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Regular commentary from our experts on topical tax issues

Issue 3

# BEPS Bill and MLI update

**The BEPS Bill has been reported back by the FEC. The changes are largely minor – mainly clarifications**

**The BEPS Bill now awaits enactment. This will be 30 June 2018 at the latest, given the 1 July application date for a number of the proposals**

### Snapshot

The Taxation (Neutralising Base Erosion and Profit Shifting) Bill (the "BEPS Bill") has been **reported back** from the Finance and Expenditure Committee of Parliament (the "FEC"). The **Officials' Report** on submissions has been released at the same time. KPMG's **taxmail** and **submission** provide more detail on the original proposals.

In short, the proposed changes to the transfer pricing and thin capitalisation rules, limitations on setting related party debt interest rates, and introduction of new deemed permanent establishment ("PE") and hybrid rules are all recommended to proceed.

Submissions recommended that the BEPS Bill should be deferred to allow further consideration of the right approach for New Zealand. In the absence of a deferral, they sought greater certainty of application of what are very complex proposals.

There is some tinkering, mainly aimed at clarification at the edges. The most significant changes affect the rules for setting related party debt interest rates.

Otherwise the broad thrust is unchanged. For those affected, there is no option but to consider how the BEPS Bill will apply to their circumstances. Although the Officials' Report is detailed in its policy considerations, it does not consistently provide guidance on how the rules will work in practice. Much will depend on the post enactment Tax Information Bulletin. Depending on when that is published, and its content, there may be some delay in determining Inland Revenue's view of how the rules apply.

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The **Order in Council** to implement the Multilateral Instrument (the "MLI") to amend New Zealand's Double Tax Agreements ("DTAs") to implement tax treaty related BEPS changes has been signed by the Government General. (See KPMG's submission to the FEC on the MLI **here**.)

This completes the domestic process for giving effect to the MLI. As the MLI has already been ratified by five DTA-partner countries, it will progressively amend NZ's DTAs as other countries also give it effect.

## BEPS Bill highlights

### Related party debt interest rate setting rules

The rules are more favourable to taxpayers than the original BEPS Bill but are even more complex. The reported back version of these rules can be summarised as applying as follows:

| **Members of a worldwide group** | |
|---|---|
| Third party debt is more than 20% of total debt. | Can use third party debt funding as the basis for determining related party debt pricing. |
| Less than $NZ10m of related party debt. | Can apply Inland Revenue's "safe harbour" interest rate approach. |
| Finance and insurance companies. | Apply credit rating equal to highest indebted member of the global group. |
| NZ less than 40% debt funded or debt ratio less than 110% of group debt ratio with lender resident in ultimate parent's country or taxed at 15% or higher. | Apply NZ credit rating using standard transfer pricing method. |
| Other entities. | Assumed NZ credit rating of two notches below highest indebted global group member, if that credit rating is BBB+ or higher (one notch if less than BBB+). |
| **Standalone entities** | |
| NZ less than 40% debt funded and lender resident in ultimate parent's country or taxed at 15% or higher. | Can use third party debt funding as the basis for determining related party debt pricing. |
| Other entities. | Apply NZ credit rating using standard transfer pricing method but assuming 40% debt funding and a minimum BBB- rating must result. |

"Exotic" features of related party debt funding, such a subordination to senior debt and a term of more than 5 years, must still be ignored when undertaking the interest rate analysis (i.e. the debt is assumed to be senior unsecured lending with a term of no more than 5 years). This is unless these features are also found in third party debt of the NZ borrower and that funding is material.

The new rules will apply to all NZ borrowers that are subject to the thin capitalisation rules and where the lender and borrower are considered to be "associated" (as measured by the tests in the thin capitalisation rules, not the transfer pricing rules).

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This extended definition, as proposed by Officials in a submission to the FEC, was disappointingly (but unsurprisingly) accepted.

The new rules apply to income years beginning on or after 1 July 2018. For related party debt in place when they take effect, a taxpayer must determine the applicable interest rate on a prospective basis assuming that the new rules were in effect from when the loan was first made (or renewed, or re-priced or otherwise materially amended).

### Thin capitalisation

The proposal to reduce total assets by non-debt liabilities, when calculating the NZ debt ratio (i.e. a debt to "net assets" test for allowable gearing), is to proceed. There have however been clarifications to the types of deferred tax liabilities which will not need to be included as a non-debt liability.

### Permanent establishment avoidance and source rules

The deemed PE and source rules are largely unchanged from the original BEPS Bill's proposals. However, there are some clarifications in the reported back BEPS Bill and the accompanying Officials' Report.

Where a third party supplies the New Zealand recipient, the recipient's existence must be known to the facilitator. This is to ensure the legislation reflects the policy intent that there is a connection between the facilitation activity and the supply.

The report also clarifies that if the facilitation service is carried out remotely, e.g. over the internet from offshore, those activities should not be treated as carried out in New Zealand in applying the deemed PE rule.

Importantly, the Officials' Report confirms that the changes will tax both the deemed PE's profits as well as their payments. The latter effect is assisted by the new deemed DTA source rule. That rule has been modified to exclude certain foreign sourced dividends from its scope but otherwise will proceed.

However, there is still uncertainty regarding the application of the deemed PE and source rules. Officials have stated that they will publish additional guidance (with examples) after the BEPS Bill is enacted.

Guidance on how Inland Revenue expects profits attributable to a PE to be calculated will also be published. This should make clearer its position as well as highlighting differences between New Zealand and other countries. This guidance will need to be reviewed by affected taxpayers.

Helpfully, the Officials' Report states that Inland Revenue will take into account any current restructuring process when it investigates or assesses a taxpayer after the rules come into force.

### Transfer pricing

As expected, despite the submissions made, the transfer pricing rules changes have been accepted with minimal amendments by the FEC. The original BEPS Bill's effects will, therefore, broadly apply.

### Hybrid mismatch rules

As with the transfer pricing changes, the FEC's recommended changes to the new hybrids rules are limited to clarifications. There are no immediately obvious policy changes. Our concern remains that the breadth of the rules means there will be unanticipated and unwelcome consequences.

There is now no choice but to consider the reported back BEPS Bill's rules and their potential application to a taxpayer's particular facts. Importantly, it will not be just the New Zealand effects that will need to be considered.

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## The MLI

The Double Tax Agreements (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) Order 2018 was made on 14 May and has been signed by the Government General. The Order completes the domestic process for New Zealand to ratify the MLI.

New Zealand must now deposit the instrument of ratification with the OECD and wait for its DTA partners to do the same.

The Order will apply to specific DTAs on a rolling basis. The potential effect of the MLI can be seen in the Appendix to KPMG's submission on the MLI. Affected parties will need to watch carefully for each country's ratification of the MLI to determine the effect on their positions.

## Our view on the future of BEPS

The OECD's 2015 BEPS recommendations have changed the international tax landscape. Their implementation will change tax outcomes.

However, those recommendations are unlikely to be the end of the matter. The OECD and European Union are both focussing on the digital economy as a follow-up to the OECD's Action 1 Report.

We understand that New Zealand Officials are participating in the OECD discussions on cross-border co-ordination in taxing the digital economy. The Tax Working Group also raised the matter in its request for submissions.

For New Zealand, we expect the BEPS Bill will not be the last word. A fair tax system will remain a focus and in the headlines.

## KPMG Webcast - Taxation of the Digital Economy

KPMG's Asia Pacific Tax Centre recently hosted a 60 minute webcast discussing recent international developments in the taxation of the digital economy and the European Union's recently released digital package. Speakers included Khoon Ming Ho and Lachlan Wolfers from KPMG China and Grant Wardell-Johnson from KPMG Australia.

A replay of the webcast is available **here**.

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