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4 September 2020

Dear Sir or Madam:

ED0223 Non-resident employers

We provide our comments on the Exposure Draft Operational Statement ED0223 ("the ED").

The ED considers examples of when a non-resident employer will have a sufficient presence in New Zealand for employer obligations imposed under the Income Tax Act 2007 to apply. We have not focused on these examples as we are not convinced that the Act requires an employer's presence for an obligation to arise.

As we understand it, Inland Revenue has concluded, based on *Alcan*[1] and *Oceanic*,[2] that the territoriality principle applies so that the Act should be interpreted to require an employer's presence in New Zealand. This conclusion is neither clear nor obvious. It has tax policy and compliance implications.

We have had only limited engagement with Inland Revenue on why it considers the law to be as it states in paragraph 7 of the ED. This means, for us, there remain outstanding questions on that conclusion.

These include questions of:

- Why relevant New Zealand court decisions do not provide a better indication of the law in New Zealand than those of the UK courts?
- Do subsequent UK court decisions cast doubt on *Oceanic*'s application?
- Does a plain reading of the employer's obligations, in the context of the Act, provide a different answer?
- Are there subsequent developments, in the Act and how employers operate internationally, which provide a different focus? Can these be taken into account when there is not an explicit amendment to the rules governing employer obligations?
- How does this conclusion fit with how Inland Revenue operates in practice across a number of regimes?

[1] Alcan New Zealand Ltd v CIR (1993) 15 NZTC 10,125 (HC)
[2] Clark (Inspector of Taxes) v Oceanic Contractors Inc [1983] 1 All ER 133 (HL)

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As Inland Revenue has not published its view, we do not know how these questions have been answered. In the absence of the detail of its analysis, we have considered the interpretation of employer obligations under the Act. This is covered in Appendix 1. Appendix 1 provides a high level description of the argument – it is not a detailed technical analysis of all the provisions. However, we expect it to be readily followed by a reader who has performed detailed research.

We have taken this approach because, in our view, it is important for employers and employees to have a clear and decided view on their respective obligations. The ED raises tax and other policy questions, if its starting point is correct. We note particularly past Inland Revenue practice which enforced obligations against non resident employers with effectively penal results.

Although we have not paid particular attention to the detail of the ED, the "sufficient presence" concept is not a particularly easy to test to apply. Importantly, as with time based tests, the position will change over time as the facts change. It is likely to unwittingly create non-compliance.

It is important that the ED is on a sound footing and that it is seen to be so.

We submit that before Inland Revenue finalises the ED it should publish for comment its analysis supporting its conclusion. We expect that this would answer the issues raised by submitters but also clarity, regarding the actual and intended tax effect of non-residents employing in New Zealand, should highlight policy areas where improvements can be made. (For example, the retrospective application of PAYE withholding if the various exemptions turn out not to apply.)

In our view a full consultation on the territoriality principle's application is required before the ED is finalised.

We are, as always, happy to discuss our response and trust that it is helpful. Please do not hesitate to contact me on (04) 816 4518.

Yours sincerely

John Cantin
Partner

Appendix 1: Outline of the argument against a territorial limitation for the PAYE rules

We understand that IR's conclusion is that the Income Tax Act ("the Act") does not apply extra-territorially based on *Oceanic* and an Australian approach.

The extra-territorial principle is said to be a principle of construction – New Zealand Acts of Parliament do not apply outside the jurisdiction unless the Act states that this is the case or there is a necessary implication that it does.

We have approached the question by considering:

- The Act and how it applies, specifically:
  - The general scheme of the Act;
  - The specific employer PAYE obligations of the Act;
- Other factors, including:
  - Tax policy implications of the ED;
  - Other Acts including case law on other Acts.
- Miscellaneous other considerations including:
  - Section YD 4(17D);
  - Contradictory approaches by Inland Revenue

We consider the application of the Act is a different question from whether the Act can be enforced against a non-resident employer. We note the judgements in *Oceanic* tended to consider these items together. However, in the comments regarding the Universal Approach, the Court appeared to accept that these could be separate considerations.

1 The Act and how it applies

The Act's general application (Part B of the Act)

A non-resident with foreign sourced income has excluded income. The consequence is there is no income tax payment or other obligations.

However, the Act does apply to non-residents. Otherwise a non-resident cannot determine they have excluded income.

We acknowledge that a non-resident is not concerned with the broad reach of the Act if they only have foreign sourced income. Practically, they will only be concerned to determine the application of the Act to them if they have a connection to New Zealand. Nevertheless, the Act applies whether there is a connection or not.

We note too that application of the Act to non-residents does not raise enforcement or collectability constraints on the extra-territorial application of the Act. A non-resident, with no New Zealand connection, complies by doing nothing. Accordingly, Inland Revenue or the Courts do not need to consider enforcement.

Proposition 1: the Act, by explicit statement, applies to non-residents.

Proposition 2: the Act, by explicit statement applies to non-residents without the need for any New Zealand connection.

(We separately discuss the Rewrite.)

The Act's application to employers (Part RD)

Income subject to tax

Subsection YD 4(4) makes employment income New Zealand sourced if earned in New Zealand, whether or not the employer is resident. The employee is clearly subject to tax as a result (whether the employee is resident or not). In *Oceanic* terms, the income is chargeable to income tax.

The PAYE rules are the primary mechanism for collecting tax on that income. The extent of subsection YD 4(4) would suggest that, as the income is not territorially limited, the PAYE rules would also not be so limited. We acknowledge this distinction was at issue in *Oceanic* – income chargeable to tax and a collection mechanism imposed on an employer. However, we consider that *Oceanic* needs to be tested against New Zealand's PAYE rules.

The PAYE rules

It is not clear or obvious how Inland Revenue has applied the territoriality principle to the PAYE rules. The options include by Inland Revenue's interpretation of specific sections such as sections RD 1, RD 2(2) or RD 5. It is also possible that the interpretation is applied to Part RD as a whole.

We consider it is the interpretation of section RD 5 which is most likely to be the focus. This is because subsection RD 2(2) relies on the definitions in sections RD 3 and 5. In other words, to apply subsection RD 2(2), it must be determined whether a payment is PAYE income payment per section RD 3 and which requires determining whether section RD 5 applies (i.e. whether there is salary and wages).

If there is a PAYE income payment (per sections RD 3 and 5), then the interpretation to ensure that subsection RD 2(2) does not apply is a much larger leap. It requires a conclusion that the non-resident employer is not someone who makes a PAYE income payment.

Proposition A – Inland Revenue's conclusion: We have therefore assumed that the interpretation, applying the territoriality principle, is that section RD 5 requires that, for salary and wages, the payment must be connected to employment with a New Zealand resident employer or a non-resident who has sufficient presence in New Zealand.

We test that proposition.

In outline:

- The PAYE rules apply to a "PAYE income payment" as defined by section RD 3.
- Section RD 5 defines salary and wages as amounts in connection with a person's employment. (We use salary and wages as an example as the most likely amount to be a PAYE income payment.) A payment received by an employee of a non-resident employer will be in connection with employment and therefore:
  - Salary and wages per section RD 5; and
  - A PAYE income payment per section RD 3;
  - Section RD 2(2) applies to the non-resident employer.

Proposition 3: section RD 5 applies to payments made by a non-resident employer.

Section RD 5 has no apparent territorial limitations. Equally, it does not have an explicit extra-territorial scope. We further test therefore whether the PAYE rules necessarily imply extra-territorial application.

A concern noted in the cases is that if a law applies extra-territorially it can not be properly complied with by a non-resident and, from the jurisdiction's perspective, it cannot be enforced.

There are two provisions which can be said to answer these concerns.

Section RD 4(4) requires an employee who receives a PAYE income payment from which PAYE has not been withheld to withhold PAYE. Section RD 21 also applies to require an employee to withhold PAYE if PAYE is not withheld from a PAYE income payment. Sections RD 4(4) and RD 21 therefore only apply when an employer does not fulfil a PAYE obligation.

These provisions can be said to apply as follows:

- Section RD 5 applies to determine there is salary or wages;
- Section RD 3 applies to make this a PAYE income payment;
- Section RD 2(2) requires the employer to withhold tax;
- Sections RD 4(4) and RD 21 apply if, and only if, the employer does not withhold tax.

Further, of relevance:

- Section RD 4(4) refers to section RD 4(1) which refers to an employer or PAYE intermediary who withholds. There is a necessary link to the employer's obligation rather than section RD 4(4) applying independently when there is no withholding required.
- Section RD 4(4) requires a PAYE income payment. Section RD 21 (1) also refers to tax not withheld from a PAYE income payment. Both therefore assume an employer and therefore an obligation per section RD 2(2) to comply with the PAYE rules.

Accordingly, for these provisions to apply, there must be an employer. The employer must have prior PAYE obligations. If the employer does not have a PAYE withholding obligation, these provisions do not apply:

Proposition 4: Sections RD 4(4) and RD 21 require a non-resident employer to have a PAYE obligation before they can apply to an employee if the tax is not withheld.

In email correspondence, the Inland Revenue position on this proposition was described as:

> Section RD 4 provides that if some or all of the tax is not withheld under section RD 4(1) then the employee must provide an employer monthly schedule and pay the amount of tax. This provision does not make reference to whether or not the employer had an obligation to deduct tax.
>
> Section RD 21 is in many ways a duplication of section RD 4. Section RD 21(1) provides that "if, for any reason" some or all of the amount of tax for a PAYE income payment is not withheld at the time it is paid to an employee, the employee must provide an employer monthly schedule and pay the deficient amount. This wording, "if, for any reason", is essentially unchanged since the enactment of the PAYE rules in the Income Tax Assessment Act 1957 (section 21 of that Act).
>
> There is no indication in the words of sections RD 4(2) and RD 21(1) that liability is dependent on the employer having a liability to withhold. Although the conclusions in the Operational Statement removes a non-resident employer's obligation to deduct PAYE due to the territorial limitation, this does not mean there is not a PAYE income payment that the employee is liable to pay tax for. Section RA 8 also confirms that a person who receives a PAYE income payment may be liable for payment of the tax themselves.
>
> A review of the legislative history of the PAYE rules was also undertaken for this issue which did not find any support for the view that an employee's liability to withhold and

pay PAYE is dependent on the employer having a liability. It was concluded that the PAYE rules provide for tax deductions to be made by employers and for employees to pay deductions to the Commissioner where the employer does not make the proper tax deduction.

Under current practice, certain types of employees are treated as being responsible for paying their own PAYE, instead of their employer. These employees are known as "IR56 taxpayers". Although an IR56 taxpayer is not a defined term in the legislation, these types of taxpayers would meet the requirements under sections RD 4(2), RD 16 and RD 21 to pay their own PAYE and return this to the Commissioner.

We have not done the historical research but, as well as the analysis above, we note:

- "if for any reason" cannot impose an obligation of itself. It still necessarily implies that an obligation exists that has not been satisfied. In other words, "there cannot be a failure to deduct for any reason" if there is no obligation to deduct. "Failure" necessarily requires an obligation to do something. Simply not doing something is not a "failure to do" if there is no obligation. This must be by someone other than the employee. It is only the employer who has the obligation.
- "and for employees to pay deductions to the Commissioner where the employer does not make the proper tax deduction" also implies that the employer has an obligation. A failure to make a proper deduction is required before these provisions apply. For the employer to make a "proper" deduction it must be authorised. A "deduction" can only be "proper" if there is an obligation to do so. We note that New Zealand law would prevent an employer making a deduction from salary and wages which is not authorised by law or the employee.

Both these items suggest, on the plain words, the employer must be liable for the employee to have a liability.

This leads us to the view that the better conclusion is that there is a co-liability for PAYE. This is consistent with the Commissioner choosing to assess the employer should the employer fail to deduct PAYE. The employer or employee are liable for a failure to deduct.

This speaks to enforceability of the obligation. In certain cases, an employer may be unable to pay an assessment or the Commissioner may not be able to obtain judgement. In either case, the Commissioner can assess the employee because the employer has failed to withhold.

Proposition 5: The scheme of the PAYE rules is that the employer has the primary and first obligation as it is a withholding tax.

Proposition 6: The PAYE rules contemplate that an employer may not discharge those obligations so that an employee is made liable should an employer fail.

Applying extra-territoriality to that scheme

We consider:

- the Act necessarily applies to non-residents, whether they have a connection to New Zealand or not.
- the scheme of the PAYE rules necessarily applies to a non-resident employer as that is necessary for an employee to have an obligation if an employer does not comply.
- the scheme of the PAYE rules contemplates and deals with problems of non-resident compliance and enforceability. The employee PAYE rules apply to allow the collection of PAYE at source.

On the last point, we note that compliance and enforceability appears to be a reason why in *Oceanic* the Court thought it necessary for a non-resident employer to have a sufficient presence. It was concerned that the "Universal Approach", which is equivalent to what we have concluded, might raise problems of practicality – how would/could a non-resident employer comply? – and of enforcement – how would judgement be obtained against a non-resident? We consider the Act itself answers those problems.

Changes to the business environment, court decisions and to tax rules since Oceanic and the introduction of the PAYE rules – compliance, enforceability and contemplation

Business environment

The business environment and the ability to comply has changed since *Oceanic*. Employers are much more used to having cross-border workers and have electronic and other systems to manage employees and the employer's obligations. For the most part, multi-national groups are conscious of their obligations and will seek to comply. Although compliance for non-resident employers is not straight forward, our experience is that they do so as best they are able.

This approach is further assisted by systems which no longer rely on paper or mail (or even fax). Although compliance remains onerous, it is not impossible.

The judges in *Oceanic* were attracted to the Universal Approach but considered they did not need to apply it to confirm Oceanic's liability. With evidence of the ability to comply, one of their reasons for not endorsing the Universal Approach is minimised.

UK case law

In *Agassi*,[3] the House of Lords held the territorial principle did not apply to a payment between two non-residents. The regime under which UK tax was to be withheld is very similar to New Zealand's withholding tax regime which are also within the PAYE rules.

The Universal Approach has subsequently been applied by the UK courts. There are, at best, competing judgements. Given that *Oceanic* left open the application of the Universal Approach, it seems the better view of the UK law is that the Universal Approach should apply unless there is a clear intention to limit the application of a particular rule.

Enforcement

Since *Oceanic*, New Zealand has issued the Double Tax Agreements (Mutual Administrative Assistance) Order 2013. Amongst other matters, this order (by Article 11) allows New Zealand to recover tax claims in another country. This is subject to certain constraints. However, provided the taxpayer is in a country which has also ratified the Convention (to which the Order gives effect) New Zealand is able to enforce a tax claim.

We note that this means there may be different outcomes depending on the state of residency of the employer. This suggests to us that the better view is that enforceability is a separate question from whether an obligation arises in the first place. Otherwise, the interpretation of the PAYE rules would vary with the location of the employer. A Universal Approach is logical and, based on our analysis contemplated by the Act. If the application if the Universal Approach is not enforceable against the employer, it is enforceable against the employee.

Original contemplation

We understand that legislation should be interpreted as "Parliament is always speaking".

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[3] *Agassi v Robinson (Her Majesty's Inspector of Taxes)* [2006] UKHL 23

We have not researched the matter. However, given the PAYE rules originated in the 1950s, we would have expected there would have been minimal, if any, employees of non-resident employers without a sufficient presence in New Zealand. It is unlikely that Hansard and other records would assist with the Parliamentary intention.

It seems from Inland Revenue's own research (quoted above), there is no clear statement either way. Given the then factual background that is not surprising. However, it should not be taken as strong evidence that the territorial rule was to apply.

Proposition 7: Conclusion (without the full benefit of Inland Revenue's analysis)

Based on the analysis we have done on the Act as it stands, we consider the ED's starting point is incorrect.

We consider that Parliament contemplated that PAYE obligations may not be complied with. It established a regime where employees would be required to comply if the employer failed to do so. This regime would not apply if the employer does not have an obligation.

Although these "back up" rules have wider application, it equally applies to an employee of a non-resident employer. The scheme of the Act and the PAYE rules necessarily imply that the territoriality principle should not apply.

We consider New Zealand Courts would take this as the better view of the law.

2 Other ("non Act") factors

Our conclusion is based on an analysis focused solely on the Act and its interpretation. We have also considered other factors (but note that this is not an exhaustive consideration of the potential impact of New Zealand law on employment in New Zealand).

Tax policy implications

If the ED's starting point is correct:

- non-resident employers of resident employees will be incentivised to offer fringe benefits and other non-salary and wages remuneration;
- IR 56 cannot be enforced against employees so they will be provisional taxpayers.

This is a different result than for both resident employers and non-resident employers with sufficient presence.

We consider there is an available interpretation, which is arguably a better view of the law, that does not produce these results.

Employment law

The Employment Relations Act does not appear to have an explicit override of territoriality principle (except for applying certain international agreements in NZ) but the Supreme Court decided New Zealand law applied.

Brown and Sycamore concluded that Employment Relations Act 2000 applied to a Hong Kong company's employment contracts with NZ based employees despite a clause that it was governed by Hong Kong law. [4] The requirement to retire at 55 was held discriminatory.

[4] *Brown and Sycamore v NZ Basing Ltd [2017] NZSC 139*

The Court seemed to consider that employment is different from contract issues, that statutory requirements (such as the Employment Relations Act imposed) could apply. If the employment is within the jurisdiction, then New Zealand law can and does apply.

(Note the decision includes a reference to tax being deducted from the employees' wages. It is not clear whether this was because Inland Revenue considered there to be a "sufficient presence" or whether this was an agreed basis to deal with tax.)

We consider this case strong support for the view that the territoriality principle does not apply to the tax consequences of employment in New Zealand. The PAYE rules are statutory requirements which apply to employment. As with employment law, it would be odd if Parliament did not expect the tax rules to equally apply to employment.

KiwiSaver Act

Section 62 of the KiwiSaver Act states that the employer is not liable if PAYE does not apply to the salary and wages.

Inland Revenue's pamphlet says that if the employer is non-resident, the KiwiSaver Act only applies if it has a fixed establishment:

> About this guide
>
> This guide tells you about your KiwiSaver obligations as an employer. The KiwiSaver Act 2006 covers employers who are New Zealand residents or who carry on business from a fixed establishment in New Zealand. Employers who are not New Zealand residents or do not carry on business from a fixed establishment in New Zealand, may choose whether they offer KiwiSaver in their workplace. A non-resident employer may choose to make KiwiSaver deductions and contributions for their eligible employees. Non-resident employers who are intending to participate in KiwiSaver and who are not registered for PAYE should contact Inland Revenue for more information.
>
> For more information about employer obligations for complying funds1 go to ird.govt.nz

IR's statement appears to be an application of the territoriality principle as it is applied in the ED. There does not appear to be anything more specific in the legislation to justify this conclusion.

For the reasons discussed above, Inland Revenue's pamphlet is incorrect.

We further note, as *Brown and Sycamore* means that employment law has effect for non-resident employers, that it would be odd if Parliament contemplated a different result for KiwiSaver for New Zealand based employees depending on whether their employer had a sufficient presence or not.

Other factors conclusion

Our brief review of other factors confirms our view that a Universal Approach to the PAYE rules is logical and consistent.

Proposition 8: Consideration of "non" Act factors supports the conclusion that the extra-territoriality principle does not apply to the PAYE rules.

3 Miscellaneous other considerations

Subsection YD 4 (17D)

Subsection YD 4(17D) may be another example of the intended extra-territorial application of the Act. It applies to deem an NZ source for an amount which NZ is allowed to tax under a DTA.

A DTA has authority by section BH 1 – one of the core provisions.

The possible "sufficient connection" with NZ is that someone in NZ:

- pays the amount; and/or
- receives the supply.

However, the income is the non-resident's who, by definition does not have a sufficient connection with NZ. Otherwise, YD 4(17D) would not be required to establish a New Zealand source.

Prior to section YD 4(17D), New Zealand had the reverse problem – it could collect the tax (from the New Zealand payer) but there was no obligation established by the Act – it was foreign sourced income of a non-resident.

Given this and that section YD 4(17D) is a charging provision, the latter suggests that the Act is intended to have extra-territorial application.

Rewrite impact

As we have not researched the history of the PAYE rules, it is possible that the scheme we have outlined in our analysis was introduced as a result of the rewrite of the PAYE rules and Part B. The outcome we have argued for may therefore be an unintended change from the Rewrite.

However, we consider the analysis to be a plain reading of the words. As the Rewrite was not intended to change the application of the Act, it must be considered to be a correct translation of the pre-Rewrite words.

Inland Revenue Practice

We appreciate that the ED, if it is finalised, would and should standardise Inland Revenue practice. However, it is our experience that the extra-territoriality principle is inconsistently applied by Inland Revenue.

For example:

- Inland Revenue will argue that section RD 20 has extra-territorial application to two non-residents subject to the non-resident contractor rules (similar to the UK rules in *Agassi* and part of the PAYE rules by virtue of sections RD 2 and 8).
- Resident employers are not allowed to include employees of non-resident associated employers in their PAYE reporting and payments. Inland Revenue generally insists that the non-resident registers as an employer and complies with the PAYE rules.
- Non-resident employers with only employees present in New Zealand (i.e. unlikely to have a sufficient presence) have made voluntary disclosures to Inland Revenue. Inland Revenue has accepted those disclosures and has enforced the PAYE rules.
- One non-resident employer was assessed PAYE on the no declaration rate when former workers were unable to be contacted to complete the relevant forms.
- As part of a multinational group's international employment policies, employees who are transferred internationally are entitled to the same net contributions to their home superannuation schemes. This means that a New Zealand resident company was making KiwiSaver contributions in respect of employees who were living and working outside New Zealand for a non-New Zealand employer. The result of an employer paying a KiwiSaver contribution for a former employee is that ESCT should be paid at 33% (section RD 67). In this case, the individual was not New Zealand resident, and had no New Zealand working

days and therefore no New Zealand tax obligation. However, Inland Revenue recognised that the application of the rules is extra territorial and that the withholding obligation applied.

Inland Revenue, by its action, appears to consider that the extra-territoriality principle does not apply to the PAYE rules.

Although that can not be used to require Inland Revenue to continue to apply the Universal Approach, the effect of a change of approach is likely to lead to integrity concerns. Those who have complied will doubt whether they should have done so or whether they should in the future. This impact should be considered in determining the better view of the law.

Conclusion - miscellaneous other considerations

Proposition 9: Based on this analysis, the other factors considered do not change the conclusion.

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