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Regular commentary from our experts on topical tax issues

Issue 2

New BEPS measures announced

Snapshot

At today's International Fiscal Association meeting, the Minister of Revenue announced consultation on three new Base Erosion and Profit Shifting ("BEPS") measures (accessible **here**):

— A rule to tax foreign multinationals ("MNEs") on NZ sales by using a related NZ entity. Additionally, transfer pricing changes will allow Inland Revenue ("IRD") to re-characterise transactions which it considers do not align with economic substance; put greater onus on taxpayers to justify their NZ transfer pricing positions and encourage "cooperation"; and extend the period IRD can dispute transfer pricing matters to 7 years.

— Further tightening of the thin capitalisation rules, which deny NZ interest deductions, including linking deductible debt to the parent entity's credit rating and requiring the value of assets to be calculated net of non-debt liabilities (such as trade creditors).

— Further detail on NZ's implementation of the Multilateral Instrument (the "MLI") which has the potential to affect all of New Zealand's DTAs.

These latest BEPS changes are aimed at arrangements that avoid a NZ taxable presence or reduce NZ taxable income

They are largely based on international, in particular Australian, adoption of similar rules

When reading the consultation documents, the impact of NZ-"ising" these changes needs to be kept in mind

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What are the proposals?

Avoiding a NZ taxable presence and transfer pricing rule changes

The proposals include:

A rule to stop large MNEs (those with global turnover of more than €750m) avoiding a NZ taxable presence (called a Permanent Establishment or "PE") by using a NZ related party to support local sales activities. The rule will apply:

- Where there are sales to NZ consumers or businesses;
- A related entity in NZ (e.g. a subsidiary or dependent agent) carries out activities in NZ (e.g. using local employees) to bring about those sales;
- Some or all of the sales are not attributed to a NZ PE; and
- The arrangement is designed to defeat the intention of NZ's tax treaties (DTAs).

Strengthening NZ's transfer pricing rules by:

- Allowing IRD to disregard transfer pricing arrangements where legal form does not align with economic substance. This will effectively allow IRD to re-characterise transactions to impute what it considers to be "arm's length conditions".
- Shifting the burden of proof for transfer pricing disputes from IRD to taxpayers and extending the period IRD can challenge a transfer pricing issue to 7 years (from 4 currently).
- Increasing IRD powers to access information, including allowing it to issue an adjustment to large MNEs that are "uncooperative" based on the information available at the time. This will still be subject to the normal disputes process, although the disputed tax will need to be paid earlier in the process.

Further limiting interest deductibility

While the Government is not proposing to replace the current thin capitalisation interest limitation rules (which are based on debt:assets), it is proposing a number of changes to strengthen the rules:

- Limiting the interest rate on related party debt to that based on the credit rating of the parent (plus a margin). This is designed to anchor the NZ deductible interest to a MNE's total cost of funds. Special rules are proposed where there is no identifiable parent or the there is no credit rating.
- Requiring an adjustment to "assets" in the thin capitalisation calculation to require these to net-off against "non-debt liabilities" in the balance sheet other than interest-free loans (e.g. trade creditors and provisions).
- A number of specific changes, including a special exemption for certain infrastructure projects controlled by a single non-resident; removing the ability to use valuations for thin capitalisation that differ from financial statement values; and removing the ability to measure assets and debt on the last day of the income year.

Implementing the MLI in NZ

The Government has reiterated its aim to sign the MLI in mid-2017. The latest consultation outlines how the MLI will operate in practice to amend New Zealand's DTAs, how the substantive provisions will address BEPS concerns, and the NZ implementation process and next steps.

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Our initial thoughts

Today's release provides plenty of food for thought over a short time frame. Feedback is requested by early to mid-April. Even more than usual, the detail and the consequential effects require careful consideration. Some initial comments on these measure follow.

PE Avoidance

The main proposed PE avoidance rule is based on (part of) the Diverted Profits Tax in the UK and Australia's Multinational Anti-avoidance Law. This is aimed at what the Government considers are "in" country sales, rather than sales "to" consumers in a country (e.g. online sales). However, it is worth noting that use of third party as well as related party sales channels can create a NZ PE under the proposals.

The aim is to change large MNE behaviour, rather than collect revenue. The risk is how other countries may react to such a unilateral rule, and the corresponding impact on NZ MNEs selling to those countries (as opposed to in those countries).

Further, consequential source rule changes (e.g. to prevent fragmentation of activities) as well as specific rules for life insurance are proposed. The source rules have the potential to tax more than expected.

Transfer pricing

The introduction of a transfer pricing re-characterisation rule is aimed at "commercially irrational" arrangements that would not be entered into by third parties. Like the PE avoidance rule, it follows Australia introducing such a rule.

It is worth bearing in mind that some transactions within a multinational group only arise because it is an MNE. This does not mean that the transactions are commercially irrational. The application of this re-characterisation power will need to be considered carefully, and should be applied sparingly, by IRD. An "exceptional circumstances" condition for application of the re-characterisation rule seems reasonable if the intention is to only apply it to aggressive arrangements.

Another key change is to the onus of proof in transfer pricing matters, moving from the Commissioner to taxpayers. Relatedly, the new administrative rules to buttress IRD's access to information will allow the Commissioner to impute an "uncooperative" large MNE's tax liability based on information she holds. The justification is the asymmetry of information held by IRD versus the MNE (again, to encourage affected MNEs to comply). However, this will cut both ways, as IRD will not only receive information from other tax authorities (e.g. under Country-by-Country reporting and other information exchanges), the Commissioner may also have comparables data the taxpayer does not on which she bases her assessment.

The proposal to shift the transfer pricing "statue bar" to 7 years has been justified on the basis that transfer pricing issues can take longer to investigate (and other countries, notably Canada and Australia, having similar time frames). These assumptions need to be tested. The aim of Business Transformation is faster, more certain, action by IRD. It will have more information. Extending the statute bar period is contrary to the way that IRD is seeking to change the system. The Australian and Canadian time frames do not sit with the NZ context.

Thin capitalisation

We welcome the Government's confirmation that the current thin capitalisation rules are broadly appropriate. The alternative was NZ adopting interest limitation rules based on a percentage of EBITDA, as recommended by the OECD. While that has been resisted (for the time being at least), NZ deductible interest will be linked to the parent's borrowing capability. Such a rule, if implemented, would make NZ unique around the world.

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Our concern is that this has the potential to be a blunt instrument, for what will be widely varying circumstances across taxpayers. It assumes the NZ operations have the same assets, risks and functions as the parent (or rest of the group). To demonstrate otherwise, the NZ subsidiary (or group) will need its own credit rating.

The change to net rather than gross assets has the potential to shift the thin capitalisation "safe harbour" more significantly and much less predictably. Its effect will vary compared to the current 60% safe harbour depending on the role and size of non-debt liabilities. This, along with the other changes proposed, and the lack of a transitional period, will mean the thin capitalisation proposals will have the widest impact.

MLI

The third consultation confirms the broad shape of how the MLI will be implemented in NZ. NZ's preferred approach is for comprehensive adoption of the substantive MLI BEPS provisions (including those that are not minimum standards for adopting the MLI). This compares with potentially more selective adoption of the MLI BEPS provisions by other countries. This may impact which of NZ's DTAs will be "covered agreements" under the MLI. It is also worth noting that Officials have expressed a preference for a Principal Purpose Test as NZ's general treaty anti-abuse rule.

Actions

Submissions are due on 10 April (MLI) and 18 April (PE avoidance, transfer pricing and interest). Consideration should be given to whether the proposals will lead to a fair (or fairer) tax system. Good policy reasons will be required to change the broad proposals, but real focus on the detail can help get to that answer.

A likely timetable suggests these new rules will apply from 1 April 2019, for 31 March balance dates. Assessments of the potential impact should be made to inform submissions and identify any short term actions.

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