International treaty examination of the Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Report of the Foreign Affairs, Defence and Trade Committee

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Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Recommendation

The Foreign Affairs, Defence and Trade Committee has conducted an international treaty examination of the Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and recommends that the House take note of its report.

New Zealand has a current double taxation agreement with Japan, but it is 50 years old and needs to be updated.

The new agreement aims to reduce tax barriers for New Zealand businesses with operations in Japan, making it easier for them to return profits made in Japan to New Zealand. The profits will be paid out to New Zealand shareholders or re-invested in the New Zealand economy. The arrangement is reciprocal, so it also reduces taxes on Japanese businesses in New Zealand. Although New Zealand will forgo about $3 million in tax revenue per year, the agreement encourages foreign investment, to an extent that is however hard to quantify.

We heard that New Zealand's total investment in Japan is worth approximately $3.7 billion, and Japan's in New Zealand just over $8 billion.

We asked if the Inland Revenue Department thought that the prospect of paying less withholding tax in New Zealand would make Japanese companies more inclined to invest. We heard that withholding tax is quite often passed on to the New Zealand business involved. One of the main benefits of the agreement is that it provides investment certainty: for example, a Japanese investor wanting to invest in New Zealand could refer to the text of the agreement instead of having to compare two sets of legislation to find out the tax implications.

Appendix A

Committee procedure

The treaty was referred to the committee for examination on 22 February 2013. We met on 21 and 28 March 2013 to hear evidence and consider it. We heard evidence from the Inland Revenue Department.

Committee members

John Hayes (Chairperson)
Hon Phil Goff
Dr Kennedy Graham
Hon Tau Henare
Dr Paul Hutchison
Su'a William Sio
Lindsay Tisch

Appendix B

National Interest Analysis

Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Executive summary

1 The Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and its accompanying Protocol (collectively known as "the new DTA") has been negotiated to replace the existing Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("the existing DTA"), signed in Wellington on 30 January 1963. The existing DTA with Japan is New Zealand's oldest double taxation agreement (DTA) and has some major gaps and deficiencies compared to modern DTAs.

2 Japan is New Zealand's fourth largest trade and investment partner. The Japan DTA is therefore an important treaty in New Zealand's overall DTA network.

3 Since 2008, New Zealand has sought to enhance the competitiveness of its DTA network by negotiating new DTAs that reduce withholding tax rates with its major trading partners and modernise its most important treaties (starting with Australia, the United States, Singapore, Hong Kong and Canada). The new DTA with Japan is the next major step towards implementing this strategy.

4 The main objective of these new DTAs is to reduce tax barriers to New Zealand businesses that expand offshore. However, because DTA provisions are reciprocal, they also reduce New Zealand taxes on foreign investment into New Zealand. For this reason, the new DTA with Japan has an estimated revenue cost to New Zealand of $3 million per year. This reflects the fact that there is twice as much Japanese investment in New Zealand than New Zealand investment in Japan. DTAs will generally give rise to favourable economic benefits (such as a potential increase in trade and investment) that can be expected to offset such fiscal costs.

5 It is proposed that the new DTA be incorporated into domestic legislation through an Order in Council. The new DTA will then be brought into force through an exchange of diplomatic notes. The new DTA will enter into force on the date of the later of the two notes.

Nature and timing of the proposed treaty action

6 The Convention between Japan and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and its accompanying Protocol (collectively known as "the new DTA") was signed in Tokyo on 10 December 2012. It was signed in English and Japanese, with both texts having equal authenticity. The English text of the new DTA is attached at Annex 1.

7 Subsequent to satisfactory completion of the Parliamentary treaty examination process, in accordance with Standing Orders 394 to 397, the new DTA will be incorporated into domestic legislation through an Order in Council.

8 In accordance with Article 31 of the new DTA, the new DTA will then be brought into force through an exchange of diplomatic notes, confirming the completion of all necessary domestic procedures for entry into force in each country. The new DTA will enter into force on the date of the later of these notes.

9 As each provision of the new DTA comes into effect in accordance with Article 31, the equivalent provision of the existing DTA will cease to have effect. The existing DTA will terminate once all of its provisions cease to have effect.

10 Like other DTAs, the new DTA will not apply to the Cook Islands, Niue or Tokelau.

Reasons for New Zealand becoming party to the treaty

11 Japan is New Zealand's fourth largest trade and investment partner.

12 The Japan DTA is therefore one of the most important treaties in New Zealand's overall DTA network. It is important for New Zealand to maintain a competitive DTA network in order to retain and grow internationally competitive companies. The existing DTA with Japan is New Zealand's oldest DTA and has some gaps and deficiencies compared to modern DTAs.

Ensuring New Zealand remains a competitive place to do business

13 Since 2008, New Zealand has sought to enhance the competitiveness of its tax treaty network by negotiating new DTAs that reduce withholding tax rates with its major trading partners, and modernising our most important treaties (starting with Australia, the United States, Singapore, Hong Kong and Canada). The new DTA with Japan is the next major step towards implementing this strategy.

14 A major objective of these new DTAs is to reduce tax barriers on New Zealand businesses that expand offshore. In particular, the new DTA with Japan provides for a 0% rate on certain dividends. This helps to remove an artificial impediment to the repatriation of foreign profits.

15 This change can be shown by considering the effects on a New Zealand business which sells products through a subsidiary in Japan. Currently, under the existing DTA, any profits earned by the Japanese subsidiary will be subject to a 15% withholding tax rate when a dividend is paid back to the New Zealand parent company. Under the new DTA, the Japanese tax on this dividend will reduce to 0%. This will make it more efficient to return the income back to New Zealand, where it can be reinvested or paid out to shareholders.

Importance of a modern DTA

16 The new DTA will replace an existing DTA with Japan. The existing DTA was signed in 1963 and has some major gaps and deficiencies compared to modern DTAs (for example it does not include interest or royalties Articles, which are two of the most important Articles in modern DTAs). The existing DTA is very different to New Zealand's other DTAs and uses an old style of drafting that can be difficult to apply and interpret. The new DTA will address these issues and provide taxpayers with the level of certainty and protection that they expect from a modern DTA.

Advantages and disadvantages to New Zealand of the treaty entering into force and not entering into force for New Zealand

Advantages to New Zealand of the new DTA

16 The advantages can be summarised as follows:

Outbound investment

- As explained in the previous section, the new DTA will enhance the competitiveness of New Zealand's overall DTA network. Along with other international tax settings, this helps New Zealand to retain and grow internationally competitive businesses.
- The new DTA reduces tax barriers to New Zealand businesses that invest into Japan. In particular, it provides for a 0% rate on certain dividends, which helps to remove an artificial impediment to the repatriation of foreign profits.

Inbound investment

- The new DTA will also make it easier for Japanese investors to invest into New Zealand by reducing compliance costs and "headline" rates of withholding tax. Compared to domestic law, DTA settings are "locked in" which provides certainty for long-term investments. Updating the DTA to modern treaty practices makes it easier for investors to understand how the DTA will apply, and ensures consistency with other DTAs.
- Despite these benefits, the new DTA with Japan is not expected to have a large impact on levels of inbound investment. This is because New Zealand already has some existing measures in its domestic law that reduce withholding taxes on certain forms of foreign investment.
- These existing measures reduce the cost of agreeing to lower withholding taxes on dividends and interest under a DTA. For example, because New Zealand provides exemptions and tax credits for imputed dividends (where the company has already paid 28% New Zealand tax on its profits), the cost of reducing withholding tax on dividends is limited to a small number of unimputed dividends. On interest, the cost of reducing withholding taxes is limited to related party loans, as a 2% approved issuer levy already applies to loans from unrelated parties.
- However, there are still some cases where the new DTA will make a difference, by going beyond the reductions available in domestic law. For example, under the new DTA, the rate on related party interest will be reduced from 15% to 10%, and the rate on royalties will be reduced from 15% to 5%. These rates will bring the Japan DTA into line with New Zealand's other major DTAs.

Disadvantages to New Zealand of the new DTA

18. The disadvantages can be summarised as follows:

Revenue cost

- For the reasons given in the previous paragraph, the new DTA with Japan has an estimated revenue cost to New Zealand of $3 million per year. However, DTAs generally give rise to favourable economic benefits (such as some expected increase in trade and investment) that can be expected to offset such fiscal costs.

Administrative obligations

- The new DTA provides for assistance in collecting taxes imposed by the other country. Inland Revenue will incur some costs if a request for assistance in collection is made by the Japanese Revenue. However, New Zealand has entered into such arrangements in a number of its treaties and has a well-established system to deal with any requests. It is expected that any cost incurred will be marginal. Further, the arrangement is reciprocal, which means that New Zealand will be able to make a request to the Japanese Revenue for assistance to collect taxes in Japan on behalf of New Zealand.
- There are some general disadvantages to concluding a DTA (for example the "locked-in" nature of a treaty or the costs incurred in administering the exchange of information provisions). These disadvantages are less relevant when renegotiating an existing DTA, as many of these disadvantages will already have been absorbed by New Zealand. Therefore, apart from the reduction in revenue and marginal increase in administration costs as discussed previously, there are no new disadvantages created as a result of the new DTA.

19 New Zealand has the option not to enter into the new DTA with Japan. This would mean that the existing DTA would continue to apply, although it is out-of-date compared to modern treaty practice and New Zealand policy developments. In particular, the high withholding tax rates on dividends, interest and royalties would continue to apply.

20 Compared to the existing DTA, the new DTA has only minimal disadvantages and significant benefits for New Zealand. It is therefore in New Zealand's interest for the new DTA to enter into force.

Obligations which would be imposed on New Zealand by the treaty

21 The new DTA will not impose any requirements on taxpayers. Instead it requires the governments of Japan and New Zealand to restrict their taxing rights on a reciprocal basis. It also requires tax authorities to assist each other by exchanging tax information and by collecting taxes if requested by the other tax authority. The new DTA will not require the imposition of any tax that is not already imposed under domestic law.

22 Where income is derived from one country (the country of source) by a tax resident of the other country (the country of residence), the country of residence generally retains taxing rights under the new DTA. The main impact of the DTA is to restrict the ability of the country of source to tax the income in certain circumstances. Where both countries are permitted to tax the income, the DTA requires the country of residence to provide a credit for the tax imposed by the country of source. For example, if a royalty payment is made between Japan and New Zealand, Japan's taxing right would be limited to a 5% withholding tax and, when New Zealand taxes the payment, New Zealand would provide a tax credit for the 5% of Japanese tax paid.

23 The key provisions of the new DTA are summarised in the following table. In some cases, the allocation of taxing rights is similar or identical to the existing DTA, but in other cases there is no equivalent provision in the existing DTA.

Key provisions of the new DTA

Type of income	Relevant article in the new DTA	Is there a similar provision in the existing (1963) DTA?	New DTA allows source country to tax?
Business profits	Articles 5 and 7	✓	Only if business income is connected to a permanent establishment in the source country (e.g. a fixed place of business such as a branch office).
Income from services	Article 5(5)	✓ but only for independent services (self-employed people)	Only if the services are performed in the source country for more than 183 days in a 12-month period.
Income from natural resources	Article 6	✓	✓
Income from international ships and aircraft	8	✓	✕
Dividends	10	✓	Source country tax is limited to 15% of the dividend or 0% if the dividends are paid to a company that owns at least a 10% shareholding and meets certain other conditions
Interest	11	✕	Source country tax is limited to 10% of the interest payment or 0% if paid to a bank or the other government. In the case of NZ-sourced interest, the 0% rate also requires AIL to be paid by the NZ borrower (this is consistent with NZ's existing domestic law)
Royalties	12	✕	Source country tax is limited to 5% of the royalty payment.

Alienation of property	13	×	✓
Employment income	14	×	✓ if employment is performed in the source country and certain other criteria are met.
Director's fees	15	×	✓
Entertainers and Sportspeople	16	×	✓
Pensions	17	×	×
Government service	18	✓	Can only be taxed by the Government of which the person is an employee.
Payments to students	19	✓	Payments from a foreign government are not taxable in the country where the student is studying
Income derived through a silent partnership	20	×	✓
Other income (not previously mentioned)	21	×	✓

Non-discrimination

24 Article 25 of the new DTA prevents a country from applying tax laws which discriminate on the grounds of nationality, situs of an enterprise, ownership of capital, and (in limited circumstances) residence. This is a very common treaty DTA provision that is not expected to apply in practice. However, there is a remote risk that a taxpayer may attempt to use the non-discrimination provision to challenge a legitimate tax measure which protects the New Zealand tax base. To minimise this risk, the Protocol to the DTA explicitly excludes from the scope of the non-discrimination rule certain elements of New Zealand's existing tax rules that would be most vulnerable to a legal challenge. Being reciprocal in nature, the non-discrimination provision will help to protect New Zealand businesses operating offshore from any potential discrimination under Japan's tax system.

Administrative requirements

25 As is the case with the existing DTA, both countries will have to comply with various administrative requirements imposed by the new DTA. These include a general requirement to eliminate double taxation by giving credits for overseas tax paid (Article 24), complying with the mutual agreement procedures set out in the new DTA (Article 26), and complying with the arrangements for the exchange of information (Article 27).

26 The new DTA also authorises the New Zealand and Japanese tax authorities to assist each other in the collection of taxes (Article 28). The existing DTA did not contain any similar provision. New Zealand only includes this in DTAs with countries where the provision can be expected to give rise to real benefits. This is likely to be the case with Japan.

Differences with other recent DTAs

27 In most respects the DTA with Japan is consistent with New Zealand's other recent DTAs with major trading partners. However the new DTA with Japan does depart from these other recent DTAs. These differences are explained below.

10% ownership threshold for dividend exemption (Article 10)

28 New Zealand has negotiated DTAs with Australia, the US and Hong Kong which provide a zero percent withholding tax rate on dividends paid by subsidiaries to parent companies. In these DTAs the zero percent rate applies when the parent owns at least 80% of the subsidiary (and certain other conditions are met). A 5% withholding tax rate applies to companies that own between 10% and 80% of the dividend-paying company. A 15% rate applies to all other dividends.

29 The DTA with Japan relaxes these ownership thresholds so that a dividend exemption applies when a company owns 10% or more of the dividend paying company. There is no 5% rate in the DTA with Japan. Instead, all other dividends are taxed at a 15% rate.

30 The new rates with Japan are likely to be a favourable precedent for New Zealand. The fiscal cost to New Zealand should be minimal as under domestic law New Zealand already provides an exemption for imputed dividends paid to non-residents who own at least 10% of a New Zealand company. On the upside, New Zealand companies will be able to benefit from a reciprocal reduction in foreign taxes on dividends that they receive from significant offshore investments.

A broader arbitration provision (Article 26)

31 One of the benefits of DTAs is that they provide for taxpayer disputes to be resolved through "mutual agreement" by the revenue authorities in both countries. The mutual agreement procedure provides a quick and satisfactory outcome in almost all cases. However, it does require co-operation between the countries party to the treaty. If the revenue authorities are unable to reach agreement, the taxpayer may be left with no alternative but to go to court, possibly in both countries.

32 To address this shortcoming, there is an international trend for countries to include in their DTAs a facility for taxpayers to request mandatory arbitration of cases that are still unresolved after 2 years. This provides a strong incentive for revenue authorities to resolve mutual agreement cases in a timely fashion.

33 New Zealand has thus far only agreed to include arbitration in its DTA with Australia. In that DTA, arbitration is limited to questions of fact (although there is scope for New Zealand and Australia to agree to extend arbitration to other issues, in the future).

34 The new DTA with Japan would be the second time New Zealand has agreed to include an arbitration provision, but unlike with Australia, the provision with Japan is not limited to questions of fact, so it potentially has wider application.

35 In practice, arbitration is unlikely to be triggered. In New Zealand's experience, very few cases have been brought by taxpayers under our DTAs, and almost all of these have been settled within 2 years.

Reservations

36 The treaty does not allow either country to make a reservation.

Measures which the Government could adopt to implement the treaty action

37 Subject to the successful completion of the Parliamentary treaty examination process, the new DTA will be incorporated into domestic legislation by Order in Council pursuant to section BH 1 of the Income Tax Act 2007. Section BH 1 authorises the giving of overriding effect to DTAs by Order in Council. The overriding effect is limited to the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993. The override of the Inland Revenue Acts enables the provisions of the new DTA to provide relief from tax that would otherwise be imposed under domestic law. The override of the Official Information Act is necessary to ensure that confidential communications with the other contracting state are not required to be disclosed. The override of the Privacy Act is necessary to ensure that information regarding natural persons can be exchanged according to the terms of the treaty.

38 The only alternative to an Order in Council for implementing a DTA would be by the enactment of a dedicated statute. This is not preferred as it would unnecessarily increase the amount of primary tax legislation.

Economic, social, cultural and environmental costs and effects

39 No social, cultural or environmental effects are anticipated.

40 As noted in this NIA, the overall economic effects of the new DTA between New Zealand and Japan are expected to be favourable. The new DTA will enhance the existing investment and trade relationship by ensuring that the arrangements governing double taxation between New Zealand and Japan are up-to-date and provide the levels of certainty and protection that taxpayers expect from a modern treaty.

41 Compliance costs for New Zealand businesses are expected to be reduced as a result of the treaty action. This is because New Zealand businesses will have clearer and more up-to-date guidance about when they will be liable for tax on activities in Japan, in line with internationally recognised norms. The same will also be true for Japanese businesses operating in New Zealand.

The costs to New Zealand of compliance with the treaty

42 The new DTA with Japan is expected to have an estimated revenue cost to New Zealand of $3 million per year. This is due to the fact that the DTA reduces New Zealand's ability to tax interest, royalties and unimputed dividends paid by New Zealand companies to Japanese investors. The reciprocal nature of the DTA means that there are some

offsetting revenue savings from Japan reducing its taxes on payments to New Zealand investors. This means that more income can be taxed in New Zealand, but there is still an overall cost as there is twice as much Japanese investment in New Zealand than there is New Zealand investment in Japan.

43 Officials expect that any additional revenue cost (outside the reduction in the withholding tax rates) will be minimal because the new DTA is a replacement of an existing DTA, and the allocation of taxing rights generally remains the same between the new DTA and the existing DTA.

44 It has been noted above that Inland Revenue could incur some administrative costs because Japan will be able to request New Zealand to collect Japanese taxes in certain circumstances. While these costs cannot be quantified precisely, they are expected to be small. New Zealand has entered into such arrangements in a number of other DTAs and has a well-established system to deal with any requests. In addition the reciprocal nature of the arrangement is means that any costs incurred will likely be offset by benefits accruing to New Zealand from the ability to ask Japan to collect taxes on our behalf.

Consultation

45 The Ministry of Foreign Affairs and Trade, and the Treasury, have been consulted about the terms of the new DTA and the content of this extended NIA, and those agencies agreed that implementing the DTA would be in New Zealand's interest.

46 On 29 June 2012, Japan and New Zealand announced that officials had reached an agreement in principle on the text of a new DTA. Businesses and tax practitioners have welcomed this development but, consistent with international practice, officials have not publicly disclosed or consulted on any specific details of the new DTA.

Subsequent protocols or amendments to the treaty and their likely effects

47 No further amendments are anticipated at this time. New Zealand will consider future amendments on a case-by-case basis. Any amendments to the new DTA will be subject to the normal domestic approvals and procedures. Although there is no amendment clause in the new DTA, amendment would be subject to the usual requirements of the Vienna Convention on the Law of Treaties.

48 An accompanying Protocol forms an integral part of the new DTA and will be signed at the same time. Countries often prefer clarifying provisions and departures from their standard treaty model to be located in an accompanying Protocol.

Withdrawal or denunciation provision in the treaty

49 Under Article 32, either country may terminate the new DTA after the DTA has been in force for at least 5 years. A country must give at least 6 months' notice that they wish to terminate the DTA.

50 In such an event, the new DTA will cease to have effect for withholding taxes on interest, dividends and royalties from 1 January in the year following the year in which the notice of termination is given. The provisions for other taxes would cease to have effect for income years beginning on or after 1 April in the year following the termination notice for New Zealand, and 1 January for Japan.

Agency Disclosure Statement

51 Inland Revenue has prepared this extended national interest analysis (NIA). It has undertaken an analysis of the issue of implementing the new DTA between Japan and New Zealand, and the legislative and regulatory proposals arising from that implementation. As part of that process, it has considered the option of not entering into the treaty. Inland Revenue is of the view that there are no significant constraints, caveats or uncertainties concerning the regulatory analysis. The policy aligns with the Government Statement on Regulation.

52 The Ministry of Foreign Affairs and Trade, and the Treasury, have been consulted about the terms of the new DTA and the content of this NIA, and those agencies agreed that implementing the DTA would be in New Zealand's interest. On 29 June 2012, Japan and New Zealand announced that officials had reached an agreement in principle on the text of a new DTA. Businesses and tax practitioners have welcomed this development but, consistent with international practice, officials have not publicly disclosed or consulted on any specific details of the new DTA.

53 Inland Revenue is of the view that the policy options considered will not impose additional costs on business; nor impair private property rights, market competition, or the incentives for business to innovate and invest; nor override fundamental common law principles.

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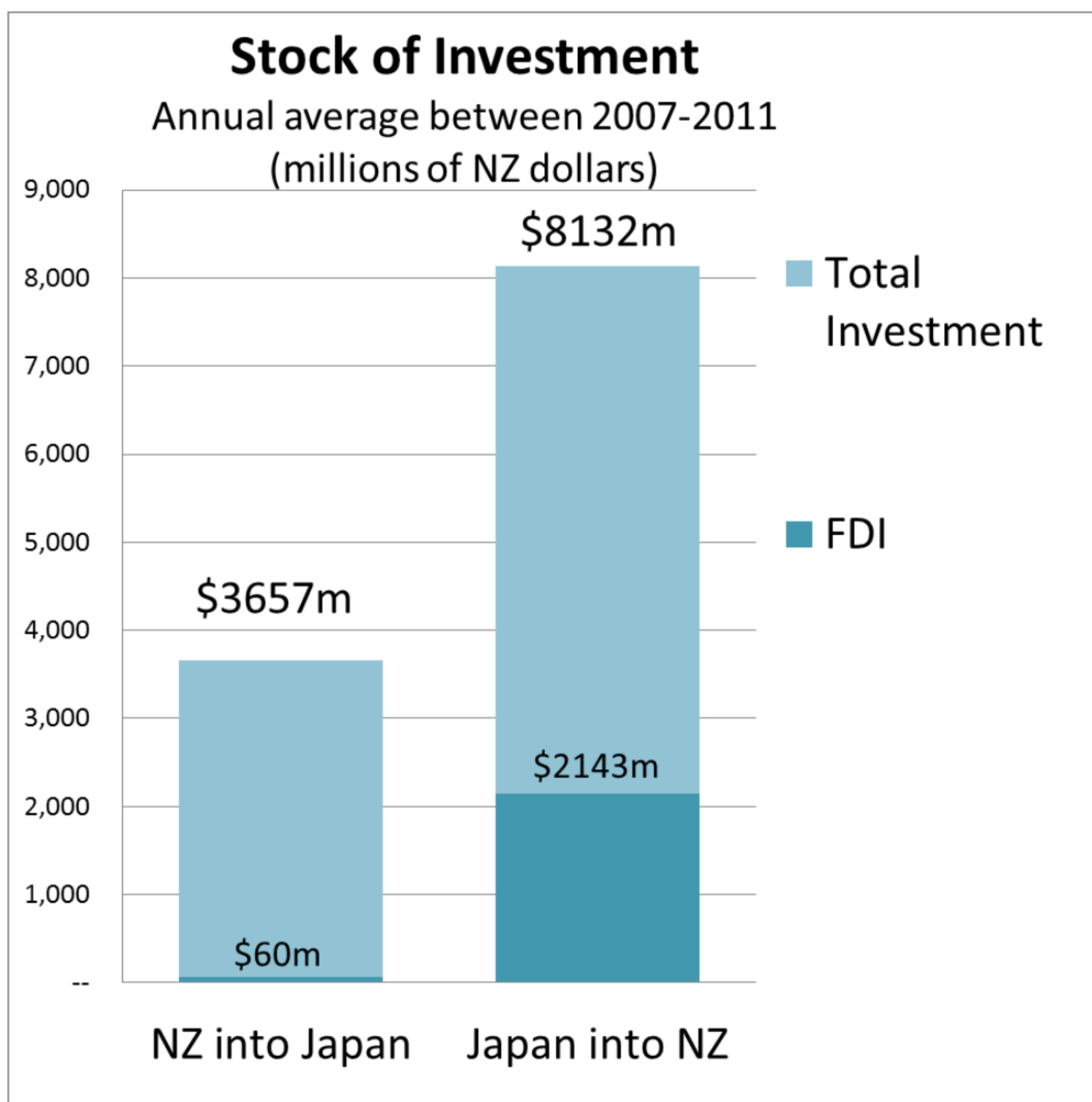
2 November 2012

Supplementary information:
New Zealand-Japan cross-border investment and trade

Japan is New Zealand's fourth largest investment partner. The following table illustrates the average stock of NZ investment into Japan and Japanese investment into New Zealand during the period 2007 to 2011.



The darker portion of the bar chart shows direct investment, which comprises debt and equity in companies in which the investor has a 10% or greater shareholding. Direct investment from New Zealand into Japan averaged $60 million between 2007 and 2011. Direct investment from Japan into New Zealand averaged $2.14 billion in the same period.

Total investment comprises the dark and the light portions of each bar. Total investment from New Zealand into Japan averaged $3.66 billion over the period. Total investment from Japan into New Zealand averaged $8.13 billion in the same period.

Japan is also our fourth largest trading partner. In the year to June 2011, total bilateral trade between New Zealand and Japan was worth $6.34 billion. Exports to Japan in this period were worth $3.45 billion. Top exports include aluminium, with 19 percent share, wood (13 percent), dairy products (12 percent), fruit and nuts (9 percent) and meat (9 percent). In the same period, New Zealand's imports from Japan were worth NZ$2.7 billion. Vehicle imports from Japan make up almost half of all Japanese imports. Other imports include machinery, with 16 percent share, mineral fuels (7 percent), electric machinery (6 percent) and rubber (3 percent).