described in the Bill) are often subject to detailed negotiations between the respective branches (or the foreign bank and the New Zealand Branch), particularly as they relate to independent profit centres and are also subject to detailed and complex transfer pricing analysis. As the imposition of AIL in essence alters the pricing of such notional loans a 5 year grand-parenting is more appropriate.

    Recommendation: The current 2 year grand-parenting for notional loans with an onshore branch is extended to 5 years.

21. Subpart FG is stated to apply “for the purposes of the NRWT rules” (section FG 1). However, section FG 2(1), states that a notional loan to a foreign bank's New Zealand branch is treated "for the purposes of the Act" as "money lent to the branch". We are unsure why this inconsistency exists and the commentary to the Bill provides no explanation of what or how other parts of the Act would impact the notional loan.

    Recommendation: The reference in section FG 2(1) to “for the purposes of the Act” should be removed.

22. We are unsure of the purpose of sections FG 3(b) and FG 3(c). They appear to indicate that the interest on the notional loan is incurred by the New Zealand branch and derived by the foreign bank. However, we note that the interest on the notional loan is already treated as incurred and deductible through the combined application of the Income Tax Act and relevant Double Tax Agreements.

    Recommendation: Remove sections FG 3(b) and FG 3(c).

23. NZBA supports excluding loans from a foreign bank to unrelated third parties (which are sourced in New Zealand for income tax purposes) from the proposed onshore branch changes. Adopting such an approach ensures a significant compliance burden would not be pushed onto a significant number of third parties.

24. Proposed section YD 5(9) contains various definitions for the purposes of calculating the apportionment of income sourced from New Zealand for an offshore branch. These definitions refer to the “value” of certain assets. However, it is uncertain as to what value should be applied to such assets.

    Recommendation: Reference to “value” in proposed section YD 5(9) should be to the value as recorded in the relevant accounts. Such values should be non-controversial, are subject to accounting standard obligations and are generally applied for income tax purposes.

25. Clause 5(4) of the Bill determines the timing of application of the offshore branch rules. Clause 5(4) refers to a “member of a banking group”. This reference, however, is undefined.

    Recommendation: The reference to “member of a banking group” in clause 5(4) of the Bill should be amended to a “New Zealand Banking Group” (which is a term currently defined in the Income Tax Act).

26. We understand that proposed new subsection RF 2(3)(e) is designed to confirm that NRWT on interest paid by a New Zealand bank will be a final tax. The drafting of proposed subsection RF 2(3)(e) refers to a “member of a banking group”. This reference is undefined.

    Recommendation: Proposed subsection RF 2(3)(e) is amended to refer to a “New Zealand Banking Group” (which is a term currently defined in the Income Tax Act).

NZBA does not support the proposals to impose NRWT on back to back loans on banks as they will be impossible to apply in practice

27. It appears, at least from the commentary to the Bill, that if a New Zealand subsidiary does not pay the NRWT applicable where the “back to back” loan rules in proposed section RF 12I apply, then the New Zealand bank will be obliged to pay the NRWT (though operation of the proposed “as agent” provision). As noted, this conclusion is drawn more from the commentary to the Bill, as the words of the Bill itself are extremely difficult to understand. NZBA considers it inappropriate to push this obligation onto banks. Banks may have no knowledge of whether the back to back loan rules apply, whether or not the NRWT was paid by the New Zealand subsidiary or what the NRWT liability would be. Adopting such an approach merely creates rules that are bound for failure in practice. By way of further explanation:

    a. A bank may have no knowledge of whether the “back to back” loan rules are applicable. The “back to back” loan rules are triggered where, it appears, there is an intention or purpose by the non-resident parent of the subsidiary to have a so called “back to back” loan. This intention or purpose may not be known, nor necessarily can be assumed, by a bank.

    b. It is highly unlikely that a bank will have knowledge of whether or not the New Zealand subsidiary has paid the NRWT. This places banks in an untenable and unfair situation. For example, if the New Zealand subsidiary was audited by Inland Revenue who identified that NRWT should have been, but was not paid, by the New Zealand subsidiary, the Inland Revenue may seek payment from the bank. In essence, the bank becomes liable for the poor tax compliance of the New Zealand subsidiary over which a bank no control.

    c. Assuming the NRWT should be based on an accrual of interest per the non-resident financial arrangement income (**NRFAI**) rules (which appears to be the case from the commentary to the Bill and the example in the Bill), the bank would have no knowledge of what that interest would be. The NRFAI rules are

complex. They require an inherent knowledge of whether or not the proposed de-minimis rules would apply, determining the deferral calculation and the detailed workings of how the payer of the interest determines their accounting and income tax positions. The bank would simply not have this knowledge.

d. The New Zealand subsidiary will be a New Zealand taxpayer within the New Zealand tax system. As such, if the New Zealand subsidiary did not pay NRWT but should have, it should be the only entity that is liable for the NRWT.

Recommendation: The proposed “as agent” obligations placed upon banks in the Bill are removed.

The criteria for the AIL registration rules should be expanded to ensure appropriate entities and debt issuances are not prohibited from accessing the AIL regime

28. Proposed section 86G of the Stamp and Cheque Duties Act sets out the criteria for who can register for AIL. One such criteria is a “wholly-owned subsidiary of a widely-held company” (section 86G (2)(d)). However, it is not clear from the Bill whether section 86G (2)(d) applies where a widely held company wholly owns a subsidiary through one or more wholly owned intermediate entities.

    Recommendation: Proposed section 86G (2)(d) is amended to provide clarity that indirect wholly ownership of a subsidiary by a widely held company will satisfy the AIL registration criteria.

29. Further in relation to proposed section 86G, registered banks operating in New Zealand may not necessarily be widely held companies or wholly owned subsidiaries of widely held companies (for example, Kiwibank). However, NZBA considers all registered banks operating in New Zealand should be entitled to register a transaction for AIL.

    Recommendation: The criteria in proposed section 86G (2) should be expanded to include registered banks and members of a registered bank’s wholly-owned group.

30. The Bill proposes that members of a New Zealand banking group have the ability to reduce the rate of NRWT to 0% by, instead, paying AIL on interest paid to associated persons under existing arrangements. However, contradictions exist between the wording in Bill and the commentary to the Bill on when this ability to pay AIL will be applicable. The commentary states that the “ability for a member of a banking group to pay AIL on an interest payment to an associated party will apply from the date of enactment”. However, clause 5(2) of the Bill provides that the ability to pay AIL applies "from the first day of the person's income year that starts after the date on which this Act receives the Royal assent". This application date is later than outlined in the commentary to the Bill. NZBA considers there to be no reason for delaying the ability to pay AIL on interest payments made by a member of a New Zealand banking group to an associated person.

Recommendation: Clause 5(2) of the Bill is amended so that the ability to pay AIL is applicable for all arrangements from the date the Act receives Royal assent.

An additional provision should be incorporated into the Bill to provide for the 0% rate of AIL to apply to debt issued via a Limited Disclosure Process under the FMCA

31. At present, for offers of securities under the FMCA (as opposed to the Securities Act 1978) to access the 0% rate of AIL under section 86IB (1)(b)(i) of the Stamp and Cheque Duties Act the issue of a security must be either:

    a. a regulated offer for the purposes of the FMCA; or

    b. an offer referred to in clause 19 of Schedule 1 of the FMCA.

32. Registered banks are exempt from the regulated offer regime (per clause 21 of Schedule 1 of the FMCA). For offers made under the regulated offer regime, a Product Disclosure Statement is required.

33. Therefore, a registered bank can only access the 0% rate of AIL under section 86IB (1)(b)(i) if the issue of a security is an offer referred to in clause 19 of Schedule 1 of the FMCA. Clause 19 of Schedule 1 of the FMCA requires the offer of a Quoted Financial Product (**QFP**) – in essence an offer of the "same class" as a previously issued security quoted on a licensed market. If a registered bank does not issue under an offer of a QFP, it will be required to issue via a Limited Disclosure Document (**LDD**) process (per clause 24 of Schedule 8 of the Financial Markets Conduct Regulations 2014). This may occur where the registered bank amends the documentation of a security issue, such that the issue will not be of the "same class" as a previously issued security quoted on a licensed market. However, subsequent security issues of the same class as those offered via a LDD can be an offer of a QFP. The only material difference between a LDD and a PDS is that a LDD is not required to disclose certain financial information about the issuer. An LDD contains greater disclosures than that required for a QFP.

34. However, a LDD issue will not qualify for the 0% rate of AIL as it will not be a regulated offer or an offer referred to in clause 19 of Schedule 1 of the FMCA. This appears to be an unintended gap in the Stamp and Cheque Duties Act, most likely due to recent amendments to the FMCA and the Financial Markets Conduct Regulations 2014. If the gap is not remedied, then whenever a registered bank issues a new class of listed securities, the first offer of that class will not qualify for the 0% rate of AIL, but all subsequent offers (being offers of QFPs), would qualify for the 0% rate AIL. This is an anomalous outcome and appears contrary to the policy intent of the 0% rate of AIL rules (to promote the New Zealand debt/ capital markets) and places registered banks at a disadvantage to non-bank issuers.

    Recommendation: NZBA submits that the Stamp and Cheque Duties Act is amended to allow LDD offers to access the 0% rate of AIL. Further, we submit that any such amendment should be retrospective for any interest paid on such LDD

offers post 1 December 2014 (when the Financial Markets Conduct Regulations 2014 and the amended section 86IB (1)(b)(i) of the Stamp and Cheque Duties Act came into force), or at least when the Bill was introduced to Parliament.

NZBA supports the proposed changes to the bad debt deduction rules for limited recourse arrangements of securitisation vehicles

35. NZBA supports the amendments in the Bill to section DB 31. These amendments ensure a matching of timing between when taxable income arises and deductions are available for certain limited recourse arrangements. This is particularly relevant to the banking industry to ensure securitisation vehicles operate as intended both commercially and for the purposes of the tax legislation more generally. We further support these amendments having effect from 20 May 2013, which was when the original provisions regarding limited recourse arrangements came into effect.

We support the proposed changes to clarify the deductibility of interest where life reinsurance arrangements are involved

36. NZBA supports the amendment in the Bill to section DB 7. This amendment provides certainty to taxpayers on the deductibility of interest expenditure for companies where the company or another wholly owned group company derives exempt income by way of a life reinsurance claim derived from a non-resident reinsurer. NZBA also supports this amendment applying from the income years including 1 July 2010 and later income years.