TaxMail

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Regular commentary from our experts on topical tax issues

Issue 1

Draft BEPS Act guidance

Snapshot

Inland Revenue has released five draft special reports which provide guidance on how it considers key elements of the Taxation (Neutralising Base Erosion and Profit Shifting) Act will apply. The new **BEPS Act** is covered in previous taxmails, available **here** and **here**.

The draft special reports, which can be downloaded **here**, cover:

- Interest limitation
- Hybrid and branch mismatch arrangements
- Transfer pricing
- Permanent Establishment avoidance
- BEPS-related administrative measures

The new BEPS Act contains some of the most complex tax legislation that we have seen in recent times. It was passed quickly. There is uncertainty about its practical application and we anticipate remedial legislation will be needed. Inland Revenue's view of what the rules are intended to achieve is therefore important.

The draft special reports provide the first view of how Inland Revenue expects the new BEPS Act to work. The complexity and breadth of the rules mean the request for feedback is welcome

The drafts should be reviewed to see whether your particular arrangements are covered and, if not, feedback provided

Contact us

John Cantin
Partner, Tax
T: +64 4 816 4518
E: **jfcantin@kpmg.co.nz**

Darshana Elwela
Partner, Tax
T: +64 9 367 5940
E: **delwela@kpmg.co.nz**

Kim Jarrett
Partner, Transfer Pricing
T: +64 9 363 3532
E: **kmjarrett@kpmg.co.nz**

Bruce Bernacchi
Partner, Tax
T: +64 9 363 3288
E: **bbernacchi@kpmg.co.nz**

Matthew Gan
Director, Tax
T: +64 4 816 4779
E: **mgan@kpmg.co.nz**

Perhaps the most interesting aspect of the guidance released is that it is in draft, for public feedback. This is not standard practice. It acknowledges that, while Inland Revenue considers it has covered the important issues, taxpayers and advisors will have further questions. It is also important to note that the drafts are not Inland Revenue's final view. One of our concerns is the proposed timing of finalised guidance.

We strongly encourage taxpayers to review the draft guidance and apply it for their circumstances, to see whether it helps to clarify the new rules for them, or raises further questions or uncertainty.

Public feedback is due by **28 September**. There is, therefore, a short window for taxpayers to make their voices heard as we continue to adapt to the new world of international tax.

The draft BEPS special reports

Initial thoughts

Overall, the draft special reports should be helpful to taxpayers. They contain several examples to make the application of the new rules more 'concrete'. Some taxpayers will find their circumstances covered by the examples, others will not. There is an opportunity to have those gaps covered by submitting on the drafts, to ensure Inland Revenue's guidance on the principles to be applied is as clear as possible.

Some broad comments and our initial observations on the individual reports follow.

Finalisation should occur sooner, not later

It is important that Inland Revenue's view is clear for taxpayers as soon as possible. The new BEPS Act already applies and will apply progressively to more taxpayers, as new income years commence.

The final guidance is not due to be published until early 2019. This is too late in our view. Given public feedback will close at the end of September, we encourage Inland Revenue to finalise the guidance as soon as possible thereafter, to give clarity. We believe this should be before the end of 2018.

The international tax landscape is constantly evolving

The new international tax environment requires multinationals to keep a close watch on developments around the world. For New Zealand tax teams, this means understanding foreign as well as NZ BEPS developments.

As an example, since the new BEPS Act was enacted, Australia has passed into legislation its own hybrid mismatch rules, and EU countries are expected to enact equivalent rules by 1 January 2020. These will change the New Zealand tax impacts of hybrids arrangements as the New Zealand hybrid rules' application depends on foreign countries' treatment of the arrangements.

Further, the BEPS Multilateral Instrument (MLI) was ratified by New Zealand a few weeks ago. This will impact our Double Tax Agreements (DTAs) with participating countries on anti-abuse, dispute resolution and transfer pricing (at a minimum), and other provisions on a treaty-by-treaty basis. However, it relies on New Zealand's DTA partner countries also bringing the MLI into force. As the MLI progressively changes our DTAs, or not, this will change the application of the new BEPS rules (such as the application of the deemed permanent establishment rule).

Interest limitation

The new restricted transfer pricing rules for calculating interest on related party debt were the most controversial change as they are a departure from the global approach. Inland Revenue's response is they should not result in double taxation.

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John Cantin
Partner, Tax
T: +64 4 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
Partner, Tax
T: +64 9 367 5940
E: delwela@kpmg.co.nz

Kim Jarrett
Partner, Transfer Pricing
T: +64 9 363 3532
E: kmjarrett@kpmg.co.nz

Bruce Bernacchi
Partner, Tax
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E: bbernacchi@kpmg.co.nz

Matthew Gan
Director, Tax
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E: mgan@kpmg.co.nz

That said, the draft guidance sets out how taxpayers can invoke the Mutual Agreement Procedure (MAP) to alleviate double tax. A taxpayer's first approach should be to the foreign tax authority, copying in Inland Revenue. (This is to ensure that technically MAP can be used.) Inland Revenue will then work to resolve the matter as quickly as possible.

The draft guidance also provides some comment on related party guarantee fees. This is welcome to understand how Inland Revenue considers these fees sit alongside the restricted transfer pricing rules for interest. In a nutshell, the OECD is developing its guarantee fee guidance. Inland Revenue is monitoring this work. In the interim, Inland Revenue acknowledges that guarantee fees may be appropriate for external debt. However, it would expect that the total cost of borrowing externally in New Zealand and paying a guarantee fee to an offshore related party to not be materially higher than the offshore related party borrowing and on-lending to New Zealand under the new restricted transfer pricing rules. While we appreciate Inland Revenue's position, in our view a legislative remedy is required to ensure this outcome.

Hybrid and branch mismatch arrangements

The longest special report is the one on hybrid mismatches. This is not surprising given the complexity and scope of the hybrid rules. The rules are not intended to capture many arrangements as taxpayers are expected to alter their arrangements to avoid the rules' application. However, the challenge is determining whether you are 'in' or 'out' of these rules (and need to restructure as a result).

There are 34 examples, some taken from the OECD's hybrid mismatches report but New Zealand-ised, to help you answer this question. They also provide helpful guidance on the consequences of being 'in'.

Special attention should be paid to the commentary on imported mismatches. This rule denies deductions in New Zealand, where the hybrid or branch mismatch is not in New Zealand. The targeted arrangements can be eye-wateringly complex and not necessarily easy to spot. Detailed investigation of the foreign tax impacts will be required.

Transfer pricing

The explanation of the new transfer pricing rules – to determine the arm's length conditions and Inland Revenue's ability to disregard or replace commercially irrational arrangements – is well laid out and should be helpful to taxpayers. However, Inland Revenue should explicitly state that this only applies in exceptional circumstances.

The messaging on transfer pricing documentation leaves some uncertainty. There is no explicit legislative requirement to prepare documentation. However, the onus of proof shifting from Inland Revenue to taxpayers suggests that documentation should be prepared and follows similar onus of proof rules implemented by other countries with explicit documentation requirements.

Further, the draft guidance reiterates that penalties could apply if documentation is inadequate or if transfer pricing positions are incorrect. (Also, if there is no documentation it will be easier for Inland Revenue to argue that the arrangement is commercially irrational.) These are indirect ways of suggesting documentation should be prepared, which falls short of an explicit requirement, and sends mixed messages to taxpayers. The guidance would be more useful if it set clear expectations on documentation that was consistent with the other guidance on transfer pricing.

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John Cantin
Partner, Tax
T: +64 4 816 4518
E: **jfcantin@kpmg.co.nz**

Darshana Elwela
Partner, Tax
T: +64 9 367 5940
E: **delwela@kpmg.co.nz**

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E: **kmjarrett@kpmg.co.nz**

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Partner, Tax
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Director, Tax
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E: **mgan@kpmg.co.nz**

Permanent establishment (PE) avoidance

The draft guidance expands on the application of the new deemed PE rules. Specifically, there are a number of examples on the application of the "sales test" (i.e. when sales are made by a non-resident multinational to New Zealand-based customers). The examples cover a range of scenarios from online platforms through to "fly in/fly-out" visits by employees of a foreign multinational to New Zealand. These will provide useful guidance for cases that clearly fit within the examples.

The examples illustrate that the sales test in the new deemed PE rules is drafted differently to the equivalent test in the broadened PE definition, which will apply under the MLI. This may potentially lead to different outcomes depending on whether a DTA applies (and the specific MLI changes have effect for a treaty).

The New Zealand and/or foreign income tax avoidance aspect of the deemed PE rules is one of the more difficult parts. Our initial comment is that the draft requires further work to provide clear guidance on what is a more than merely incidental tax avoidance purpose.

The draft guidance notes that New Zealand's approach for profit attribution to a permanent establishment (which differs from the authorised OECD approach) should be used for deemed PEs. It does not include guidance on practically applying this approach but this is expected shortly.

Concluding comments

Inland Revenue's release of draft guidance, for comment, is welcome. This is particularly as the new BEPS rules are very complex and wide ranging.

Your feedback will be critical to improving the clarity and quality of the guidance.

However, it should be remembered that the special reports are evidence only of the policy intent of the new BEPS Act. Inland Revenue can, and does, take a different view of how tax legislation applies when considering particular arrangements, and in disputes.

The draft guidance, when finalised, will therefore only be the start of the journey to certainty.

For further information

John Cantin
Partner, Tax
Wellington
Phone: +64 4 816 4518
Email: **jfcantin@kpmg.co.nz**

Darshana Elwela
Partner, Tax
Auckland
Phone: +64 9 367 5940
Email: **delwela@kpmg.co.nz**

Kim Jarrett
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Email: **mgan@kpmg.co.nz**

kpmg.com/nz
twitter.com/KPMGNZ