5 October 2018

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National Office

Inland Revenue Department

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Dear Grant and Philip

Income tax – How schedular payment rules apply to non-resident directors' fees PUB00302

Thank you for the opportunity to provide comments on this item.

We support the publication of the Commissioner's view on how the schedular payment rules apply to directors' fees paid to non-resident directors. There is uncertainty regarding this issue and treatments in practice are varied. The matter has been further highlighted following the publication of interpretation statement IS 17/06, "Income tax – application of schedular payment rules to directors' fees".

Operationalisation

It is imperative that the Commissioner issues an operational statement together with the release of the final interpretation statement. Furthermore, the final statement should have a prospective application date.

The Commissioner's view expressed in paragraph 14 of the draft statement is that "all directors' fees a New Zealand company pays to a non-resident individual have a New Zealand source, regardless of whether the directorship services are performed in New Zealand or from overseas." This conclusion does not reflect current commercial practice. We are aware that some taxpayers apportion the directors' fees paid to non-resident directors to reflect where the directors' services have physically been performed.

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The Commissioner has also previously accepted that remuneration paid to a non-resident individual director does not have a New Zealand source; and that apportionment applies if the non-resident director partly performs director services in New Zealand. This view was published in Inland Revenue Technical Rulings, paragraph 43.12 – 43.12.1.2. We appreciate that these statements cannot now be relied on as representing the Commissioner's current view. Nevertheless, they are likely to have been relied on in the past and influenced the approach adopted in practice today.

While this inconsistency in approach is unsurprising, the consequence is that the exposure draft may have caused concern and confusion to taxpayers/non-resident directors and advisors. There is also a high risk that without an accompanying operational statement and a prospective application date, the interpretation statement may undermine business confidence and restrict the opportunities available to New Zealand companies to engage high calibre directors with global expertise.

To mitigate these risks and provide assurance to taxpayers we strongly recommend that:

- the interpretation statement have a prospective application date (e.g. from 1 April following the date the statement is published); and
- the Commissioner publish an operational statement confirming that resources will not be employed to pursue cases where taxpayers have applied a different but reasonable treatment prior to the application date of the statement (for example, an apportionment of the directors' fees has been made on a reasonable basis).

We also note that the change in the source rules as a result of the enactment of section YD 4(17D) has had a material impact on the position and in a lot of situations will now override the rules in subsections YD 4(4) and YD 4(18). Section YD 4(17D) has application to income years beginning on or after 1 July 2018 which for most directors with a standard NZ balance date will be from 1 April 2019. Subject to our comments below regarding the need to reconsider the effect of this position from a policy perspective, it should also be made clear in the operational statement that the new rules will apply from 1 April 2019.

Technical issues

We set out below our comments on technical issues discussed in the exposure draft.

Section YD 4(17D)

As noted in paragraph 17 of the exposure draft, section YD 4(17D) was included in the Income Tax Act 2007 (the Act) on enactment of the Taxation (Neutralising Base Erosion and Profit Shifting) Act (the BEPS Act) on 27 June 2018. The provision applies for income years beginning on or after 1 July 2018.

Notwithstanding the specific wording of this new provision, we consider that the application of it to the payment of directors' fees to non-resident directors is outside the intent of the enactment and results in overreach.

New section YD 4(17D) has been enacted in legislation that is focused on measures to address Base Erosion and Profit Shifting; in particular, the changes included in the BEPS Act relating to the permanent establishment rules. The mischief intended to be countered by section YD 4(17D) was expressed in the Commentary to the Bill as:

> "Multinationals are currently able to structure their affairs so that their sales income does not have a source in New Zealand, even if they have a New Zealand-resident subsidiary that is carrying out significant sales activities here."

The discussion in the Commentary following this statement continues in this context.

We do not consider it to be within the spirit of the amendment to apply the provision to other types of income. To do so the Double Tax Agreement acts as a sword (gives rise to a taxing event) rather than a shield (protects taxpayers from double taxation). As noted below, we disagree with the conclusions in relation to subsections YD 4(4) and YD 4(18). On this basis the new rule under section YD 4(17D) has materially changed the landscape for the taxation of non-resident directors' fees.

We recommend that the appropriate policy position is revisited as it seems absurd that a different outcome should be obtained if a director provides their services individually or via a non-resident company. Subject to this reconsideration of the appropriate policy position, further discussion is required in the exposure draft regarding the background to the introduction of section YD 4(17D) and the intended scope of the provision.

Sections YD 4(4) and YD 4(18)

We disagree with the analysis of the application of sections YD 4(4) and YD 4(18). It is not sufficiently robust to support the conclusion that directors' fees New Zealand companies pay to non-resident individuals will have a source in New Zealand.

The cases cited in paragraph 24 are cases involving the derivation or earning of employment income, and not directors' fees. Furthermore, Keane DJ in his judgment in *Case P17* (1992) 14 NZTC 4,115 did not consider the interpretation or application of section YD 4(18). His judgment was decided applying section YD 4(3) (contracts made or performed in New Zealand).

Paragraph 27 states that in the absence of special circumstances, the "place of performance" will likely have a stronger influence on the source of employment income. This statement is subsequently discounted.

We are not convinced that the special factors listed in paragraph 28 carry sufficient weight to support the Commissioner's view that the location of the directorship services provided to New Zealand companies has a diminished importance when determining the source of the fees paid. The first and second bullet points refer to the statutory basis for the position of a director not the performance of the directors' duties/services. The third bullet point relates to the quantum of directors' remuneration. The fourth bullet point is about prosecution. The fifth bullet point does not recognise that in order for a New Zealand company to maximise the benefit of a non-resident director's knowledge and experience, it is inevitable that the director will perform some of his/her duties and tasks outside New Zealand. We consider it to be a quantum leap from the points in paragraph 28 to the conclusion in paragraph 22 that the directors' fees paid to an individual non-resident director is sourced in New Zealand.

Applying a schematic approach the company residence rules in sections YD 2(1)(d) and YD 3(4)(d) of the Act suggest that the location of where directors' services are provided is a relevant factor to consider. The tests in these provisions support the view that the place of performance of directors' duties will determine the source of the directors' fees paid.

For completeness the exposure draft should also set out the Commissioner's view on how the source rules apply to directors' fees paid by a dual resident company to a non-resident director – noting that the factors set out in paragraph 28 are only relevant to New Zealand incorporated companies and the directors' fees articles in New Zealand's DTAs will generally only apply to a non-resident director where the company is treaty resident in New Zealand (otherwise we expect the business profits article should apply as is described for US resident individual directors).

As noted above, to date taxpayers have adopted tax positions on the basis of section YD 4(4) and (18) being subject to apportionment. It would be unfair for the Commissioner to now seek to challenge those positions applying a subsequent change in her view of the law. We reinforce our recommendation above that the Commissioner issue an operational statement contemporaneously with the interpretation statement when it is published.

Apportionment of directors' fees paid to non-resident entities

With respect to directors' fees paid to non-resident entities, the exposure draft states the Commissioner accepts that apportionment applies under section YD 5.

Section YD 5(3) requires the result of the apportionment to be the same as that which "a separate and independent person would have if they were carrying out only the person's activities in New Zealand and dealing at arm's length". The reference to an arm's length result suggests that the amount allocated to a New Zealand source may vary from a simple apportionment of the remuneration agreed between the parties.

More guidance is required in the exposure draft on the satisfaction of this criteria. For example, what kind of evidence does the Commissioner require to support/determine the arm's length rate of a non-resident director's fee? What is the extent of the evidence that the Commissioner would require? The level of guidance could also extend to what the Commissioner would accept as reasonable for the purposes of section YD 5(3) in determining the arm's length amount, for example, reference to third party sites, and/or publication of acceptable remuneration for directors.

It would be helpful if the exposure draft discussed and gave examples illustrating the Commissioner's approach to calculating the apportionment and the evidence required to support it. Example 3 attempts to do this; however, we consider that it should be expanded to illustrate not only when the Commissioner would be satisfied that the requirements in section YD 5 are met but also indicate what evidence is required to be retained. In the facts of example 3 there is no guidance on how the arm's length fee was determined (i.e. what source(s) were referred to in order to conclude that $1,000 represented "what an independent third-party director would also receive for the same activities").

Inconsistent tax position

The Commissioner's conclusions regarding how the source rules apply to directors' fees paid to non-resident individuals and entities are summarised in the flowcharts in paragraph 34. The flowcharts highlight inconsistent tax positions arising from these conclusions:

- directors' fees paid to a non-resident individual will always have a New Zealand source;
- directors' fees paid to a non-resident entity may or may not have a New Zealand source.

As noted above, we question whether this is the correct policy outcome.

The issue should be referred to Policy and Strategy for their review. If necessary, the law should be amended to ensure coherence.

Withholding obligations

Paragraph 57 discusses the time when tax must be withheld from directors' fees paid to a non-resident. It would be helpful if this paragraph also mentioned the payment due dates and the implications of pay day reporting.

Contract of service/contract for service

The use of "contracts for service" and "contracts of service" in paragraph 38 is inconsistent with the meanings expressed in Interpretation Guideline IG 16/01, "Determining employment status for tax purposes (employee or independent contractor?)". This states at paragraph 5:

> "The common law distinguishes between contracts **of** service and contracts **for** services. A contract of service means there is an employer-employee relationship; a contract for services means there is a principal-independent contractor relationship."

Paragraph 38 of the exposure draft discusses the exclusions from the schedular payment rules for payments of salary and wages and extra pay. It states:

> "These types of payments will arise only when a person is employed (under a contract for service) to perform directorship duties. The Commissioner considers that, in the most cases, non-resident individuals who perform directorship services, do so as contractors (under contracts of service), not as employees."

The references to "contract for service" and "contracts of service" in paragraph 38 should be swapped around to be consistent with IG 16/01.

Flowcharts

We suggest that it would be useful if flowcharts 2 and 3 could be more directly linked with flowchart 1 so there is an easy, cohesive set of flowcharts that can be followed without need to comprehend all of the surrounding commentary to apply them and get to the right result.

This could be as simple as showing on flowchart 1 where the next step requires consideration of flowcharts 2 and 3. If this is not done, it would be useful to include some additional steps at the start of flowchart 2

to step through whether any services are performed in New Zealand and whether or not the non-resident entity is a non-resident contractor as is shown in flowchart 3.

Editorial corrections

We attach in the Appendix a few editorial corrections.

Please contact Lindsay Ng with any queries you may have.

Yours sincerely

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NZ Tax and Financial Services Leader

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Senior Tax Advocate

Appendix

Paragraph	Error
11	"Contract" should read "Contracts"
27	"Case E43" should read Case E46"
29, example 2	"meeting" in the last sentence of the first paragraph should read "meetings"
34, flowchart	"provided" in the first question in the top box on the left should read "provide"
50	"the" should be added in this part of the sentence: "... if the total amount of contract payments that the non-resident contractor has received ..."
56	"registered" should be deleted
56, flowchart 2	"in" should be added after "fewer days" in the sentence in the third box on the left
56, flowchart 3	"a" should be added after "less in" in the sentence in the fourth box in the middle