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Abstract
The avoidance of non-resident withholding tax ("NRWT") on interest can occur in two main ways. The parties may adopt structures and/or arrangements which seek to circumvent the statutory provisions defining 'interest' or requiring the tax to be deducted, or alternatively a non-resident lender may exploit an inequality of bargaining power so as to force the resident borrower to bear the cost of the NRWT as well. The New Zealand government has responded to these difficulties by enacting an "approved issue levy" regime, which can provide an alternative to interest NRWT. The author examines the features of this new regime and contemplates its implications.

Keywords
non-resident withholding tax, New Zealand, taxation, approved issuer levy

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NEW ZEALAND'S APPROVED ISSUER LEVY - A PRAGMATIC "CONCESSION"

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The avoidance of non-resident withholding tax ("NRWT") on interest can occur in two main ways. The parties may adopt structures and/or arrangements which seek to circumvent the statutory provisions defining "interest" or requiring the tax to be deducted, or alternatively a non-resident lender may exploit an inequality of bargaining power so as to force the resident borrower to bear the cost of the NRWT as well. The New Zealand government has responded to these difficulties by enacting an "approved issuer levy" regime, which can provide an alternative to interest NRWT. The author examines the features of this new regime and contemplates its implications.

New Zealand's love-hate relationship with interest income

During the last five years New Zealand's architects of tax policy have been giving unprecedented attention to passive income flows, and the country has seen the introduction of a series of innovative and experimental approaches to the taxation of interest income.

The timing of interest income and deductions (and other cashflows relating to financial arrangements) is regulated by the accrual regime in ss 64B-64M of the New Zealand Income Tax Act 1976 ("ITA") – provisions of awe-inspiring width, which can extend to such diverse arrangements as assignments of income, debt defeasances, options, swaps, futures contracts, convertible notes, deferred property sales and foreign currency transactions.

Onshore payments of interest income have, since 1 October 1989, been subject to resident withholding tax, or "dividend and interest PAYE" as it is euphemistically termed by the Inland Revenue Department. This concept has been retained in New Zealand, notwithstanding the abandonment of similar proposals in countries such as West Germany (as it was then).

It may also be observed that interest flows from New Zealand borrowers to non-resident lenders are subject to non-resident withholding tax ("NRWT") in the normal way, but in 1989 Parliament sought to strengthen the resolve of the NRWT by tightening the definition of "interest" (in s 2 of the ITA) to read:

> "Interest", in relation to the deriving of income, resident withholding income, or non-resident withholding income by any person (hereafter in this definition

referred to as the "first person"), means every payment (not being a repayment of money lent and not being a redemption payment), whether periodical or not and however described or computed, made to the first person by any other person (hereafter in this definition referred to as the "second person") in respect of or in relation to money lent to the second person making the payment or to any other person . . .

Even the expression "money lent" is defined in the following terms:

"Money lent", in relation to any person, means –

(a) any amount of money advanced, deposited, or otherwise let out, whether on current account or otherwise, by the person;

(b) any amount of credit given (including the forbearance of any debt), whether on current account or otherwise, by the person;

(c) any amount advanced, deposited, or let out, or for which credit is given, by the person pursuant to any obligation or arrangement that is similar to any advancing, depositing, letting out, or giving of credit, of any of the kinds referred to in paragraph (a) or paragraph (b) of this definition;

(d) any amount paid to, or for the benefit of, or on behalf of, or dealt with in the interest of or on behalf of, any other person in consideration for an agreement to pay or a promise to pay by the other person, where that amount is exceeded by the amount payable to the person pursuant to the agreement or the promise –

whether or not the advancing, depositing, or letting out, or the giving of credit, or the obligation or arrangement, or the agreement to pay or promise to pay, is secured or evidenced by writing; and, for the purposes of paragraph (d) of this definition, the expression "other person", where it last appears in that paragraph, shall include any further person where the other person and the further person are associated persons . . . .

The need for something else

But this did not solve all the problems thought to exist in relation to interest NRWT in New Zealand. On the one hand, many companies were thought to be avoiding or evading the tax (using complex transactions, branch operations and the like), and the Commissioner's ability to detect and challenge these arrangements has been hampered by the fact that his information and recovery resources – as regards non-residents – have been limited, irrespective of his power to issue an assessment under s 321 of the ITA.

In addition, however, many overseas lenders have (in their loan documentation) required that interest be paid to them on a gross basis, without the deduction of any New Zealand taxes. This may be a result of the non-resident being located in a low-tax jurisdiction (where New Zealand tax credits are of little or no benefit), the recipient having tax losses, rebates or group reliefs (which would render such credits unnecessary in reducing a tax liability in the country of destination), or merely that the lender is unwilling to receive less than the agreed interest (for reasons of cashflow or general principle). If the non-resident's bargaining position is stronger than that of the New Zealand borrower, the latter can be disadvantaged by effectively having to pay a higher rate of interest, being the interest agreed "grossed up" by an amount sufficient to include the NRWT on the total.

The prevalence of this situation, and its inevitable tendency to push up domestic interest rates in New Zealand, has led the Government to enact an alternative to NRWT on interest paid to non-residents.

The cavalry arrives?

Since 1 August 1991 a New Zealand resident borrower has been permitted to apply to the Inland Revenue Department ("IRD") for status as an "approved issuer". This application is made to the IRD's Non-resident Centre in Dunedin, and successful applicants are allocated a reference number to be quoted on future correspondence and forms for the registration of securities. According to the Minister of Finance's 30 July 1991 Budget papers, "approved issuer status will normally be granted". An approved issuer is then able to register particular debt securities where the holder of the instrument is a non-resident, and the interest under such registered securities can be paid free of the deduction of NRWT. The cost in doing so, however, is the payment of a (tax deductible) levy equivalent to 2 percent of the exempt interest actually paid. An approved issuer must pay the levy within 14 days of the end of the month in which the exempt interest is paid to the non-resident (although this will become 20 days from 1 June 1992).

Some criticism has been levelled at the approved issuer levy regime on the basis of two limitations upon its scope. First, registration (and, therefore, NRWT relief) is only possible for debt instruments in respect of which the money has been lent on or after 1 August 1991. This means that residents with existing cross-border borrowings are prejudiced unless they can refinance – an option which, if possible, may give rise to practical and/or financial disadvantages. Secondly, the election to pay approved issuer levy and to ignore NRWT cannot be made in respect of borrowings between associated parties. Clearly, the possibility of manipulation must be recognised (and guarded against) in this context, but many commentators have argued that the regime should not be excluded purely on the basis of association if the circumstances, terms and interest rate of the loan are completely commercial and at arm's length.

Locating the levy provisions

The imposition of the Approved Issuer Levy is not to be found in the ITA – rather the levy is a creature of the New Zealand Stamp and Cheque Duties Act 1971 ("SCDA").

Following the enactment of the New Zealand Stamp and Cheque Duties Amendment Act (No 2) 1991, s 86G of the SCDA provides for an "approved issuer" to make written application to the Commissioner for registration of:

(a) any transaction involving money lent to that approved issuer; or
(b) any class of transactions involving money lent to the approved issuer . . .

Thus it will be seen that it is also possible to register a *class* of securities – an important point in relation to practicality, administrative convenience and the (somewhat over-exposed) notion of tax simplification.

The term "approved issuer", however, takes its meaning from s 309(1) of the ITA, following its amendment by the New Zealand Income Tax Amendment Act (No 4) 1991. An application for "approved issuer" status is made pursuant to s 311A of the ITA, and may be filed by any person "to whom money is, has been, or may in future be lent". This, too, demonstrates a gratifying element of flexibility as it permits approval to be sought by residents who may seek offshore finance in the future, or who have already undertaken such borrowings. In the latter case, though, registration will only be possible for securities in relation to which "the Commissioner is satisfied that the money lent or to be lent under the transaction or class of transactions . . . was or is to be lent on or after the 1st day of August 1991" (SCDA, s 86H(1)(b)).

A resident's "approved issuer" status is not granted automatically, and it is also subject to review, as s 309(1) of the ITA provides that an "approved issuer" is "*at any time* a person in respect of whom an approval under s 311B of this Act *remains in force*" (emphasis added). Under s 311B of the ITA the Commissioner may decline to approve an application if:

- it is not a "duly completed" application for approval, "in writing and in such form as the Commissioner may approve" (ss 311A and 311B(1)); or
- he considers that (since the later of 1 August 1991 or two years prior to the date of application) the applicant has "been responsible for serious default or neglect in complying with that person's obligations under the Inland Revenue Acts".

If the Commissioner proposes to decline a person's application on the second of these grounds, he must give the person notice in writing of that fact within 20 working days after the date on which the application was received. According to the Inland Revenue Department's explanatory pamphlet on the levy (IR291A), however, it is the Department's expectation that applications will be processed "within a much shorter time" than this.

Similarly, when the Commissioner intends to revoke an approval on the same ground (under s 311C of the ITA) the issuer must be so notified in writing, but (by virtue of s 311C(3)) any such revocation does not affect the status of interest payments made thereafter in relation to money borrowed under a "registered security" before the date of revocation and while the borrower was an "approved issuer". To provide otherwise would have left such issuers exposed to quite different liabilities than were anticipated when the funds were borrowed.

Exempt, but not "exempt"

The mechanism by which relief is provided from NRWT is also of interest (almost by definition . . .). There is no exemption from NRWT, as such, where approved issuer levy is paid in connection with a registered security. Instead, s 311(1)(aa) of the ITA now imposes a NRWT rate of zero percent where there is interest paid by an "approved issuer" in respect of a "registered security" between persons who are not "associated persons". The term "associated persons" is given meaning by s 8 of the ITA, which looks at

substantial identity of shareholders or controllers (as outlined in s 7 of the ITA), a company and any shareholder who holds 25 percent or more of its capital, persons who are "relatives" (as defined in s 2), and a partnership and the "associate" of any partner.

A reading of s 311(1)(aa) of the ITA in isolation would suggest that such interest could be zero-rated for NRWT purposes even without making payment of the 2 percent levy (the rate is provided for in s 86J of the SCDA). However, it should be noted that the draftperson has covered this possibility, albeit in a fashion which hardly assists accessibility and ready comprehension, in s 86I of the SCDA. That provision states:

> For the purposes of Part IX of the Income Tax Act [ie the NRWT provisions] and section 86J of this Act, and notwithstanding any provision of that Part IX of that Act, a payment of interest shall be treated as being paid by an approved issuer in respect of a registered security only where and to the extent that payment is made by the approved issuer of approved issuer levy on the leviable value of the registered security at the time of the payment of interest –
> (a) at the rate specified in section 86J of this Act; and
> (b) by the date specified in section 86K of this Act, or by such later date as the Commissioner may determine pursuant to section 86M of this Act.

The payment date specified in s 86K is the fourteenth day of the following month in relation to interest paid up to 31 May 1992, and thereafter the twentieth day of the following month – to accord with revised tax payment dates introduced as a simplification measure. The "leviable value" is defined in s 86F as the amount of any interest payment.

Given that approved issuer levy is paid significantly after the payment of the interest to which it relates, the draftsperson's retrospective operation of s 86J of the SCDA upon s 311(1)(aa) of the ITA is far from ideal. This is because, unless the zero-rate applies at the time the interest is "paid", the New Zealand resident payer is required by s 312 of the ITA to "make a deduction" of the appropriate NRWT from the gross interest payment. The drafting technique used has created a period of limbo where it will not be known (by anyone) whether the taxpayer has breached his, her or its statutory obligation to deduct unless the levy payment date has passed. For this reason, it is clear that some amendment should be made to s 312 to qualify the deduction obligation. If amendments are to be made, it is submitted that other aspects of the approved issuer levy legislation could profitably be reviewed. In particular, the effect of s 86I of the SCDA should be contained in s 311 of the ITA, without forcing taxpayers to discover that the seemingly plain words of s 311(1)(aa) are given an artificial meaning in another statute.

As an aside, the peculiar zero-rating mechanism adopted has given rise to a curious situation in relation to New Zealand Government Stock and Treasury Stock held by non-residents. For the non-resident holders to be relieved of their liability to NRWT, it is necessary for the *issuer* of the stock to pay approved issuer levy – but this is unlikely in the light of the issuer's identity. Nevertheless, it is understood that the Debt Management Office has applied for "approved issuer" status, and is now paying interest on such stock to non-residents free of NRWT but with 2 percent deducted from the

coupon payment. There is no legislative basis for making such a deduction, but the non-residents were apparently given the option of bearing the 2 percent or instead having full NRWT deducted. Not surprisingly, most are not complaining too loudly about this extra-statutory levy deduction.

It should also be noted that the new levy can only provide relief from New Zealand NRWT, rather than from New Zealand liability to taxation. Accordingly, non-residents who have a fixed establishment in New Zealand will still be liable to that country's income tax as they would not have been subject to the NRWT regime.

Giving credit only where credit is due

Cynical taxpayers might be inclined to observe that there must be some implication(s) following from the decision to call the new alternative impost a "levy" (rather than a "tax") and to place its roots in the SCDA. Tax practitioners will have immediately concluded that this will lead to tax credit implications for the non-resident lender.

Under a "normal" scenario (of which there may only be few), NRWT would be deducted from a New Zealand borrower's payment of interest to the non-resident at the rate of (say) 10 percent (assuming a country with which New Zealand has entered into a comprehensive double tax treaty). In its country of residence, the lender would return the gross amount of interest, and offset the NRWT deducted against its tax payable in that country, as a foreign tax credit. Accordingly, as long as the lender is taxable and its tax rate (on net income) is sufficient to absorb the whole tax credit, the scales are relatively balanced. (The word "relatively" is used because if the other jurisdiction maintains an imputation regime there will usually be a preference for paying local tax rather than New Zealand tax, as the latter will not provide imputation-type credits which can be utilised by the company's shareholders). By contrast, the approved issuer levy will not generally be a creditable payment from the non-resident's point of view, as:

- it will not be a foreign "income tax" (but will be a levy on interest *paid* by New Zealand residents); and
- the non-resident will not have incurred the levy in any event, as the liability falls upon the resident issuer (whereas the actual liability for NRWT is the non-resident's, even though the resident has a statutory obligation to deduct).

Thus, in theoretical terms, the imposition of NRWT may not increase the resident borrower's financing costs at all, whereas the approved issuer levy constitutes a certain, additional (albeit deductible) cost of 2 percent of the interest paid. As we have seen, though, the comparison is not as simple as this, because the New Zealand resident may already (for a variety of reasons) have been forced to "gross up" the interest payments to accommodate the NRWT payable – giving an extra burden of around 11 percent of the interest. Such taxpayers are obviously better off with the new levy and there has seemingly been significant interest in this alternative – both locally and from overseas.

The foreign tax credit issue may become quite complicated where the Debt Management Office has deducted a 2 percent "levy" from Government Stock and Treasury Stock interest paid to non-residents, as described above. Is this a deduction of "approved issuer levy" for which the non-resident is not technically liable, or is it a reduced rate of NRWT?

The levy may also be attractive to some taxpayers who have entered into arrangements aimed at avoiding New Zealand NRWT entirely. If they are concerned at the efficacy, or long-term future, of such arrangements, it may be that they would be willing to "buy" certainty under the approved issuer levy regime for a cost well below the NRWT rate they have sought to circumvent.

There may also be something of a non-financial cost of registration, however, by virtue of the disclosure aspects of the regime. The application for registration of any security is required, by ss 86G and 86H of the SCDA, to be in writing, "in such form as the Commissioner may approve", and to be "duly completed". The IRD requires such applications to be made on Form IR291B, which requires the taxpayer's Approved Issuer Number, and details of:

- the issue date (or expected issue date) of the security;
- the date of redemption;
- the face value of the security;
- the redemption value in New Zealand dollars;
- the coupon interest rate;
- the date on which the first interest or coupon payment is due; and
- whether the security is a fixed or variable principal instrument.

Overall, however, these disclosures seem relatively innocuous, and it is probably more likely that some taxpayers would shy away from voluntarily revealing funding arrangements entered into with related companies, entities and persons. Thus, it may be that the non-availability of the levy alternative where the parties are "associated" may limit the disincentive effect of disclosure.

It is also possible that some taxpayers will choose not to follow the approved issuer levy route, and it is noteworthy that s 311C(2) of the ITA provides for the revocation of "approved issuer" status at the taxpayer's request. If the offshore lender is a tax-paying entity resident in a comparable-or-higher tax rate country (without an imputation regime), it may still be possible for the borrower to negotiate a "traditional" loan under which the non-resident accounts for New Zealand NRWT as a foreign tax credit in the ordinary way. If the New Zealand resident is not forced to "gross up" the interest paid, this approach will prove less expensive than incurring the additional 2 percent under the new levy regime.

Conclusion

This, then, is the latest of the "interesting" experiments undertaken by New Zealand in its search for tax revenue. The approved issuer levy differs, however, from many of the other taxation regimes implemented since 1987 in that it is also motivated by a desire to retard domestic interest rates.

Some may argue that the levy amounts to an admission of defeat on the Government's part in relation to NRWT avoidance, and is an effective reduction in the rate of interest NRWT. Whether or not this is so, the levy does exhibit a pragmatic response to the two principal avenues for avoiding interest NRWT (namely, the adoption of highly technical structures or merely requiring the resident borrower to bear the cost). It remains to be seen whether the concept of such a levy proves to be a success, and if other jurisdictions will be tempted to consider a similar approach.