NEW ZEALAND
BANKERS ASSOCIATION

30 October 2015

NRWT: related party and branch lending
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EXTENSION OF AIL TO APPLY TO ONSHORE BRANCH BANKS

The New Zealand Bankers Association (NZBA) would like to make a submission on the proposed extension of the issues paper NRWT: related party and branch lending to onshore branches. This extension is to apply AIL to the notional loan that an onshore branch may recognise in calculating the profits that are attributable to the New Zealand permanent establishment.

1. Executive Summary

1.1. The NZBA has a number of concerns with the application of AIL to onshore branch funding. There are a number of issues to be considered and developed and the NZBA believes that there should be a comprehensive review of permanent establishments and the appropriate policy settings. This needs to have its own programme and own timetable (as was undertaken in Australia). A 16 day window to respond with no detail of the extent of any recommendations that will be made to Ministers is not satisfactory, particularly given the length of time these policy settings and outcomes have been known by Inland Revenue.

1.2. The notional interest amount is not a deduction under the Income Tax Act 2007. It is not interest as no money has been lent. It is in fact merely a proxy to determine a fair and appropriate attribution of profits to a branch i.e. it is an element in the calculation of branch profit. It is not appropriate to use part of the attribution calculation to impose an additional tax on the permanent establishment:

- This would be in conflict with New Zealand's 'source taxing rights' (i.e. that it can only tax profits that are attributable to the permanent establishment).
- There is uncertainty as to whether such an extension of AIL would be effective (under New Zealand's double tax agreements) and is against the principles negotiated with treaty partners.
- The proposed tax on the notional loan interest is in clear conflict with the model OECD commentary that prohibits countries attempting to 'respect' this notional loan and interest for the purposes of taxing the interest.

- This would result in over-taxation for banks compared to other corporates that have the same fungible funding structure. The tax cost for an onshore bank should not be greater than a corporate (or quasi-bank / insurance company).

1.3. Even if there is a policy basis for identifying 'notional interest' to impose AIL (which we don't accept), there are other policy concerns and implications:

- The attribution calculation includes a number of interest and non-interest flows that would be captured (including derivatives and other funding costs). This creates inconsistency with domestic New Zealand banks (that are only subject to AIL on interest).

- Following the wrong principles to identify notional interest and impose AIL creates an incentive to reduce or change the functions undertaken in New Zealand to move the balance sheet offshore. It also creates an incentive to apply different profit attribution calculation methods. There would also be an increased focus on different branch accounting alternatives (and internal treasury function workings).

- There is concern that Inland Revenue may impose tax on 'grossed up' positions (exaggerating the impact / cost). Time needs to be taken to ensure that there is a careful understanding of what may be 'gross' or 'net' in the accounts (like liquidity charges) and where transactions might 'offset'.

1.4. If an amount is to be applied (which we do not believe is appropriate), AIL is an alternative to non-resident withholding tax to protect New Zealand borrowers from 'gross up' clauses where lenders don't value foreign tax credits. This framework should be preserved and NRWT should be applied first so that a tax credit may be claimable in the foreign jurisdiction, and AIL should be an election.

1.5. Australia's section 160ZZZJ was pointed to by Inland Revenue as a policy approach to support the proposal. Australia has a different legislative starting point, different withholding tax rules (significantly, the section 128F exemption) and an environment that means onshore branches are less reliant on offshore / group capital. The "50%" withholding tax position on the notional loan was a pragmatic rather than a policy driven outcome and New Zealand should not automatically follow this. New Zealand should follow the world and not just look to Australia in modernising its tax system. Further, in respect of the Australian position, both the Henry Tax Review and the Johnson Financial Centre Forum Report recommended the abolition of withholding tax on Bank inter-branch funding. This recommendation was accepted by the Australian Government in its 2010 Budget.

1.6. New Zealand is reliant on importing capital and is a net borrower. Imposing an additional AIL cost on onshore branch funding will have a number of economic implications for New Zealand. These should be properly weighed and understood. The proposal should not be rushed into law without adequate consideration of the economic impact. In particular, the impact on the cost of capital in the light of the Government's business growth agenda should be evaluated carefully.

1.7. The NZBA also recommends giving consideration to relaxing the 0% AIL criteria so that onshore branches are able to use them.

2. DETAILED ANALYSIS

2.1. Profit attribution is not an interest deduction

2.1.1. The attribution of profits to a permanent establishment is an extremely complex exercise. In Part II of the OECD report *Special Considerations for Applying the Authorised OECD Approach to Permanent Establishments* the OECD sets out its views on the exercise required for permanent establishments of banks. The document runs for over 40 pages. Key to the attribution is the need to identify where the economic ownership of the asset resides based on an extensive functional analysis and then, only if the asset is determined to be economically owned in the permanent establishment, there is a need to determine how that asset was funded. This is where the concept of the notional loan arises so that the fair and appropriate level of income is apportioned between the functions in the country of source and its home office.

2.1.2. This exercise was not intended to create a loan for income tax purposes but merely to allocate the income. In law and in practice, no loan and therefore no interest exists. Notional interest is merely an adjustment to the level of profit attributed to the New Zealand branch under the prescribed methodology.

2.1.3. In May 2015 the NRWT: related party and branch lending discussion document was released with a number of proposals. NZBA made a submission on this paper on 16 June 2015. In the NZBA submission the question of AIL being imposed on onshore branch funding was discussed in detail (see paragraphs 4.3 – 4.12).

2.1.4. In summary, these were:

- Inter-branch / head office balances are "notional" so there is no interest to impose NRWT or AIL on.
- New Zealand does not have 'source country' taxing rights, as:
    - Article 11 does not apply (there is no interest / no payment).
    - Article 7 only allows New Zealand to tax the non-resident to the extent of profits that are attributable to its permanent establishment.
    - There are strong arguments that AIL is, or could be viewed by DTA partners as 'income tax' (so that the DTA does apply). The submission raised various support from:
        - International jurisprudence;
        - New Zealand jurisprudence;
        - New Zealand's practice of including AIL 'protections' in its negotiation of DTAs (which it would not need to do).

2.1.5. The OECD commentary (Model Tax Convention on Income and Capital) clearly sets out that it is not appropriate to use the 'notional loan' and 'interest deduction' as a means by which New Zealand can tax the interest. Paragraph 28 of the Commentary on Article 7 clearly sets this out:

> *"The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7...Similarly, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to the permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is part of for the purposes of paragraph 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise...."*

2.1.6. It is difficult to argue that AIL is not a tax on 'interest' and against the spirit and principle of the above.

2.1.7. It appears that Inland Revenue is concerned with an interest deduction being allowed but with no associated tax levied on the interest (i.e. NRWT or AIL). As noted above there is no interest deduction, it is a means to allocate profit. It is an outcome of the current policy settings in domestic legislation and under the OECD model / and New Zealand double tax agreements.

2.1.8. The outcome is also not unique to banks and often applies to corporates (and other institutions) that have pooled or fungible funding costs. Under the attribution of profits calculation for a corporate, a share of the external funding cost is allocated to the permanent establishment. However, as no particular loan has an economic link with the permanent establishment (because the funding is fungible, from a pool), there is no withholding tax (i.e. New Zealand does not have source taxing rights on the interest). This is covered in the OECD commentary (*OECD Model Tax Convention on Income and on Capital (15 July 2014)),* in relation to the Article 11, paragraph 5 commentary:

> *"27. In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a "taxable quota" proportional to the importance of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut..."*

NZBA would be very concerned where a bank suffers a greater level of taxation than another taxpayer with the same / equivalent funding.

2.2. *Other policy concerns and implications*

2.2.1. Even if there is a policy basis for identifying 'notional interest' to impose AIL (which we don't accept), there are other policy concerns and implications.

2.2.2. The methodology of attributing income to a permanent establishment is integral to whether the notional loan and interest calculation is appropriate to impose AIL on. This is a more complex balance than merely pointing to a notional loan and interest deduction (and saying that is what a locally incorporated bank would have been subject to).

2.2.3. As discussed above, the 2010 Report (Attribution of Profits to Permanent Establishments) sets out a methodology for attributing profits to a bank permanent establishment. We have some specific comments on this report (given that this is the basis of the notional loan interest that Inland Revenue is recommending AIL to be imposed on):

- "Interest" in that report is intended to have a broad meaning to encompass a wide range of receipts and payments in the nature of business profits earned by a bank...(para 3). This is wider than the New Zealand definition of interest.
- 'Economic ownership' of the bank 'assets' (and balance sheet) is the key principle in relation to what the local balance sheet of a branch should look like. This then dictates whether:
    - The New Zealand permanent establishment should recognise the asset and therefore require a notional loan and funding cost, or
    - Recognise only part of the asset (and therefore part of a notional loan) (e.g. for an asset that is considered 'jointly' owned by different parts of the bank and its permanent establishments).
    - Not recognise the asset on the New Zealand balance sheet and instead recognise 'income' (more akin to the provision of a service).
- The Report sets out approaches to determining the relevant 'key entrepreneurial risk taking functions' to help determine who the economic owner of the asset is. However, it acknowledges throughout the paper that its focus is on determining an arm's length outcome (rather than an accurate allocation of an interest expense). In the discussion around the treasury function, at paragraph 170:

    > *"In practice, banks will use a variety of methods to set prices of internal "interest" dealings."*
    >
    > *"It should be stressed that the method used is irrelevant as long as an arm's length reward is given to the treasury function, and internal "interest" dealings are priced within an arm's length range..."*

    A specific example is given in relation to the allocation of free capital, and that one approach is to recognise a loan back to the treasury centre (i.e. to recognise interest income to offset some of the notional interest loan and interest deduction).
- The Report discusses different 'attribution' approaches, including some that may be for a service fee or for a share of profits, and that this can be on a net or a gross basis.

2.2.4. Where New Zealand starts imposing AIL or withholding tax on the notional loan and interest expense component of the above, then the different methods discussed in the Report will have different tax outcomes. Under some attribution methods there will be more notional interest than others, whereas the basis of the Report is that there should generally be 'indifference' between different approaches. The example included above is a clear scenario. Where the branch makes an adjustment to free capital by lending to the treasury function, this would create a greater AIL cost than there should be (as the balance sheet is grossed up).

2.2.5. There may be a number of scenarios where a branch's balance sheet might be 'grossed up' or recognised 'net'. In the attribution of profits to a permanent establishment, it doesn't matter whether a gross or a net approach is taken to branch accounting. An example is a liquidity charge (this represents the cost to a bank of having to maintain a portion of low yielding liquid assets). The cost is often driven by the 'negative interest' difference between the bank's cost of borrowing (to fund the assets) and the income on the underlying assets. NZBA's position is that AIL should not apply to the charge. However, it highlights different approaches to branch accounting which should not give rise to a different tax outcome. There may be a number of similar 'net' or 'gross' transactions, and also 'offset' scenarios that NZBA would like time to consider (e.g. two transactions with the same counterparty), and engage with Inland Revenue on what the policy target is / should be.

2.2.6. The AIL proposal creates a bias for 'choosing' different attribution methodologies (and branch accounting alternatives). This will cause disruption to bank systems that have evolved to harmonise across a number of jurisdictions (consistent with OECD principles). An incentive also arises for banks to change the functional structure of their 'New Zealand' branch to 'move the balance sheet' offshore. This would mean only limited functions are carried on by the New Zealand branch (i.e. a service presence rather than a capital presence). This is because there would be a higher tax rate applied where the permanent establishment is the economic owner of an asset (income tax, plus AIL) compared to where it is not the economic owner (only income tax).

2.2.7. The Reserve Bank of New Zealand should be included in this consultation as a stakeholder in any tax incentive to reduce branch balance sheets in New Zealand.

2.2.8. The notional loan and interest is recognised in NZD and will have an interest rate that is set at arm's length. It does not reflect how a local New Zealand bank (as opposed to a New Zealand branch of a foreign bank) would access wholesale funding. This will often be in non-NZD currencies, and overlaid with derivatives to manage both the currency risk (back to NZD) and interest rate risk (fixed / floating / periods). The AIL amount that a New Zealand bank suffers is only on the interest cost (not the derivative costs), which will often be at a lower interest rate (e.g. in USD, EUR and GBP currencies all of which have a lower interest cost than NZD). For a New Zealand bank, the additional 'interest differential' on the relevant derivative gives rise to a 'funding or interest expense' for tax purposes, but not the imposition of a tax on that interest (no withholding tax, nor AIL). Imposing a withholding tax or AIL cost on these derivative flows is inconsistent with international practice (and raises difficult questions such as whether all derivatives are equal and which flows should be captured).

2.2.9. There are a number of other 'expenses' that a New Zealand bank incurs in raising funding that will not be within the ambit of NRWT or AIL. These include costs associated with raising debt e.g. legal fees, line/facility fees, guarantee fees, registry and trustee fees as well as other associated debt-raising costs. They also include costs that may provide funding and a deduction for a funding cost, but may not give rise to an interest amount for NRWT or AIL purposes (an example being a sale and repurchase 'repo' or similar transaction). It is often the case that the interest rate that is set on the notional loan (for the purposes of attributing income) will 'factor in' a number of these costs and other treasury related functions.

2.2.10. Imposing AIL on all of the NZD notional interest cost would be an unfair (and inconsistent) tax cost for onshore branches compared with New Zealand resident banks. As discussed below, domestic banks also have a choice of whether to apply NRWT or AIL (which will be extended to related party debt).

2.3. *If AIL is to apply it should be as an alternative to NRWT*

2.3.1. AIL was introduced as a concessionary regime to facilitate the importation of capital into New Zealand. It was established to reduce non-resident withholding tax to 0% (where AIL applied), where the withholding tax credit was not valuable overseas. It reduced the 'cost' that lenders might impose on New Zealand borrowers where they would demand a gross up clause for unvalued withholding tax that would be suffered.

2.3.2. Inland Revenue appears to be proposing that the role of AIL is to be mandatory which is a fundamental change to the purpose of AIL. NZBA would expect that a policy setting change to 'tax' interest should firstly be managed by introducing non-resident withholding tax to apply. This would potentially give rise to a tax credit in the head office/another jurisdiction and help minimise double taxation. Where a tax credit was unavailable, then AIL should be a concessionary election (consistent with why AIL was introduced).

2.3.3. It appears that Inland Revenue may be proposing to apply AIL as it would not be able to apply NRWT under its various double tax agreements. This would be misusing AIL from a policy perspective. AIL has always been intended as a concessionary tax on interest (and alternative to NRWT). To try and apply AIL in this instance, where such withholding tax cannot be levied, in order to argue that it is outside of New Zealand's 'double tax agreement' protections is inconsistent and changing the purpose of AIL. NZBA does not support this extension, and is concerned at the lack of process and policy governance around imposing a tax on interest that is in excess of New Zealand's source taxation rights.

2.4. *Australian comparison*

2.4.1. The Australian section 160ZZZJ was pointed to as a justification for New Zealand adopting a new policy of mandating that notional loan interest be subject to AIL. However, there are a number of differences with the Australian policy settings and our understanding of the basis of section 160ZZZJ being a late pragmatic inclusion to the Part IIIB rules, that lacked a strong policy basis.

2.4.2. The complexity of taxing permanent establishments and changing long standing settings is demonstrated by Australia's: *"Review of Tax Arrangements Applying to Permanent Establishments"*. The process started in May 2012 with a projected completion date of April 2013. It concluded on 4 June 2015, some three years after commencement and two years outside the original completion date. NZBA submits that the proposed AIL changes should be considered as part of a similar comprehensive review in New Zealand, rather than being rushed into law as a late addition to the AIL / non-resident withholding tax issues paper.

2.4.3. NZBA believes that it is difficult to point to section 160ZZZJ in isolation as justification for extending AIL in New Zealand. Under Australian domestic legislation a notional loan is deemed to arise (section 160ZZZ) (to the extent an amount is recognised in the financial statements as a loan). The amount of the interest expense is prescribed in the legislation as LIBOR (or an equivalent BBSW rate under the Administrative Solution following AUD ceasing to be LIBOR quoted). This is not a reflection of the actual interest cost that the permanent establishment may suffer. This policy setting was criticised during the Global Financial Crisis for not supporting banks by providing a full deduction for the funding costs that they suffered. More significantly, this policy setting is aligned with a frequently used exemption from withholding tax under section 128F and in a different wholesale / retail banking environment than New Zealand.

2.4.4. Section 160ZZZJ was a late inclusion to the policy setting in relation to withholding tax on the notional loan. Whether it should be subject to withholding tax was a matter of debate, and we understand the resulting 50% impost was a pragmatic solution rather than having a strong policy basis. We also understand that it is not a significant source of taxation, due to banks raising funding under section 128F, where no withholding tax applies.

2.4.5. On 11 May 2010 the Australian government announced as part of the Budget that it would phase down interest withholding tax and abolish withholding tax on borrowings by an Australian branch from its head office. This followed from recommendation 3.4 of the Johnson Report 2009 and the Henry Tax Review.

2.4.6. As a contrast to New Zealand:

- New Zealand branches are more dependent on group treasury / funding than Australian equivalents;
- Australian branches are able to raise funding under section 128F (with no withholding tax), compared to New Zealand;
- Section 160ZZZJ is a withholding tax / income tax and potentially gives rise to a foreign tax credit (for the head office), compared to AIL in New Zealand (leading to double taxation of interest);
- It is difficult to point to a policy basis for section 160ZZZJ (i.e. the industry considers that it should be akin to section128F);
- The Australian domestic legislation has a prescriptive approach, recognising a notional loan, a prescribed (LIBOR) interest rate and also a recognition of other inter-branch / head office transactions (including derivatives and foreign exchange). NZBA would welcome certainty in relation to these other areas as part of a wider review of the correct balance of policy settings for permanent establishments.

2.5. Economic cost

2.5.1. There are a number of economic consequences that will flow from an increased tax cost for onshore branches. These include:

- Raising borrowing costs for New Zealanders (as the increased cost of AIL will ultimately be passed on). The same arguments that were promoted to Ministers Joyce and English by the NZBA in relation to the initial AIL / NRWT issues paper, are intensified by this proposal. This is not a scenario of transferring value from the private sector to the public sector. It will create a deadweight cost to the economy that should only be undertaken carefully and consciously, having undertaken a comprehensive measure of the economic impact;

- Creating an incentive to raise money locally rather than accessing international funding;

- There may be an unexpected impact to non-resident banks that invest in New Zealand limited partnerships. NZBA assumes that these banks may also be subject to AIL under these proposals. This could have an impact on a number of public private projects (PPPs);

- Increasing the disparity from international tax settings where banks enjoy withholding tax exemptions as previously discussed.

2.5.2. NZBA would welcome further discussion on whether the 0% AIL rules can be extended to allow onshore branches to more easily participate. Specifically, this would include, relaxing:

- the requirement that debt be denominated in NZD;

- the requirement for a New Zealand based registry / paying agent; and

- the listing / widely held test to align to Australia's section 128F setting.

The NZBA would welcome engaging in a dialogue with Inland Revenue on this matter. Given the significant issues raised above, it is imperative that any change to the policy settings in respect of AIL and branch profit attribution are adequately considered both from a domestic and international position, and not rushed into law out of expediency.

Yours faithfully

Campbell Rapley
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NZBA