Tax Tips Alert

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The Government's final BEPS policy decisions
Signficant, complex changes and worryingly coming faster than almost all other countries

Significant and complex changes are coming, faster than we think they should, to New Zealand's tax rules governing cross-border relationships. In this special edition of Tax Tips, we provide an update on the Government's *recently released policy decisions* on new BEPS-related measures. We also highlight several key aspects of the Multilateral Instrument recently signed by the Government along with 75 other countries. People who need to be across the key changes are those involved in businesses operating both in New Zealand and overseas as they are likely to be affected by some, if not all, of the new rules.

Update on the Government's BEPS-related proposals

Last week, the Government announced its policy decisions on BEPS-related proposals first released in September 2016 and March 2017. We described the original proposals regarding hybrid mismatches in our September 2016 Tax Tips Alert, and regarding interest limitation, permanent establishment avoidance, transfer pricing and administrative measures in our March 2017 Tax Tips.

This latest Government announcement follows an extensive consultation process with stakeholders including PwC following initial release of the proposals. Most of the proposals have remained unchanged in principle from when they were announced. However, we are pleased to see that a number of important clarifications and concessions we argued for have been made. The Government has acknowledged that, as a result of the consultation, the proposals are now much more appropriately targeted towards the BEPS arrangements of concern.

Targeted consultation on some aspects of the proposals will continue over the next few months with draft legislation for all policy measures expected to be introduced before Parliament towards the end of the calendar year and enactment before 30 June 2018. If enacted, the changes will take effect for income years commencing from 1 July 2018, with limited exceptions.

Limiting interest deductions on related-party loans – proceeding, but with a revised approach

New approach proposed for pricing related-party loans

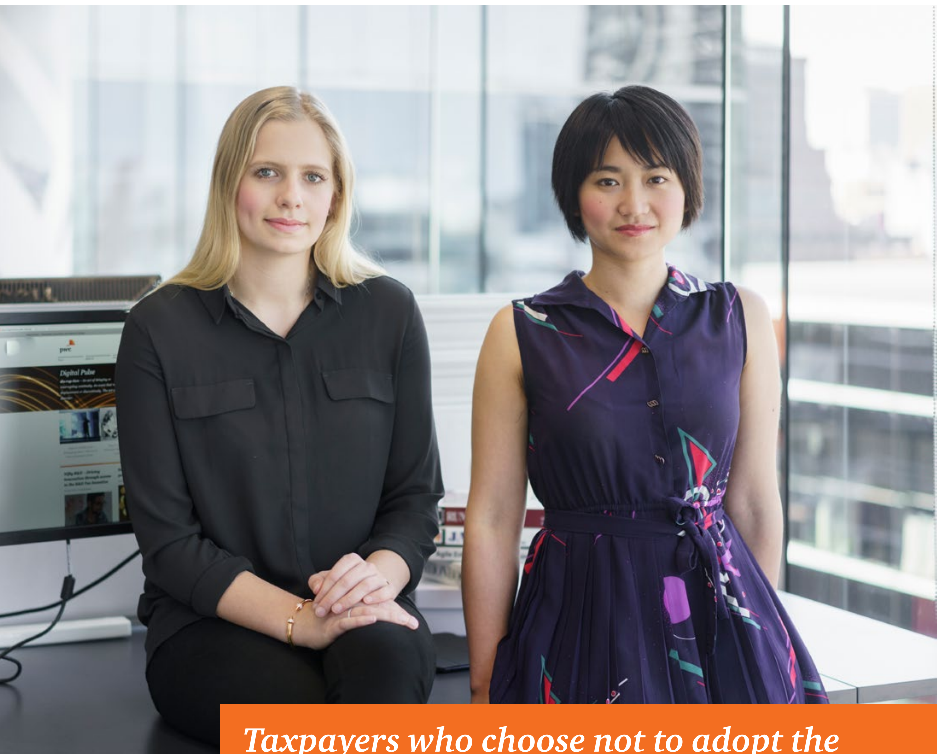
We are pleased to see that the Government has moved away from its previously proposed, and controversial, interest rate cap within New Zealand's domestic thin capitalisation regime. Instead, it has proposed:

- a 'restricted transfer pricing rule' within the transfer pricing regime, which would require inbound related-party loans to be priced as plain vanilla senior debt with a rebuttable presumption of parental support – that is, no 'exotic terms', unless the foreign parent has substantial third party debt that includes those terms; and
- an administrative safe harbour in the form of the previously proposed interest rate cap.

This approach addresses a number of the concerns about the interest rate cap proposal that we raised with Inland Revenue during consultation. The new approach allows for flexibility in the interest rate able to be applied in justified circumstances and, in our view, should not result in a significant departure from existing transfer pricing rules (certainly not compared to the previous proposals). We are expecting, and will be involved in, further consultation around the precise detail of these new measures.

Furthermore, as it is now a transfer pricing measure, taxpayers will still be able to seek relief for double taxation under New Zealand's double tax agreements (DTAs) – in our view, it is very important that the mutual agreement procedures in the DTAs are available if needed to help resolve problems. Another important concession made by the Government is that grandfathering will apply in relation to existing Advance Pricing Agreements.

Taxpayers who are not currently pricing related-party debt in a way consistent with the interest rate cap will need to decide whether they will be able to maintain their current approach under the new rules, or whether it will be preferable to take advantage of the safe harbour. Either way, it will be critical for taxpayers to keep contemporaneous transfer pricing documentation. Taxpayers who choose not to adopt the safe harbour should expect strong scrutiny from Inland Revenue, and will need to have robust and defendable justification well documented.



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Proposals for calculating asset values retained in principle but amended

The Government intends to continue with the proposal that taxpayers will be required to calculate their assets net of non-debt liabilities for thin capitalisation purposes. Almost all submitters argued that deferred tax liabilities should be carved out from the adjustment, so the Government has determined that there will be further consultation on whether this exception (and others) should be included.

Following submissions from us and others, the Government has agreed that the net current value method for valuing assets will be retained, but will very likely be tightened to require an independent expert's valuation – this is another area where we expect further consultation. We support this approach and expect most taxpayers using this method are already adopting a value that is commercially supportable with valuations so this requirement should not be too onerous on taxpayers. This new valuation requirement seems reasonable in exchange for the alternative method remaining available.

The Government has also listened to submissions (and the rationale) and decided to retain the year-end calculation date method, but an anti-avoidance rule will be introduced to ensure that taxpayers do not repay loans just before year-end for thin capitalisation purposes. Again, we would have been very concerned if the Government had not changed its view on this issue – compliance costs would have been huge if quarterly (or daily) averages were the only options available!

Other thin capitalisation proposals also proceeding

- The $1 million interest de minimis threshold will extend to taxpayers subject to the inbound rules, provided that the taxpayer has only third party debt.
- Interest on related-party debt will be denied if the New Zealand entity is controlled by a group of non-residents acting together and the 60% safe harbour threshold is breached.
- Taxpayers engaged in certain infrastructure projects will be able to claim a full interest deduction on all third party debt even if their debt to asset percentage exceeds 60%.

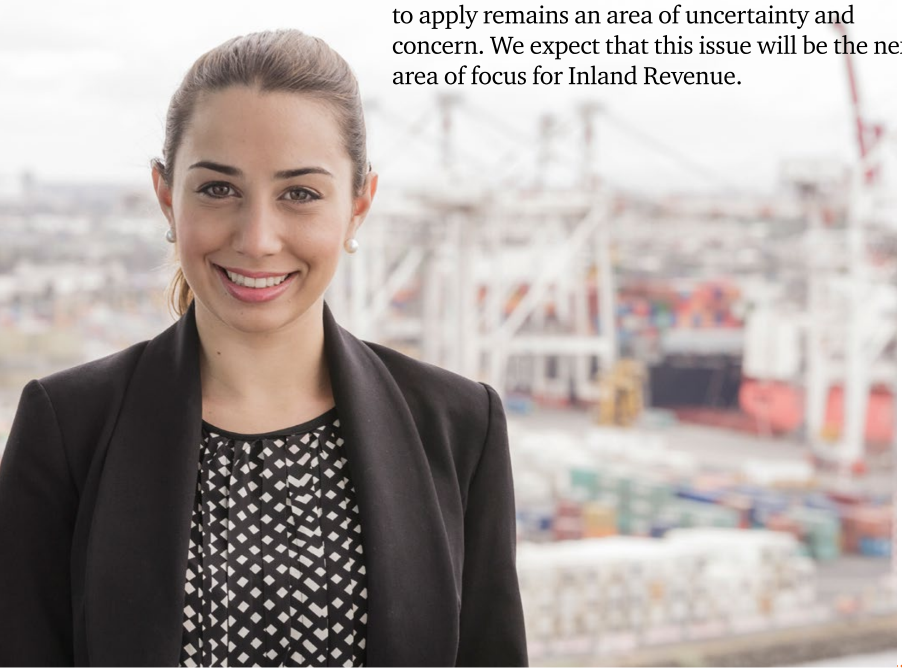
Transfer pricing – proceeding unchanged on key proposals

The Government's proposals to update New Zealand's transfer pricing rules are generally proceeding without change, including aligning them with the Organisation for Economic Cooperation and Development (OECD) new transfer pricing guidelines[1] and Australia's new rules, shifting the burden of proof from Inland Revenue to taxpayers and extending the time bar from 4 to 7 years. Taken together, all of the proposals represent a significant overhaul of New Zealand's existing legal framework. The rules will place greater expectations on taxpayers and will also lead to greater uncertainty. We expect that as a result there will be an increased need for agreed solutions between Inland Revenue and other tax authorities, with taxpayers seeking solutions in the form of bilateral advance pricing agreements and via mutual agreement procedures. We have previously highlighted to Inland Revenue the need for increased guidance and resourcing to assist taxpayers to comply with the new regime. Our view is that these matters will become even more critical in the future.

Permanent establishment avoidance and related proposals - proceeding with vital clarifications

The Government's announcements reiterate its objective to strengthen the existing New Zealand permanent establishment (PE) rules under which the Government considers a minority of multinationals artificially avoid having a taxable presence in New Zealand.

The BEPS papers clarify the original proposals and further refine them in response to submissions received as part of the consultation process. We are pleased to see that the Government has taken on board a number of our submissions as to the scope of the new rule. However, the attribution methodology of PEs that New Zealand is intending to apply remains an area of uncertainty and concern. We expect that this issue will be the next area of focus for Inland Revenue.



Key takeaways

The proposed changes were described fully in our March 2017 Tax Tips. In summary:

- The Government has recognised our concern that the PE avoidance rule as proposed was too broad and has clarified that:
  - the scope of the new rule is intended to be aligned with the pending changes to some of New Zealand's DTAs under which a PE will arise for a non-resident if a person *"habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the [non-resident]"*; and
  - the new rule should not apply to ordinary commercial arrangements – Officials are currently deliberating how best to achieve this outcome.
- The Government has confirmed that this new PE rule will be enacted into New Zealand legislation and will expressly override any DTAs which do not incorporate the widened definition mentioned above.
- The Government has confirmed that, if a non-resident is deemed to have a PE in New Zealand, the proposed changes will allow the Government to charge non-resident withholding tax (NRWT) on overseas royalties paid by the entity with respect to its New Zealand sales.
- The measures include proposed changes to the existing source rule to ensure that all income attributed to the deemed PE will expressly have a New Zealand source. The original proposal was limited to income covered by the PE and royalty articles under any DTA. As the Government is broadening its original proposal, it is seeking further consultation on this matter.
- The Government's current intention is to target activities closely linked to the conclusion of a sale. Marketing services and/or back office support functions are not considered sales activities for the purposes of the proposed changes for the time being. However, OECD discussion drafts released in June 2017 indicate that these services may be incorporated into a wider PE definition going forward. The key question of scope limitation remains a real focus of concern.

We expect to be consulted on these key aspects and to be engaged in dialogue with policy officials in the next phase before draft legislation is released.

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 edition).

Attribution of profits remains uncertain

The Government is clearly committed to strengthening our PE rules. However, if a PE is created in New Zealand as a result of these proposals, the key issue that remains outstanding is – what is the resulting tax outcome for a New Zealand PE? We have suggested to Inland Revenue that guidance in the area of branch profit attribution is urgently needed (for the reasons explained in our March 2017 Tax Tips). As yet, there is no indication this will be forthcoming.

The OECD has recently released for public comment a discussion draft setting out high-level principles on profit attribution, illustrated by way of a number of examples.[2] However, the OECD's guidance on profit attribution is currently not helpful in the New Zealand context as it follows the OECD's historic profit attribution approach (known as the Authorised OECD Approach) which New Zealand has made an explicit reservation against.

As such, while we expect this issue to be the next area of focus by Inland Revenue, it is likely to remain the biggest source of uncertainty and concern for some time for multinationals affected by the new rules.

Administrative measures for uncooperative large multinationals - proceeding with limited amendments

Proposed administrative measures giving Inland Revenue greater power to collect information and issue reassessments to 'uncooperative' large multinationals (i.e. global turnover exceeding EUR750 million) are set to proceed. Important amendments to the rules as proposed are that:

- affected multinationals will no longer be required to pay the disputed tax in advance; and
- New Zealand subsidiaries of multinationals will only be required to pay the multinational's tax if the multinational does not do so.

It remains to be seen how 'non-cooperation' will be defined. We expect that we will be involved in further consultation on these matters.

[2] OECD: Attribution of Profits to Permanent Establishments (22 June 2017).

Hybrid mismatches – proceeding with clarifications

The Government has confirmed it intends to implement the full range of the OECD recommendations in relation to hybrid mismatches, adjusted where appropriate for the New Zealand context.

The Government's general expectation is that the hybrid rules would not apply to most businesses on the assumption that most businesses will not have hybrid arrangements. However, we are not convinced this will be the case - the proposals are broad and may apply not only to companies but branches, trusts, and limited partnerships. It is therefore critical for all businesses that operate cross-border (i.e. have presence in New Zealand and overseas) to consider the potential application of the rules to ensure they do not have any unexpected tax exposure.

What is a hybrid mismatch?

Essentially, a hybrid mismatch arises where there is non-taxation of a payment as a result of an entity or an arrangement being treated differently for tax purposes by different countries. See our September 2016 Tax Tips Alert for a more detailed explanation.

Common examples include:

- a payment which is interest in one jurisdiction (therefore deductible) but a dividend in another (therefore exempt);
- a limited partnership treated as transparent in its country of formation but not in a partner's country (or vice versa);
- a trust that is not taxed anywhere due to how the trust is treated in the country of the settlor, trustee, and beneficiary respectively; or
- a dual resident company or branch that offsets losses in two countries.

The hybrid mismatch proposals look to eliminate unintended tax benefits arising in these situations primarily by disallowing deductions or, in some cases, by increasing taxable income.

Government responses to issues raised during consultation process

The OECD's recommendations are summarised in the Government's document. The Government's proposals for New Zealand follow the OECD's recommendations for the most part. However, the papers provide additional details on some of the specific proposals as well as some welcome deviations from the OECD's recommendations. We outline the key issues below:

- *Application dates* – the papers confirm the proposed application date of 1 July 2018 as mentioned above, with the exceptions that certain proposals relating to New Zealand limited partnerships and trusts will apply from 1 April 2019 and unstructured imported mismatches proposals will be delayed till 1 January 2020.
- *Foreign branches* – the hybrid proposals will apply to branches as recommended by the OECD, although Officials have suggested modifications in recognition that the rules should not apply to New Zealand companies with simple branch structures.
- *Opaque election* – New Zealand investors in foreign hybrids may be entitled to elect to treat the hybrid as a company for New Zealand tax purposes as an alternative to the hybrid rules applying.
- *Australian limited partnerships* – the papers indicate there will be a focus on the use of Australian limited partnerships by New Zealand businesses, which they consider can be used inappropriately to lower New Zealand tax liabilities by generating double deductions in both Australia and New Zealand.

Multilateral Instrument (MLI) – How to amend most of New Zealand's DTAs (in one move)

New Zealand was one of 76 countries to sign, or indicate its intention to sign, the OECD's Multilateral Instrument[3] on 7 June 2017. 28 of New Zealand's 40 DTAs are expected to be covered by the MLI after it is enacted by both parties, including our DTAs with Australia, China, the United Kingdom, Japan, and Korea. DTAs that will not be changing at this stage include those with the United States, Malaysia, Taiwan, and Thailand.

The MLI is an outcome of the OECD's BEPS Action Plan. At this stage, it is expected that around 1,100 DTAs will be updated and amended to take into account new treaty provisions dealing with perceived treaty abuse and improved dispute resolution processes. There is more background to the MLI on our global website.

What the MLI means for New Zealand's DTAs

New Zealand's strategy in adopting the MLI

New Zealand's strategy has been to be comprehensive and adopt as many MLI provisions as possible. Officials' justification for this approach is that the MLI provisions are base protection measures that are consistent with New Zealand's existing treaty policy. Further, it is claimed that, by signing up to the relevant MLI provisions, New Zealand will have consistency across its treaty network and will be able to rely on the new OECD commentary relating to those provisions. The MLI provisions are also likely to form the basis for New Zealand's DTA negotiation model in the future.

New Zealand has therefore elected for covered DTAs to be updated and amended by the MLI process in the following areas:

- *Preventing the granting of treaty benefits in inappropriate circumstances:* A 'principal purpose test' will now apply to all of New Zealand's covered DTAs – a person will generally be denied treaty benefits in circumstances where their principal purpose is to take advantage of the DTA – and other specific anti-abuse rules will also be adopted.
- *Preventing the artificial avoidance of PE status:* The concept of a PE has been widened, making it more likely that a resident operating cross border will be taxed on business profits in the country in which profits are sourced.
- *Neutralising the effects of treaty-related hybrid mismatch arrangements:* Provisions dealing with fiscally transparent entities and dual resident entities will be incorporated.
- *Providing improved mechanisms for effective dispute resolution:* Taxpayers will be able to require tax authorities to settle disagreements by way of mandatory binding arbitration (other than disputes in relation to New Zealand's general anti-avoidance rule).

[3] OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) (the Multilateral Instrument).

How the MLI will change New Zealand's DTAs (and when)

The MLI does not apply to change all DTAs in the same way – there will only be a change where there is a 'match' between the elections made by New Zealand and each of its treaty partners. Given the comprehensive approach New Zealand has taken to adopting the MLI, how exactly any given DTA will change will be driven by whether the relevant DTA partner has signed the MLI and what elections that partner has made for the different treaty provisions impacted by the MLI. For example:

- New Zealand elected for the MLI to apply to 36 of its 40 DTAs, but due to choices made (to date) by other countries only 28 are changing at this stage.
- All countries are required to adopt a 'principal purpose' test as a minimum OECD standard so all of the 28 covered DTAs will contain this provision. However, only around half of the 28 treaty partners in the MLI process have chosen to incorporate further specific anti-abuse rules.
- At this stage, only 11 of the 28 treaty partners have elected to adopt the key change to the concept of a PE – of New Zealand's major trading partners, only Japan will apply the extended concept. For example, Australia has not elected to adopt the PE changes – which we found surprising. The Australian logic appears to be that it will seek to amend the PE clauses on a treaty by treaty bilateral basis.
- There is a similarly low take-up currently of the provisions related to hybrid mismatches (which is also surprising given it is another flagship BEPS change recommended by the OECD).

As to the 'when' question, amendments to a particular DTA will not come into force until both countries have ratified the MLI (which for some countries will require specific legislation). There are other requirements too, which means that it is difficult to predict exactly when DTAs will begin to change. It is likely that New Zealand's DTAs will begin to change at some stage in 2019.

Our view

We are not surprised at the comprehensive approach the New Zealand Government has taken to adopting the MLI, given it is broadly consistent with the changes the Government is also proposing under domestic law as discussed above. It is disappointing (and slightly concerning) that New Zealand is virtually alone in the world in taking this approach – certainly, New Zealand's major trading partners have generally not adopted much more than the minimum standards required. It remains to be seen whether other countries will extend their choices, or whether New Zealand will successfully negotiate the changes on a bilateral basis over time.

Adoption of the MLI will mean confusion and uncertainty for quite some time for both taxpayers and tax authorities. We are pleased that policy officials have recognised this, and are considering various options for assisting taxpayers to understand the new rules. However, the MLI is a very complex instrument. Many of the new rules are subjective, introducing previously unknown concepts that may be interpreted differently in different countries. The 'principal purpose' test in particular is likely to cause challenges, especially where anti-avoidance law has not previously existed in the relevant country (however, in New Zealand there should be less confusion given the case law shift on anti-avoidance in recent years). There will be difficulties not only around what the new provisions mean but which DTAs are changed, how they are changed, and when the changes will take effect.

Let's talk

We trust this brief summary of the latest key BEPS developments in New Zealand is useful. Please contact your usual PwC adviser as we are keen to arrange more in-depth discussions with some of our team to understand how the BEPs related tax changes coming in New Zealand and the changes by the MLI to tax treaties might affect your business.

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