



# International treaty examination of the Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Report of the Finance and Expenditure  
Committee

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Contents	
Introduction	2
Benefits of the protocol	2
Costs of the protocol	3
Overall impact of the protocol	3
Recommendation	3
Appendix A	4
Appendix B	5

# International treaty examination of the Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

## Introduction

The Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income seeks to reduce withholding taxes on dividend, interest, and royalty payments made between New Zealand and the United States. It also updates the convention to reflect developments in treaty practice since the convention was signed in 1982.

We have conducted an international treaty examination of the Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and do not consider that the protocol raises issues that should prevent the Government continuing with its proposed action in respect of the protocol.

The National Interest Analysis for the protocol is appended to our report. This quantifies the costs of the protocol, but provides only a qualitative assessment of the benefits.

## Benefits of the protocol

The protocol would reduce withholding taxes on dividends paid between New Zealand and the United States. As a result, it would lower tax barriers for New Zealand businesses investing in the United States and vice versa, and would make it less costly for New Zealand businesses to repatriate their profits from the United States to New Zealand. It is expected that the protocol would make New Zealand a more attractive location from which businesses might invest or expand into the United States. In particular, it is expected to reduce incentives for firms to migrate to Australia. It is almost eight years since Australia signed a protocol with the United States introducing equivalent cuts to their bilateral treaty on withholding tax rates.

We asked the Inland Revenue Department to quantify the probable economic benefits for New Zealand companies investing in the United States. However, the department told us that it could not do so because it did not have data on non-portfolio dividends from the United States. The department also commented that it often cannot make a quantitative assessment of the costs and benefits of a treaty as a whole, even when the relevant data is available, because such costs and benefits are dynamic, complex, and very difficult to

measure. While acknowledging the difficulties of quantification in this case, we believe that a more detailed assessment would be desirable.

#### Costs of the protocol

We were told by the Inland Revenue Department that the protocol is expected to reduce New Zealand tax revenues by about \$20 million per annum. This is largely because it will reduce the withholding tax rate on royalties.

The Inland Revenue Department has been unable to quantify precisely some of the potential costs associated with the amendments introduced by the protocol. For example, because of the lower withholding tax rates, companies with non-resident shareholders would have more incentive to use deductible royalty payments and unimputed dividends to shift profits or gains offshore. This is expected to increase the pressure on the domestic company tax base, but the department cannot estimate the associated cost.

#### Overall impact of the protocol

We were told by the Inland Revenue Department that the potential benefits of the protocol are likely to outweigh the loss of tax revenue, and that the protocol is not expected to have any social, cultural, or environmental effects. However, as the department cannot quantify the protocol's economic benefits and some of its cost components, we are unable to assess its net effect on New Zealand. We encourage the Government to monitor closely the impact of the protocol on New Zealand businesses, once it is ratified and implemented.

#### **Recommendation**

We recommend that, to assist us in examining treaties in the future, departments should attempt to assess the costs and benefits of each treaty in quantitative as well as qualitative terms. In cases where quantitative assessment is difficult, more detailed attempts to set out a methodology and a basis for estimates would be useful.

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## Appendix A

### Committee procedure

We met on 1, 8, and 29 April 2009 to consider the Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income. We received evidence from the Inland Revenue Department.

### Committee members

**Craig Foss (Chairperson)**

**Amy Adams**

**David Bennett**

**John Boscawen**

**Brendon Burns**

**Hon David Cunliffe**

**Raymond Huo**

**Rahui Katene**

**Peseta Sam Lotu-Iiga**

**Stuart Nash**

**Dr Russel Norman**

**Chris Tremain**

## Appendix B

### National Interest Analysis

#### Executive summary

1 The United States and New Zealand have finalised the text of a protocol (“the US Protocol”) to amend the existing double tax agreement between New Zealand and the United States (“the Convention”). The main purpose of the US Protocol is to reduce withholding taxes on dividend, interest and royalty payments made between New Zealand and the United States. The protocol also makes certain other changes to the existing Convention and updates several technical aspects to reflect developments in treaty practice since the Convention was signed in 1982.

#### Date and nature of proposed binding treaty action

2 It is proposed that the Protocol amending the Convention between New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (“the US Protocol”) be signed at the next available signing opportunity. Subsequent to signature and satisfactory completion of the Parliamentary treaty examination process, it is proposed that the US Protocol be incorporated into domestic legislation through an Order in Council, and brought into force, in accordance with Article XVI, through an exchange of notes through diplomatic channels, confirming completion of all necessary domestic procedures for entry into force. The US Protocol will enter into force on the date of the later note.

#### Reasons for New Zealand becoming party to the treaty

3 New Zealand currently has 35 Double Tax Agreements (DTAs) in force. They are primarily aimed at reducing tax impediments to cross-border investment, but also help tax administrations to detect and prevent tax avoidance and tax evasion.

4 One way in which DTAs facilitate investment is that they limit the rate at which each country can impose withholding tax on dividend, interest or royalty payments to a person resident in the other country. The primary purpose of the US Protocol is to reduce the rates of withholding tax that apply under the existing double tax agreement between New Zealand and the United States (“the Convention”). The withholding tax rates in this Convention are no longer considered optimal now that New Zealand firms are becoming more internationally-focused.

5 High withholding taxes can reduce economic efficiency by making it more costly for New Zealand businesses to source offshore finance or repatriate income earned by their foreign operations. Double tax agreements provide an opportunity for countries to negotiate reciprocal reductions in withholding taxes that benefit both countries.

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

6 The main advantage to New Zealand of the US Protocol entering into force is that it will reduce withholding taxes on dividends paid between New Zealand and the United States. More specifically, the US Protocol will reduce the rate of withholding tax on dividends from 15% to 5% if the investor is a company that has at least a 10% shareholding in the company paying the dividend or 0% if the investor is a company that has an 80% or higher shareholding and satisfies certain other requirements. This reduces tax barriers for New Zealand businesses investing into the United States and vice versa. It makes it less costly for New Zealand businesses to repatriate their US profits back to New Zealand where they can be reinvested or distributed to shareholders. The lower dividend rates will complement the proposed international tax reforms, which are also intended to facilitate offshore investment by New Zealand businesses. Those reforms include exempting the active income of foreign companies controlled by New Zealand residents and exempting most foreign dividends received by New Zealand companies.

7 More broadly, the US Protocol creates a favourable template for reducing withholding taxes in DTAs with other countries. As the new rates are applied to more DTAs they will increase New Zealand’s attractiveness as a location for internationally-focused firms. Our Convention with the United States is a key treaty in this regard.

8 The protocol also lowers withholding tax rates for interest paid to lending or finance businesses and for royalties. This is less attractive from New Zealand’s perspective since these taxes provide some protection against companies shifting their profits out of New Zealand in order to reduce their tax liabilities. However, some lowering of these rates is acceptable as part of the wider package. Moreover, the potential impact on the New Zealand tax base is mitigated by two factors. First, a positive rate (5%) has been retained for withholding tax on royalties. Second, the protocol allows New Zealand to retain its approved issuer levy for borrowers paying interest to US lending or finance businesses. However, it does effectively “lock in” the approved issuer levy and cap it at 2% with respect to US lending or finance businesses. For instance, if New Zealand were to repeal the approved issuer levy no withholding tax would be payable on interest paid to an unrelated US lending or finance business under the treaty.

9 The US Protocol is expected to reduce New Zealand tax revenues by around \$20m per annum. This is largely attributable to the lower withholding tax rate on royalties.

10 The protocol also makes certain other changes to the existing treaty. In particular, it deletes Article 14 (Independent Personal Services) of the existing Convention. The deletion means that New Zealand can only impose income tax on a US individual that performs services in New Zealand if that person has a permanent establishment (broadly, a fixed place of business) here. At the moment, New Zealand can tax personal services if the US person has been in New Zealand for 183 or more days in a 12 month period. The provision is reciprocal, so it may also limit US taxing rights in certain circumstances, to the benefit of New Zealand.

11 The protocol also amends the definition of royalties, excluding payments for leased equipment. This means that New Zealand would no longer be able to tax lease payments for US-owned equipment used in New Zealand unless the lessor has a permanent

establishment in New Zealand. This change limits New Zealand’s ability to tax equipment lease payments, but is not unprecedented and is acceptable in the context of the wider package. Again, the change is reciprocal.

12 Not signing or otherwise progressing the US Protocol to entry into force is an option. However, in that case the potential benefits to New Zealand in terms of increased investment and international competitiveness will be forgone. These advantages are likely to outweigh the loss of tax revenues that would result under the protocol.

13 On balance, it is considered to be in New Zealand’s interest to conclude the US Protocol.

Legal obligations which will be imposed on New Zealand by the treaty action, the position for reservations to the treaty, and an outline of any dispute settlement mechanisms

14 The US Protocol will not impose requirements on taxpayers. The obligations it imposes are on the Contracting States, restricting their taxing rights under domestic law on a reciprocal basis. The US Protocol will not require the imposition of a tax that is not already imposed under domestic law.

15 The US Protocol will amend the existing Convention between New Zealand and the United States. As a result each country will be required to comply with the following rules when imposing tax on residents of either country:

- Dividends, interest and royalty payments made between New Zealand and the United States may generally be taxed in both countries. However, the country from which the payment originates cannot impose tax at a rate exceeding an agreed withholding tax rate which differs depending on whether the payment is a dividend, interest or royalty. The other country, where the payment is received, must reduce its own tax on the payment to compensate for any withholding tax imposed on the payment in the payment’s country of origin. This enables both countries to tax the payment, whilst ensuring the payment is not excessively taxed.
- The maximum withholding tax rate that each country can impose on dividends received by a resident of the other country is:
  - 0% if it is paid to a company in the other country that owns (directly or indirectly) 80% or more of the shares in the company paying the dividend and meets certain other requirements.
  - 5% if paid to a company in the other country that owns (directly or indirectly) 10% or more of the shares in the company paying the dividend.
  - 15% in all other cases. (Article VI refers);
- The maximum withholding tax rate that each country can impose on interest received by a resident of the other country is:
  - 0% if the interest is paid to a lending or finance business, provided in the case of interest that originates in New Zealand that the 2% approved issuer levy is paid.

- 10% in all other cases. (Article VII refers);
- The maximum withholding tax rate that each country can impose on royalties received by a resident of the other country is 5% (Article VIII refers).
- Article 14 (Independent Personal Services) of the existing Convention is deleted. (Article X refers). The deletion means that New Zealand can only impose income tax on US individuals that perform services in New Zealand if the US individual has a permanent establishment in New Zealand. At the moment, New Zealand can tax personal services if the US person has been in New Zealand for 183 or more days in a 12 month period. The change is reciprocal so it also limits the United States' ability to tax services performed by New Zealanders.

16 Finally, the protocol updates several technical aspects of the double tax agreement to reflect developments in treaty practice since the Convention was negotiated in 1983. These updates include:

- Extending the application of the treaty so that it applies to US citizens in third countries, but excludes former US citizens or former long-term US residents. (Article I refers).
- A new provision that clarifies that the treaty applies to fiscally transparent entities. A fiscally transparent entity is an entity that is disregarded for tax purposes, with tax imposed directly on the owners or shareholders, as happens with general partnerships. This is a standard US provision and is consistent with international norms. (Article I refers).
- A revised limitation of benefits article (Article XI). This tightens access to treaty benefits in order to prevent residents from a third country from unduly exploiting the benefits of the Convention (i.e. treaty shopping). Again, this is a standard US provision.
- An updated non-discrimination article (Article XIII). This prevents New Zealand from taxing US residents more harshly than New Zealand residents in equivalent circumstances and vice versa.
- An updated exchange of information article (Article XV). This article allows tax authorities in the United States and New Zealand to work together to prevent tax evasion. The new Article reflects the OECD standards on information exchange introduced in 2004. The key difference for New Zealand is that the Article now permits the exchange of information in relation to all taxes, rather than just income tax. This will mean, for example, that New Zealand will be able to request information from the United States to assist in auditing assessments for GST as well as income tax.

17 The US Protocol doesn't allow for reservations, and doesn't change the dispute settlement procedures under the existing Convention. Under the existing convention a mutual agreement procedure can be triggered if a US or New Zealand person considers the actions of either the United States or New Zealand results in taxation that is not in accordance with the convention. If the person's case is justified and can't be remedied by their own country, US and New Zealand tax authorities will endeavour to agree on a satisfactory solution. In addition, US and New Zealand tax authorities must endeavour to

resolve any issues as to the interpretation or application of the Convention by mutual agreement.

Measures which the Government could or should adopt to implement the treaty action, including specific reference to implementing legislation.

18 The US Protocol will need to be implemented domestically by Order in Council in accordance with section BH 1(3) of the Income Tax Act 2007. Section BH 1 of the Income Tax Act 2004 enables new DTAs and changes to existing DTAs (such as the US Protocol) to be given effect by Order in Council. It also provides that DTAs will override the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993 in relation to income tax, unpaid tax and the exchange of information relating to a tax. This override is necessary to give effect to the terms of a DTA, since they allocate taxing rights. This means that New Zealand foregoes some taxing rights available under the Inland Revenue Acts in certain circumstances. The Official Information Act is overridden to ensure that communications with other states during DTA negotiations are not disclosed. The Privacy Act is overridden to ensure that information can be exchanged regarding natural persons under the exchange of information provision (Article XV of the US Protocol).

19 Subject to satisfactory completion of Parliamentary treaty examination, the Order in Council will be promulgated and will come into effect 28 days after being published in the Gazette.

Economic, social, cultural and environmental costs and effects of the treaty action

20 The main economic effect of the protocol is that it will reduce tax barriers for New Zealand businesses investing into the United States and vice versa. This will increase New Zealand's attractiveness as a location for internationally-focused firms. No social, cultural or environmental effects are anticipated.

Costs to New Zealand of compliance with the treaty

21 The US Protocol is expected to reduce New Zealand tax revenues by around \$20m per annum. This is largely attributable to the lower withholding tax rate on royalties.

Completed or proposed consultation with the community and parties interested in the treaty action

22 The Treasury and the Ministry of Foreign Affairs and Trade have been consulted on and agree with the proposed treaty action.

Subsequent protocols and/or amendments to the treaty and their likely effects

23 No future amendments are anticipated and the US Protocol makes no provision for amendments. However, if the need to further amend the Convention with the United States arises, this can be achieved by means of another Protocol. New Zealand would consider proposed amendments on a case by case basis and any decision to accept an amendment would be subject to the normal domestic approvals and procedures.

**Withdrawal or denunciation provision in the treaty**

**24** Article 28 of the Convention provides that either New Zealand or the United States may terminate the DTA by giving 6 months notice of termination, through diplomatic channels.

**Adequacy statement**

**25** Inland Revenue has prepared this extended National Interest Analysis and has assessed it as adequate in accordance with the Code of Good Regulatory Practice.

**Prepared by: Inland Revenue**

**Date: 24 November 2008**