KPMG

TaxMail

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Regular commentary from our experts on topical tax issues

Issue 1

(Final?) BEPS decisions announced

Snapshot

The Government has released its decisions (Cabinet Papers), the supporting policy reports, and public submissions on a number of Base Erosion and Profit Shifting ("BEPS") proposals. *Final?* Not quite as some are subject to further consultation.

The release covers:

- Rules to limit interest deductions and enhance NZ's transfer pricing rules.
- Rules to prevent avoidance of a NZ "permanent establishment".
- Rules to prevent tax mismatches from "hybrid" arrangements.
- Implementation of the Multilateral Instrument ("the MLI").

The key proposals and decisions made in response to public submissions (including KPMG's) are summarised in the following table. The changes, if any, are at the margins. The core proposals have been approved by Cabinet. The Government is aiming for legislation to be enacted by 30 June 2018. This will mean these measures will be effective from 1 July next year for those with 30 June balance dates.

The Government's release confirms that the BEPS proposals will be proceeding with minor changes

The changes are largely cosmetic and/or at the margins (e.g. to address design issues)

A December Tax Bill with final law by July 2018 is expected

Contact us

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

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

Detail of the BEPS decisions

Consultation vs final decisions table

Proposal	Final decision
Interest limitation (thin capitalisation)	
An "interest rate cap" for related-party inbound debt based on the credit rating of the parent plus a margin.	A "restricted transfer pricing rule" where the interest rate on related-party inbound debt would be set under transfer pricing rules: o ignoring certain loan terms & conditions (e.g. subordination, duration, debt levels), unless those features are also present in the taxpayer's third-party debt arrangements; and o with a rebuttable presumption that the NZ entity is supported by its foreign parent. The interest rate cap will be a "safe-harbour".
Excluding non-debt liabilities from calculation of assets for thin capitalisation purposes.	Proceed, with further consultation on the treatment of "deferred tax liabilities".
Allowing deductibility for all third party interest on certain infrastructure projects controlled by a single non-resident.	Proceed, with further consultation on technical issues.
Removing the net current valuation method as an alternative to financial statement values for thin capitalisation.	Use of the net current valuation method will be limited to valuations by an independent expert valuer.
Removing the option to measure assets and debt at year-end for thin cap.	End of year valuation option retained, but with accompanying anti-avoidance rule.
Permanent Establishment ("PE") avoidance and transfer pricing	
An anti-avoidance rule targeted at large multinationals* avoiding a NZ PE by using NZ related entities to support its local sales.	Proceed, but with the rule more narrowly targeted at avoidance arrangements with further consultation on how to do this. (Note: two options are discussed – a more than merely incidental test or unilaterally adopting the MLI PE definition.)
A transfer pricing re-characterisation rule for arrangements where legal form differs to economic substance.	Proceed, with re-construction allowed based on the test in the OECD guidelines.
Shifting the burden of proof on transfer pricing matters to taxpayers.	Proceed.
Extending the period Inland Revenue can challenge transfer pricing matters from 4 to 7 years.	Proceed.
Increasing Inland Revenue's powers to deal with "uncooperative" large multinationals'* transfer pricing matters, including requiring tax on adjustments to be paid in advance.	Proceed, but not the requirement for tax to be paid in advance.

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Hybrid tax mismatches	
Anti-hybrid rules targeting: o Hybrid ("debt/equity") instruments, which can give rise to a deduction/non-inclusion income ("D/NI") outcome. o Hybrid ("opaque/transparent") entities, which can give rise to a D/NI or double deduction outcome. o Indirect hybrid outcomes (e.g. imported mismatches and reverse hybrid entities). o Branch taxation mismatches.	Proceed, with consultation on a few detailed issues. Limited grand-parenting of existing hybrids and some deferral of application of some of the (even) more complex rules. Confirm application of the rules to NZ foreign trusts when neither the foreign beneficiary nor foreign settlor are taxed.

** Global turnover of EUR750m or more*

MLI

The table does not cover the MLI reports and decisions. New Zealand signed the MLI and made its position public in June. The reports do provide further background on the reasons for the decisions made.

Timing

Further consultation is proposed to occur during August through October, followed by the introduction of a December Tax Bill. The Bill is expected to be enacted by 30 June 2018. On that timetable, these measures will have first effect from 1 July 2018 for those with June balance dates.

Our first impressions

There has been very little movement from the original proposals. This was not unexpected given the tone from Officials and the Minister of Revenue.

The changes that have been made are largely cosmetic and/or at the margins. They appear to be aimed at addressing technical concerns raised by submissions. However, the effectiveness of the proposals remains uncertain.

There is a strong theme that New Zealand's position – that supporting the globally agreed approach is the best position for New Zealand – is right. However, the papers also, notably for the hybrids proposals, confirm that global implementation is more limited. (We note that the justification for the hybrids rules is that 59% of New Zealand's Foreign Direct Investment is covered because the United Kingdom, European Union, and Australia have or shortly will have anti-hybrid rules).

Other countries seem to be taking a slower approach with perhaps a greater emphasis on their own self-interest. To the extent that New Zealand's implementation relies on others doing the same, there is a risk for New Zealand's position. The more cautious approach, in response to that risk, and recommended in submissions (including KPMG's) has not been accepted.

Given the tight implementation deadlines, we welcome the recommendation that exposure draft legislation be released before the Bill stage.

We make some specific high-level observations.

Permanent Establishment avoidance

The original proposal was modelled on the Australian Multinational Anti-Avoidance Law ("MAAL") and the United Kingdom's Diverted Profits Tax ("DPT"). The New Zealand proposal was labelled a "deemed PE" rule but has similar effect.

Contact us

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

Darshana Elwela
Partner
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However, the interaction of the rule with our Double Tax Agreements ("DTAs") was not clear as a result. This is particularly the case for companies based in a country which has not signed up to the MLI's PE changes.

The change is to target avoidance structures only (rather than arrangements to which a DTA's PE rules do not apply). We expect that this will limit the potential breadth of the rules. It should also make it easier for Inland Revenue to defend the application of the rule from attack by other countries.

(We note that a general principle of DTA interpretation is that a DTA will not override an anti-avoidance rule. This is the basis for the effectiveness of Australia's MAAL. By contrast, the UK's DPT is said to be effective because it is a separate tax to which the UK's DTAs do not apply).

However, given the avoidance requirement, there will remain uncertainty on its application to particular arrangements. For example, is a company which has substance in a country with a low tax rate an avoidance arrangement? We trust that this uncertainty will be resolved through further consultation. This assumes that the option of unilaterally applying the MLI PE definition does not proceed.

Interest limitation

The original interest limitation proposal was to cap the interest rate on related-party loans based on the foreign parent's capacity to borrow. This was by way of a change to NZ's thin capitalisation rules. That approach was out-of-step with the application of the "arms-length" standard in the OECD's transfer pricing guidelines.

The "replacement" restricted transfer pricing rule achieves broadly the same outcome as the interest rate cap. It requires features like subordination of related-party loans to be ignored in the interest rate analysis.

However, because it is a transfer pricing rule, the outcome can be challenged by taxpayers under the Mutual Agreement Procedures ("MAP") in NZ's DTAs. While helpful, MAP is likely to come at considerable cost. It will also require consideration of the relevant country's position to determine the likelihood of a successful challenge. Bilateral or unilateral Advance Pricing Arrangements ("APAs") may be required to provide certainty.

We welcome the retention of the year-end valuation option for assets and debt for thin capitalisation calculation purposes. Instead, an anti-avoidance rule is proposed where shareholder funding is repaid just before year-end.

It should also be noted that APAs entered into prior to the application date of these changes will be grand parented.

Transfer pricing

There has been little movement on the transfer pricing BEPS proposals.

On a positive note, the proposed re-characterisation rule will be based on the OECD's guidance, which recommends that reconstruction should only be used in exceptional circumstances. This requires related party dealings that would not be commercially rational if they were between unrelated parties. The original proposal omitted the underlined criterion. That significantly increased the potential for the reconstruction rule to be applied.

Hybrids

The Government has opted for comprehensive anti-hybrids rules, as opposed to more targeted rules. This, in our view, has potential for unintended consequences. The Officials' response is that taxpayers choosing "vanilla" debt/equity and structures should not have to worry about these rules. This ignores the commercial benefits and costs of changing existing structures.

Of interest to those who have followed the proposals is the promise to consult further on issues that may ease compliance costs, although this is likely to be limited in scope.

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

Darshana Elwela
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E: delwela@kpmg.co.nz

Further readings

For those inclined, the Cabinet Papers outlining the Government's final BEPS decisions, the supporting tax policy reports, and public submissions are available **here**. However, fair warning, there is over 1,000 pages of material!

Information on New Zealand's adoption of the MLI, and the positions taken, is available **here**.

KPMG's submissions (which may themselves be just as long) are available here:

- BEPS – Strengthening our interest limitation rules – **link**
- BEPS – Transfer Pricing and PE avoidance – **link**
- BEPS – Addressing hybrid mismatches – **link**

KPMG taxmails on the original proposals are available here:

- BEPS – Interest limitation, transfer pricing and PEs – **link**
- BEPS – Hybrid mismatches – **link**

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

kpmg.com/nz
twitter.com/KPMGNZ

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