Tax Alert
February 2013

Tax Alert

A focus on topical tax issues – February 2013

In this issue

Fundamental changes proposed to thin capitalisation rules

GST remedial issues paper released for comment

Inland Revenue update New Zealand tax residency rules

Purchases denominated in foreign currency – proposed tax reforms announced

Japan and New Zealand sign new double tax agreement

Taxation of Multinational Companies: Report Issued by Inland Revenue

Fundamental changes proposed to thin capitalisation rules

by Campbell Rose and Chris Myers

In a brief issues paper innocuously entitled "Review of the thin capitalisation rules", Inland Revenue policy officials and the Treasury have started 2013 with gusto, proposing significant changes to New Zealand's thin capitalisation rules.

The changes, if enacted, will extend the ambit of the rules so that they operate as officials consider they were intended to. Although there is a particular focus on private equity investment vehicles, certain aspects of the proposed changes, if implemented, are likely to introduce material uncertainty and potential overreach into the rules. Those currently subject to the thin capitalisation rules may also face increased compliance costs resulting from some of the changes.
There are a number of proposed amendments, but the key changes are to:

- widen the inbound thin capitalisation rules to include companies in which non-residents that are not necessarily associated for tax purposes, but who "act together", hold an interest of 50% or more;
- exclude related party debt when calculating the worldwide debt-to-asset ratio in applying the 110% safe harbour.

Other proposed changes include bringing certain New Zealand trust structures within the thin capitalisation regime, excluding capitalised interest from asset values and ignoring accounting value uplifts arising from transactions between associated parties.

The focus of the issues paper is "ensuring that more tax is collected in cases where New Zealand-sourced income appears to be escaping tax", i.e., base maintenance. The changes are proposed to take effect from the income year beginning after enactment of relevant legislation (so, at the earliest, from the 2014 income year).

Non-resident investors "acting together"

The first key proposal is to widen the inbound thin capitalisation rules to include companies in which non-residents that are not necessarily associated for tax purposes, but who "act together", hold an interest of 50% or more. This is aimed at shareholders who can "collectively act in the same way as an individual controlling shareholder to determine the level of debt the company will hold", i.e. in a way that "mimics control by a single controlling investor".

It is not proposed to exhaustively define what constitutes "acting together", but the issues paper indicates that this will include at least:

- explicit co-operation through a written or tacit shareholder agreement;

Continued on page 2...

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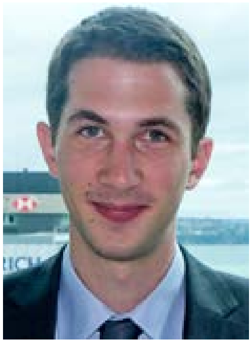

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- effective co-ordination of investors by a person or group of people, such as private equity managers.

Where this rule applies, the worldwide group for the purposes of the 110% safe harbour will be the New Zealand group.

In an environment where New Zealand is competing for foreign direct investment, such a change will inevitably introduce material uncertainty into our international tax rules. Precisely what aspects of the New Zealand company's business the relevant investors must be "acting together" with respect to – i.e. the particular subject matter of their "co-operation" or "co-ordination" - is unclear. It is not an easy task to define which such aspects are sufficient, how regularly and to what extent they must be agreed upon, to mimic control by a single controlling investor.

A proposed alternative approach outlined in the issues paper is to prescribe specific and exhaustive criteria indicating when parties are acting together. An example given is "whenever there was a shareholder agreement". However, this and any approach based on whether a shareholder agreement is on foot risks arbitrary or unintended outcomes and overreach. The mere existence of a contractual arrangement regulating the relationship between co-investors and matters relating to the relevant investment to some extent - and this is where the differences will lie as between agreements - should not necessarily be a proxy for control by a single controlling investor. Officials also do not prefer this approach, given the need for complex criteria in order to avoid easy circumvention.

In an environment where New Zealand is competing for foreign direct investment, such a change will inevitably introduce material uncertainty into our international tax rules.

A further proposed alternative is for the thin capitalisation rules to apply to all companies in which non-residents hold (in aggregate) an interest of 50% or more, whether or not acting together – this is similar to one limb of the equivalent Australian test. Publicly listed companies would be excluded. Officials observe that such a test may include shareholders that are very unlikely to be able to influence a company's debt level.

Which arrangements should (or should not) be included within the thin capitalisation rules from a tax policy perspective – i.e. how widely should the rules apply - warrants robust consultation and debate before final decisions are made regarding the proposals. In this regard it is relevant that there will always be a degree of "co-operation" under any shareholder agreement, and the extent of "co-ordination" of investors will depend upon the nature of the relevant investment mandate. The impact of uncertainty and overreach ought not to be underestimated, particularly in relation to perceptions of New Zealand as an investment destination compared with other jurisdictions.

Exclusion of related party debt when calculating 110% safe harbour

The thin capitalisation rules limit the deductibility of interest expenditure if the New Zealand group's debt-to-asset percentage exceeds 60% and exceeds 110% of the worldwide group's debt-to-asset percentage. Officials observe that, in some cases, the 110% safe harbour is always available as the worldwide group is almost the same as the New Zealand group. This can result in non-resident investors being able to use as much debt (including shareholder debt) in relation to their New Zealand investments as they wish.

The issues paper proposes amendments to ensure that the 110% safe harbour applies in a meaningful way (i.e. to a foreign parent with substantial foreign operations and third party borrowing). Debt will not count towards the safe harbour if it is linked to the shareholders of group entities. Acknowledging that this is a complex area, officials propose that debt be excluded from the 110% safe harbour calculations where:

- the debt is owed to a person having an income interest in a group entity; or

- the debt is owed to a person that has received funds directly or indirectly from a group entity, a person with an income interest in the group entity, or an associated person, on the condition or expectation of both parties that some or all of those funds would be used to provide the debt (this is to prevent back-to-back loans).

Officials perceive the number of affected taxpayers to be low, as in their view most do not have to rely on the 110% safe harbour.

To bolster this proposal, the issues paper identifies that a specific anti-avoidance rule may be introduced to counter shareholder debt being "transformed into apparently external debt". In the light of the detailed scheme of the thin capitalisation rules (particularly if the proposals are enacted), and the factors taken into account in any general anti-avoidance analysis following the Supreme Court's judgment in *Ben Nevis*, this does seem somewhat excessive.

Capitalised interest

It is proposed that capitalised interest should be subtracted from the value of assets, to the extent the interest has been deducted as a tax expense in New Zealand (the status quo being "inappropriate"). Officials state they have been advised that this is a "straightforward" compliance exercise with minimal costs.

Calculating capitalised interest on a go-forward basis from the time of acquiring assets should be straightforward. However officials do not seem to have taken into account the time and cost involved in reviewing prior tax returns and supporting material to identify previously capitalised interest, for example where an entity becomes subject to the thin capitalisation rules some years after acquiring an asset. Bearing in mind what should be a relatively immaterial amount of capitalised interest relative to the value of assets, this proposal appears to create a disproportionate compliance burden.

Other proposals

The issues paper discusses three other proposed changes to the thin capitalisation rules.

Generally assets must be recorded at cost and revaluations are not permitted for financial reporting purposes. Officials consider that this restriction is being circumvented by reporting higher asset values after internal reorganisations. In response, the issues paper proposes that, when the total accounting value of an asset of a New Zealand or worldwide group increases as the result of a sale between associated persons, this increase should be ignored.

This proposal appears to constitute the proverbial sledgehammer to crack a nut. It is not clear why a genuine increase in asset value should be ignored, particularly if (for example) an external funder is prepared to lend against the security represented by the increased asset value. In addition, internal reorganisations are often undertaken for genuine commercial reasons.

The issues paper proposes that the thin capitalisation rules should be extended to apply to resident trustees (of complying trusts) where 50% or more of the total settlements are made by a group of non-residents acting together, or by an entity subject to the thin capitalisation rules. Submissions are invited on when it would be normal, for non-tax reasons, to use a trust to hold group companies. This appears to assume a 'norm' for structuring the ownership of group companies in New Zealand, despite the Supreme Court's observations in *Penny & Hooper* that, generally, the utilisation of trust and corporate structures is not in itself offensive (it was the particular use of those structures to repatriate personal exertion income to the taxpayers that concerned the Court).

The issues paper proposes that New Zealand resident individuals or trustees will be required to consolidate with the holdings of their underlying entities (i.e. outbound groups) when establishing their thin capitalisation position.

Finally, the issues paper signals that officials may undertake future work in relation to the treatment of debt held by finance or insurance companies, and the substituting debenture rule.

Concluding observations

A significant omission from the issues paper is any discussion of whether the proposals should only apply to new funding structures entered into on or after enactment (i.e. with existing arrangements being grandfathered). Investors will have made investment decisions based upon the law in force when initially providing funding. Although it is inevitable that tax laws change from time to time, the proposed changes will equally inevitably result in real costs for investors as a result of adjusting their funding mix to preserve full interest deductibility.

The proposals seek to correct "apparent problems" with the thin capitalisation rules that have been identified by Inland Revenue in the course of its audit work. In such circumstances, the issue is whether it is equitable to affect existing investment arrangements through measures aimed at remedying defective legislative design.

The Minister of Revenue has described the foreign investment tax laws as a "delicate balancing act" – on the one hand, ensuring that non-resident investors pay their "fair share of tax" but, on the other, not discouraging investment. Whether the proposed recalibration of the thin capitalisation rules appropriately strikes that balance (in particular, through rules that are clear and appropriately targeted) is certainly worthy of debate.

The issues paper seeks submissions on the proposals by 15 February 2013 and can be accessed **here >**

If you have any questions regarding the proposals, or if you would like to discuss making a submission, please contact your usual Deloitte adviser.

GST remedial issues paper released for comment

By Vlad Skibunov

In December 2012, Inland Revenue released an officials' issues paper on GST titled "GST Remedial Issues". As the name suggests, the issues paper is concerned with the GST rules which are considered by Inland Revenue as requiring clarification or not operating as intended. As such, subject to one very important exception on "unjust enrichment", the issues paper does not raise significant policy questions.

Overall, we consider that the proposals in the issues paper strike the correct balance between offering practical answers to some of the compliance-related concerns currently faced by taxpayers and fixing some of the legislative gaps left following the introduction of the new zero-rating of land rules and apportionment rules in 2011.

In this context, it is unfortunate that the issues paper also includes the proposal to introduce an unjust enrichment rule that would require a "supplier" to issue a credit note where there is no supply for GST purposes. This proposal interferes with the freedom of contractual parties to agree on their own contractual terms and may be viewed as a revenue-gathering exercise by Inland Revenue.

In summary, the issues paper deals with the following topics:

- Credit notes when GST is mistakenly accounted for where there is no supply for GST purposes.
- Application of the hire-purchase time-of-supply rule to land transactions.
- Treatment of directors' fees.
- Consequential and remedial amendments following the introduction of the apportionment rules.
- Consequential and remedial amendments following the introduction of the zero-rating for land rules.
- Consequential and remedial amendments following the changes to the definitions of "dwelling" and "commercial dwelling".

Below, we discuss some of the more interesting proposals suggested in the issues paper.

Credit notes

Credit and debit notes are issued by suppliers to reflect that the payment for a supply may have been incorrectly stated and to allow the issuer to adjust their position accordingly. However, the requirement to issue a credit or debit note only applies where there has been a supply of goods or services by a registered person. For example, where a registered person issues an invoice on the assumption that a supply subject to GST has taken place and it is later determined that the payment is not in respect of any "supply" for GST purposes, the supplier is not required to issue a credit note.

Officials are concerned that where GST was charged by the supplier and accounted to Inland Revenue and it is later determined that no supply has taken place, the supplier will be able to recover the output tax from Inland Revenue without passing it on to the person who they consider has economically suffered the "GST" cost. Officials consider that this will provide the supplier with a windfall gain.

The Inland Revenue's solution proposed in the issues paper to this perceived problem is to require a supplier to issue a credit note in situations when the GST treatment of a supply has been incorrectly accounted for.

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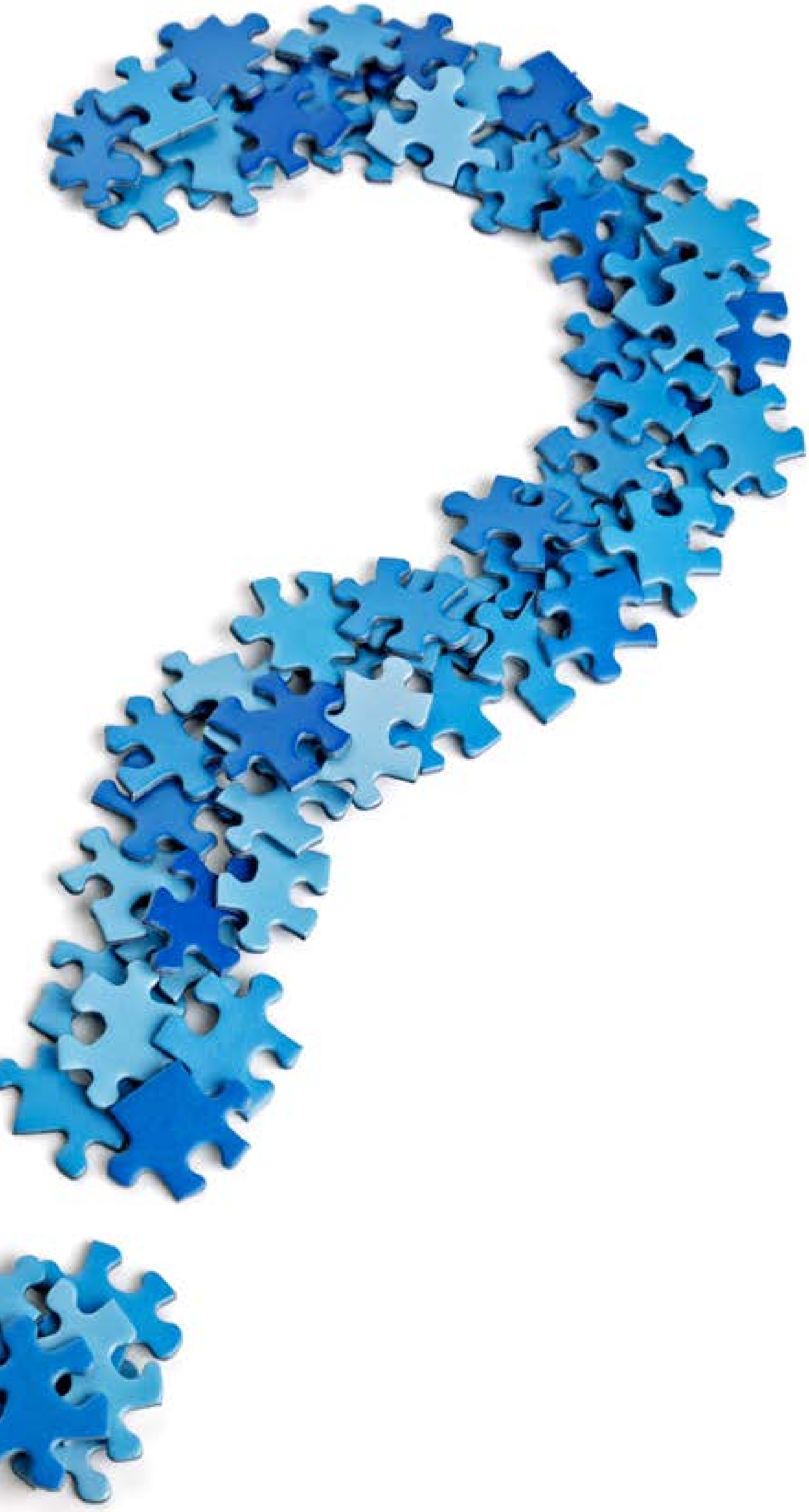

The proposed solution would likely operate – and officials acknowledge it – as a general unjust enrichment rule in practice. In its suggested form, we find it difficult to justify and support the introduction of such a rule.

Firstly, the proposed solution attempts, for practical purposes, to dictate contractual terms governing obligations of parties to a transaction rather than letting them agree on their own contractual terms. Thus, the pricing and payment issues are contractual matters and depending on the contractual terms, one of the parties will bear the risk of GST charged on a supply. For example, if a price is expressed as inclusive of GST because the supplier incorrectly believed that the supply would not be subject to GST, the supplier will bear the cost of GST if the GST is eventually charged on the supply.

Secondly, as is indicated in the above example, the rule would apply asymmetrically by practically helping the "recipient" to recover the incorrectly paid GST without providing any assistance to the supplier with recovering any GST charged on a supply which was previously considered not to be subject to GST.

For these reasons we consider that an "unjust enrichment" rule would not only be unnecessary, but also unfair.

Treatment of directors' fees

Where an employee is engaged as a director by a third-party company who is not their employer and the employee is required to reimburse the employer (which may be a company, trust or a partnership) for the directors' fees received, the employer is required to account for output tax on the reimbursement payments. The proposal deals with the concern that in these circumstances neither the director nor the third-party company are able to recover the GST component because the director is not carrying on a taxable activity and the third-party company does not have direct relationship with the employer. The outcome is that supply is not GST-neutral and one of the entities will bear the GST cost.

In practice, to ensure that the GST does not become irrecoverable cost, some employers have sought to agree directly with third-party companies to be paid "compensation" for permitting the employee to be a director, therefore allowing the third-party company to claim the input tax deduction. There is some doubt that this approach is entirely effective. The solution proposed in the issues paper would extend the ability of the third party company to claim input tax deductions to situations where it has no direct relationship with the employer, by specifically allowing the employer to issue a tax invoice for the fees. This is a good clarification and reflects common practice.

Apportionment rules

A number of the proposals in the issues paper will affect owners of land who use or have used the land for making both taxable and non-taxable supplies.

Thus, officials propose that where a taxpayer has used the GST apportionment rules to apportion between the taxable and non-taxable uses of the land, the taxpayer will have to make a compulsory wash-up apportionment adjustment where the land has been used solely for a taxable or non-taxable purposes during two consecutive adjustments periods and the percentage actual use of the land over the course of their ownership of the asset is, respectively, over 90% or under 10%.

This compulsory wash-up calculation would take the land out of the GST apportionment rules. This is a positive development as currently where a taxpayer has apportioned input tax in respect of land between the taxable and non-taxable uses, the land will always technically remain subject to the ongoing apportionment rules obligations. As such, the proposal will benefit taxpayers who intend to continue using the land for making solely taxable or non-taxable supplies, and therefore wish to take the land out of the GST apportionment rules once and for all.

Unfortunately, considering that the issues paper states that the land may again become part of the apportionment rules if the owner subsequently changes the use of the land beyond the de minimis levels stipulated by the GST Act, the benefits of the proposal are less obvious where the exclusive use of the land for either taxable or non-taxable purposes is only temporary. For this reason, we consider that although the rules are likely to be beneficial in many situations, they should not have a compulsory application but should apply at taxpayers' discretion.

Another proposal in the apportionment rules realm relates to the non-taxable sale of land for which the vendor has claimed input tax deductions.

The issues paper is concerned that there is a risk that a person may use land fully or partly for making taxable supplies and then devote it exclusively to a non-taxable purpose before disposal. In these circumstances, the person will have claimed a full or partial input tax deduction for the land without charging the GST on the sale and without having to return any of the input tax which they have claimed. It is therefore proposed to deem a supply of land to be in the course or furtherance of a taxable activity and therefore subject to GST when input tax has been claimed in respect of the land. Vendors will be able to utilise the wash-up calculation in the GST Act, which could potentially provide them with further input tax deductions.

The proposal, if implemented, would put an end to the discussion as to whether GST must be charged on supplies of land where the vendor has partially claimed input tax in respect of the land.

The issues paper is concerned that there is a risk that a person may use land fully or partly for making taxable supplies and then devote it exclusively to a non-taxable purpose before disposal.

Zero-rating of land rules

Following the introduction of the new rules in 2011, a taxable supply of land by a GST-registered vendor is subject to GST at the rate of 0% where the purchaser is registered for GST, intends to use the land for making taxable supplies and will not use the land as the principal place of residence for themselves or their relatives.

The GST Act also provides that where a supply which should have been subject to GST at the standard rate of 15% was incorrectly zero-rated under the zero-rating of land rules – for example, because the purchaser was not registered for GST or did not intend to use the land for making taxable supplies then the purchaser, rather than the vendor, must account for the output tax on the supply to Inland Revenue. Furthermore, the legislation provides that the purchaser is denied the ability to claim an input tax deduction in respect of the supply – the assumption being that by being unable to satisfy all of the requirements for zero-rating of land, the purchaser would not be able to claim that input tax deduction even if the transaction was correctly standard-rated from the outset.

Although the rule limiting the ability to claim input tax deductions works as intended where the reason for the incorrect GST treatment of a supply is an error as to the GST registration circumstances of the purchaser, the rule does not provide a right outcome where a supply is incorrectly zero-rated as a result of a genuine mistake in respect of whether the supply actually involves "land". Thus, we have already seen a number of practical examples where due to the very wide definition of "land" in the GST Act, it was not immediately obvious whether or not a supply involves "land". In these situations, if the supply is zero-rated and it is later determined that the supply did not involve land and therefore should have been standard-rated, the purchaser would have to account for the output tax on the supply to Inland Revenue and would be prevented from claiming back the GST paid. This outcome is incorrect from both the policy and practical perspective as the purchaser would be able to recover that GST if the supply was correctly standard-rated from the start.

As such, we are happy to see that officials have recognised the problem with the limitation on the ability to recover input tax deduction rule and propose to amend it to allow the recovery of the input tax to the extent that the purchaser uses the goods for making taxable supplies.

Next steps

The comments above outline some of the more far-reaching proposals in the GST remedial issues paper. We recommend that businesses consider these and other proposals in the issues paper and decide whether any of them have sufficient effect for them to warrant making submission.

Submissions can be made until 1 March 2013. After considering submissions, officials will make recommendations to the Government and legislative change will follow in due course. Please contact your usual advisor to discuss your tax position or if you wish to be involved in submissions.

Inland Revenue update New Zealand tax residency rules

By Joanne McCrae and Conor O'Brien

In December 2012, Inland Revenue released a draft interpretation statement for consultation regarding residence of individuals and companies. This statement attempts to update and replace the June 1989 Public Information Bulletin (PIB) No. 180 entitled '' New residency rules'' and also replaces a number of Tax Information Bulletins from the 1990s. Changes outlined in this draft statement have been noted to be made to ''reflect current legislation and ensure consistency with the latest case law and the Commissioner's views''.

For the purpose of this article we have focused on three proposed changes in approach for individual residency tests.

Residency is vital in determining the extent to which individuals and companies are taxed in New Zealand i.e. whether they will be taxable on their New Zealand sourced income only or on their worldwide income. However tax residency is also relevant for the purposes of the Student Loan Scheme Act, GST and the working for families' tax credit. Therefore any interpretive change to the residency rules is very important to a wide spectrum of taxpayers.

Residence of Individuals

An individual is treated as a New Zealand tax resident if either:

- They have a permanent place of abode (PPOA) in New Zealand **or**
- They are present in New Zealand for more than 183 days in total in a 12 month period. The individual will be treated as being resident from the first of those 183 days.

An individual who meets the tests above will cease to be treated as New Zealand tax resident if:

- They no longer have a PPOA in New Zealand **and**
- They are absent from New Zealand for more than 325 days in a 12 month period. The individual will be treated as not resident from the first of those 325 days.

Therefore, an individual will be considered a tax resident of New Zealand even if they are absent for more than 325 days if they continue to have a PPOA here. The residency rules appear to have been constructed to place a higher emphasis on having a PPOA in determining residence.

Key proposed changes

What constitutes a PPOA

For an individual to have a PPOA the draft statement outlines that an individual must have a particular place of abode that is an ''available dwelling''. This in itself is insufficient as courts have held that there is also a need for a broader enduring connection with New Zealand. However, the draft statement has placed a significantly higher emphasis on the availability of a dwelling in determining if a PPOA exists. The statement goes on to suggest that the term ''available'' does not mean that the property is required to be vacant and can include a property that has been rented out. It does not need to be exclusively available to the individual at all times, but available to them whenever the person requires it.

This change is particularly significant to individuals who have left New Zealand and have retained a property here as outlined below in one of the many examples from the draft statement.

Facts: Cate, who is normally resident in New Zealand, is seconded to Canada in connection with her employment, for a fixed period of three years. Cate intends to return to New Zealand after the period of secondment. Cate's partner and children accompany her to Canada. Cate and her partner own a house in New Zealand, and this is rented out while they are in Canada. Cate retains her New Zealand investments, and her connections with several professional and sporting associations here.

Result: Cate has a permanent place of abode in New Zealand.

Explanation: Cate has a place of abode in New Zealand – being the house she owns with her partner. Cate has retained ties with New Zealand – she still has a dwelling available here, maintains

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membership of several professional and sporting associations, and has investments here. Cate also retains employment ties with New Zealand, as her secondment is in connection with her New Zealand employment. Cate has an intention to return to New Zealand at the end of the three-year secondment.

Although Cate will be absent from New Zealand for a substantial length of time, this is not inconsistent with having a permanent place of abode in New Zealand. All of the relevant factors must be weighed up. In this case the strength of Cate's enduring connections with New Zealand is sufficient to establish that she has a permanent place of abode here.

This example can be contrasted to the example in PIB No. 180 which, on almost identical facts, determined that there was not a PPOA.

The key difference appears to be a change in the view of the Commissioner in relation to the impact of the period of absence. Previously the Commissioner of Inland Revenue considered 3 years to be sufficient time to break the enduring connection to New Zealand.

Our View: We do not agree with the Commissioner's view that case law supports a change in approach. Most of the cases since the original PIB No. 180 was issued relate to absences of a year or less. The outcome in such cases is non-controversial as there has been an insufficient lapse of time to break the enduring connection with New Zealand.

Relevance of 'permanent home' for DTA tie-breaker tests

As outlined above, for an individual to have a PPOA the draft statement outlines that an individual must have a particular place of abode that is an ''available dwelling''.

This definition of ''available '' will also impact upon dual resident individuals who rely on the tie-breaker tests in New Zealand's international double taxation agreements (DTAs). The first of these tie-breakers in the DTAs considers which country the individual has a permanent home available to them in. This change in approach may now mean that a large number of dual residents will be considered to have a permanent home available in New Zealand despite it being rented out. This differs from the position in the previous PIB, which recognised that where a person rents their house to non-related persons while they are overseas, that house will not be a permanent home which is available to them. While the OECD does not discuss what is ''available'', they do note that a permanent home ''must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration''. The guidance goes on to state that permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc…).

Clearly if it is rented, it is not available continuously.

Personal and economic relations / centre of vital interests test

In cases where an individual is deemed to have a permanent home in both countries, the next tie-breaker will generally be the personal and economic relations test. This test gives preference to the country with which the personal and economic relations of the individual are closer i.e. the centre of vital interests.

In PIB No. 180 more importance was given to the individual's personal relations, such as which country their family was located in, than was given to economic relations. The Commissioner has now outlined in this statement that this position is ''no longer considered to be correct''. The view the Commissioner is taking is that both the social and the economic relations of the individual should be treated with equal importance.

This part of the statement is particularly vague and is probably best illustrated by way of an example. Say Joe, an Irish individual who has lived all his life in Ireland, is married to Jane who arrived in Ireland 5 years ago from New Zealand. They have two children, a house, a car, a joint bank account and a credit card in Ireland. Joe is also a member of a professional body in Ireland. Joe also received a large inheritance which he invested in an Irish fund and from which he receives significant dividends each year. The couple decide to move permanently to New Zealand and buy a house here. They will rent the house in Ireland as the rental market is strong. They will keep the Irish bank account open to collect this rent and will also retain the credit card for any house related expenditure. Joe does not currently wish to withdraw his money from the managed fund investment as it is performing well and will therefore leave this in place. They intend to return to Ireland every year or so to see Joe's family and decide to keep the car as it is not valuable and the cost of car rental is very high. Joe wants to keep his membership with the Irish professional body (which has recognition in New Zealand) and will continue to pay the annual subscription there. However the couple have no intention of returning to live in Ireland.

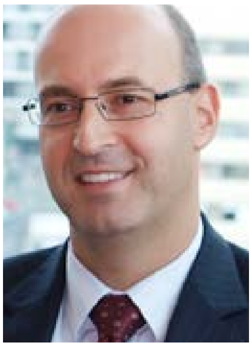
The couple are domestic tax resident in both Ireland and New Zealand. Assuming no long fixed term lease in Ireland and given the Commissioner's view on ''permanent home'' above, the couple will likely satisfy the first DTA test as they have a permanent home in both jurisdictions and can terminate the lease at any time to return. The couple will therefore go to the second tie-breaker test. Under PIB No. 180 the couple would have been treated as treaty resident of New Zealand as their family is in New Zealand with them and they intend to stay here indefinitely. However, using the Commissioner's logic of treating both personal and economic relations as equally important it is unclear, given the greater economic ties to Ireland, where the couple will be treaty resident under the second DTA test.

Our View: By placing equal value on both personal and economic relation, the Commissioner has muddied the waters somewhat and will create more uncertainty for individuals. The Commissioner's view appears to conflict with the OECD guidance in this area which notes '' the circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention''. The Commissioner also does not offer any guidance on how many personal versus economic factors it will take to treat individuals as treaty resident under this second test.

Conclusion

The draft statement in its current form does not provide individuals with clarity regarding residence and gives no indication as to whether Inland Revenue will seek to apply this new approach retrospectively. From our viewpoint there has been no case law to support a change in approach.

Submissions on this statement were due to be submitted to Inland Revenue by 31 January 2013. Deloitte has made a submission on the changes outlined in the draft statement.



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Purchases denominated in foreign currency – proposed tax reforms announced

By Iain Bradley & Annamaria Maclean

In our **August 2012 Tax Alert** we outlined and commented on the proposals included in an Officials' Issues Paper on *Financial Arrangements – the sale and purchase of property or services*. The proposals outlined in the issues paper were generally welcomed by taxpayers making purchases of goods and services in a foreign currency, given the complexity of the rules that currently apply in this area.

Since then there has been progress on these proposals. On 14 December 2012, the Minister of Revenue announced that the Government will move to simplify the rules in relation to financial arrangements that are agreements for the sale and purchase of property or services.

The Minister's announcement confirms the following:

- IFRS taxpayers will be required to follow their financial reporting treatment for almost all of their agreements for the sale and purchase of goods and services. The exception will be for capital items, other than capital items that are depreciable.

- Non-IFRS taxpayers will use a simplified version of the IFRS treatments.

- The reforms will apply from the 2013-14 income year. This is intended to cause minimal disruption and ensure that the rules do not affect provisional tax payments for current income years. However, IFRS taxpayers will be able to elect to apply the IFRS accounting treatment to **new** arrangements from the 2011-12 income year. The proposals suggest that such an election must be made for **all new** arrangements.

- The tax treatment of any existing arrangements, associated hedges and the underlying property or services, for income years before IFRS taxpayers adopt the IFRS tax treatment, will be validated in certain circumstances.

- Existing agreements will continue to use the tax treatment applied, before IFRS taxpayers adopt the IFRS treatment for new arrangements, until they mature. That is, the tax treatment of existing arrangements will not be allowed to change to another current or new alternative method. However, IFRS taxpayers will be able to elect that forward exchange contracts that are designated as hedges of the foreign exchange risks on existing arrangements can follow the IFRS accounting treatment for tax purposes, in certain circumstances.

The amendments to the tax legislation to give effect to these proposals will be included in the next available tax bill, with draft legislation expected to be released for comment in March 2013.

Comment

It appears that the intention of the Minister's release is to assist those taxpayers filing their 2012 income tax returns due at the end of March 2013. Some taxpayers may have already filed their 2012 income tax returns but others will be in the process of preparing and filing them now. Therefore it is important that these proposals are considered before 2012 income tax returns are finalised.

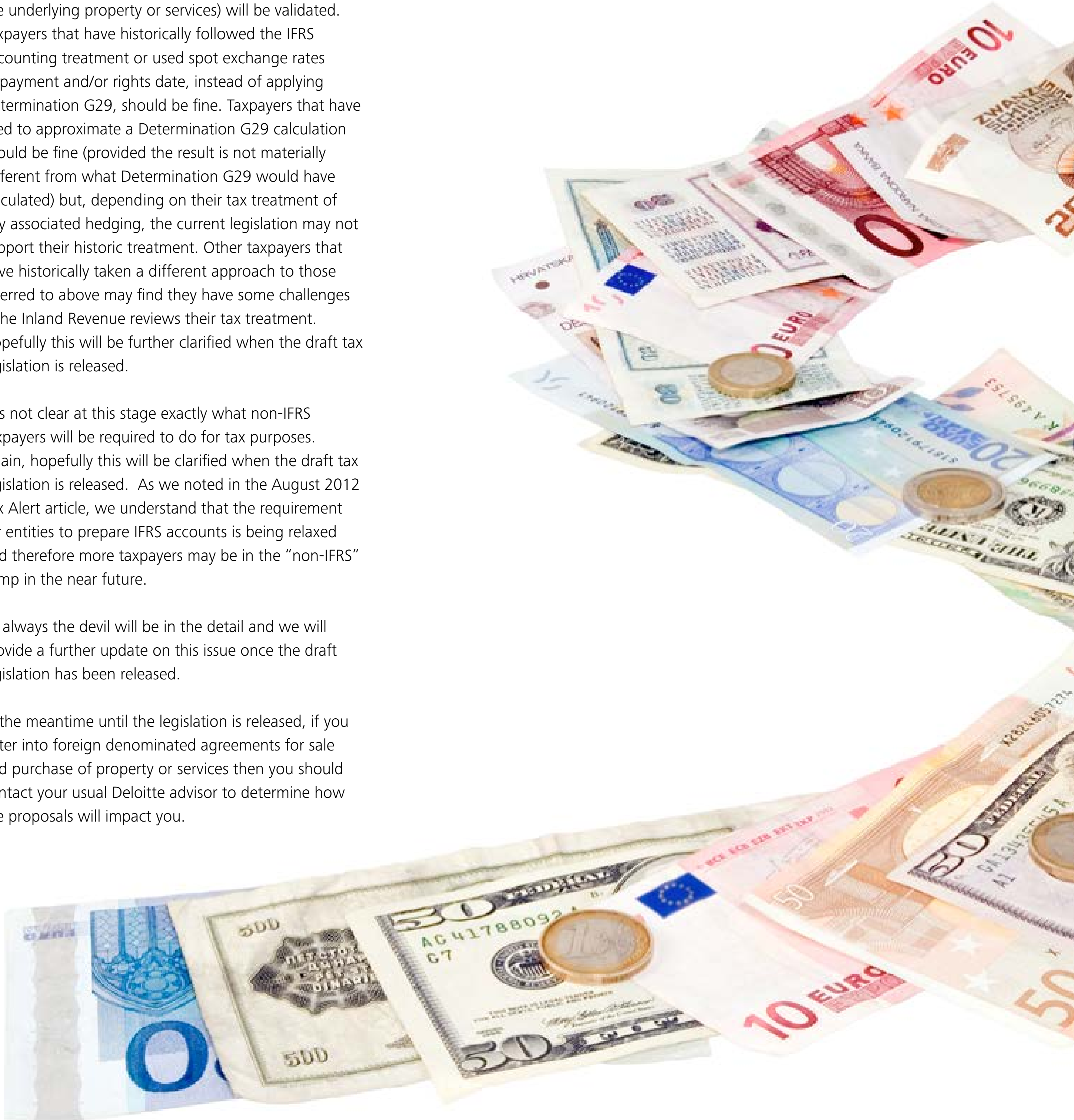
There is no expected value method allowed under the proposals so some volatility of taxable income may still arise as a consequence of agreements for the sale and purchase of property or services and any associated hedging arrangements.

It is still not entirely clear what historic tax treatment of existing arrangements (including associated hedges and the underlying property or services) will be validated. Taxpayers that have historically followed the IFRS accounting treatment or used spot exchange rates at payment and/or rights date, instead of applying Determination G29, should be fine. Taxpayers that have tried to approximate a Determination G29 calculation should be fine (provided the result is not materially different from what Determination G29 would have calculated) but, depending on their tax treatment of any associated hedging, the current legislation may not support their historic treatment. Other taxpayers that have historically taken a different approach to those referred to above may find they have some challenges if the Inland Revenue reviews their tax treatment. Hopefully this will be further clarified when the draft tax legislation is released.

It is not clear at this stage exactly what non-IFRS taxpayers will be required to do for tax purposes. Again, hopefully this will be clarified when the draft tax legislation is released. As we noted in the August 2012 Tax Alert article, we understand that the requirement for entities to prepare IFRS accounts is being relaxed and therefore more taxpayers may be in the "non-IFRS" camp in the near future.

As always the devil will be in the detail and we will provide a further update on this issue once the draft legislation has been released.

In the meantime until the legislation is released, if you enter into foreign denominated agreements for sale and purchase of property or services then you should contact your usual Deloitte advisor to determine how the proposals will impact you.



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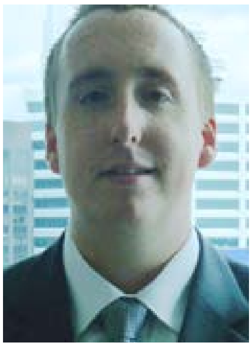

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Japan and New Zealand sign new double tax agreement

By Hadleigh Brock and Bradley Bowman

On 11 December 2012, Revenue Minister Peter Dunne announced the signing of a new double tax agreement (DTA) between New Zealand and Japan. This is a welcomed development as it will replace a very old treaty (1963) and therefore significantly refreshes the DTA in line with other international treaties.

A key change is that the withholding tax rates on dividends are reduced with new interest and royalty articles being included such that the new withholding rates that will apply are:

Income	New WHT rates
Dividends (voting power of 10%+ special criteria met)	0%
Dividends (all other cases)	15%
Royalties	5%
Interest (interest paid to financial institutions and AIL paid)	0%
Interest (all other cases)	10%

For dividends to qualify for the 0% rate, the beneficial owner of the dividend must directly or indirectly own 10% or more of the voting power of the company paying the dividend for a 6 month period ending on the date on which entitlement to the dividend is determined, and satisfy one of the following:

- The recipient of the dividend is a qualified person, being a company with its principal class of shares listed or registered on a recognised stock exchange whose shares are regularly traded;
- The recipient has at least 50% of its voting power in the aggregate owned directly or indirectly by five or fewer qualified persons as defined above;
- Competent authority approval is obtained.

Consistent with other recent treaties, the new interest article includes a 0% withholding tax where:

- The interest is beneficially owned by the Government, a political subdivision, or local authority thereof, or central bank of the country of residence, or any institution wholly owned by the Government;
- The interest is beneficially owned by a resident with respect to debt-claims guaranteed, insured or indirectly financed by the Government of residence;
- The interest is beneficially owned by a financial institution that is unrelated to and dealing wholly independently with the payer, and 2% approved issuer levy (AIL) is paid. However, interest derived by financial institutions will be subject to the 10% withholding tax rate if it is paid as part of an arrangement involving back-to-back loans or other arrangements that are economically equivalent and intended to have a similar effect to an arrangement involving back-to-back loans.

The new DTA also contains a limitation of benefits article although the scope of this article is narrower than recent treaties, relating specifically to the 0% withholding rate on interest referred to above and Article 13 relating to the alienation of property. The new DTA will also include non-discrimination and exchange of information articles.

The new DTA will come into force once both countries have given legal effect to it which in New Zealand will occur through Order in Council. It will apply to withholding taxes for amounts paid or credited on or after 1 January in the calendar year following the year in which the DTA comes into force, so is likely to be applicable for withholding taxes from 1 January 2014 onwards.

For more information on other changes in the new DTA, please contact your usual Deloitte tax advisor.

Taxation of Multinational Companies: Report Issued by Inland Revenue

By Diana Maitland and Kirsti Longley

There has been considerable media coverage and debate in New Zealand and around the world recently in relation to the level of taxation paid by multinational companies. A lot of this coverage has been hyped and has oversimplified the discussion in what is a very complex area of taxation. It is very easy for the media to spotlight the low levels of taxation paid by multinational companies, such as Starbucks, Facebook and Google, quite often without acknowledging the complete facts or circumstances of these corporations, or addressing the legality of their structures. In reality, there is unlikely to be enough public information available about these companies and their corporate structures and policies to make an informed comment on the appropriateness of the level of taxation that they pay.

What is widely known is that existing domestic international tax rules and double tax treaties were created in the world of bricks-and-mortar businesses and not in the new world of ecommerce and technology companies. The way in which multinational companies do business has changed, and the stark reality is that international tax rules have not been able to keep pace with such changes.

On 19 December 2012, the Policy Advice Division of Inland Revenue released a report titled "Taxation of Multinational Companies", to explain these concerns and how New Zealand and other countries are responding. The report also provides a brief summary of New Zealand's existing rules for ensuring multinationals are taxed on activities that they perform in New Zealand.

The report is useful reading for people interested in understanding the issues associated with how multinationals are taxed. What is important to understand upfront is that this is not a problem that New Zealand or any one country can address on its own and this is highlighted in the report which notes that it is a "global problem which requires a global response, which New Zealand will be actively involved in." In this respect, the report explains that the OECD is currently developing a tax base erosion and profit shifting ("BEPS") initiative to address the issue. A progress report will be issued by the OECD in early 2013 on actions to tackle the issue of BEPS, including strategies to detect and respond to aggressive tax planning and ensure better tax compliance. It will include discussion on whether taxation rules developed in the past are still appropriate in today's business environment, as well as present options to implement reform in a streamlined manner.

The report also highlights initiatives undertaken by a number of other countries around the world, including in Australia where the Australian Government has directed Treasury to develop a scoping paper that will set out the risks to the sustainability of Australia's

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corporate tax base from multinational tax minimisation strategies and to identify potential responses. Australia is also currently updating its transfer pricing and general anti-avoidance rules to address some problematic court decisions. Annex 1 and Annex 2 to the report sets out the background to the OECD work on BEPS and Australia's domestic law reforms, respectively.

Officials make three recommendations in the report in relation to how New Zealand should respond to the issue. They are:

1. Identifying and addressing gaps in New Zealand's own base protection rules that apply to non-resident investment into New Zealand.

2. Promoting best practice for residence taxation by all countries under their domestic law.

3. Participating in work to update and improve the international tax framework that is reflected in the OECD Model Tax Convention and other areas.

Annex 3 of the report provides a summary of the existing measures used by New Zealand to ensure that multinationals are taxed on activities that they perform in New Zealand, including transfer pricing rules, thin capitalisation rules, broader permanent establishment rules in tax treaties, withholding tax, exchanging information with other tax authorities, and the general anti-avoidance rule. The Annex also highlights a number of gaps in New Zealand's international tax rules which will look to be addressed in the future. For example, the report highlights some current gaps in New Zealand's thin capitalisation rules. An issues paper on reforms to the New Zealand thin capitalisation regime was subsequently released on 14 January 2013.

The report notes that officials will report back on developments in March 2013, which will include further information on the OECD BEPS project, after the OECD's initial analysis is published in February 2013.

It will be very interesting to see where the OECD BEPS project will lead. One thing which is clear, is that these issues fall into a very complex area of international taxation and will require an international solution, which unfortunately is unlikely to be simple or fast.

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