Tax Tips Alert

New Zealand's international tax rules

May 2018

It's a brave new world for New Zealand's international tax rules:

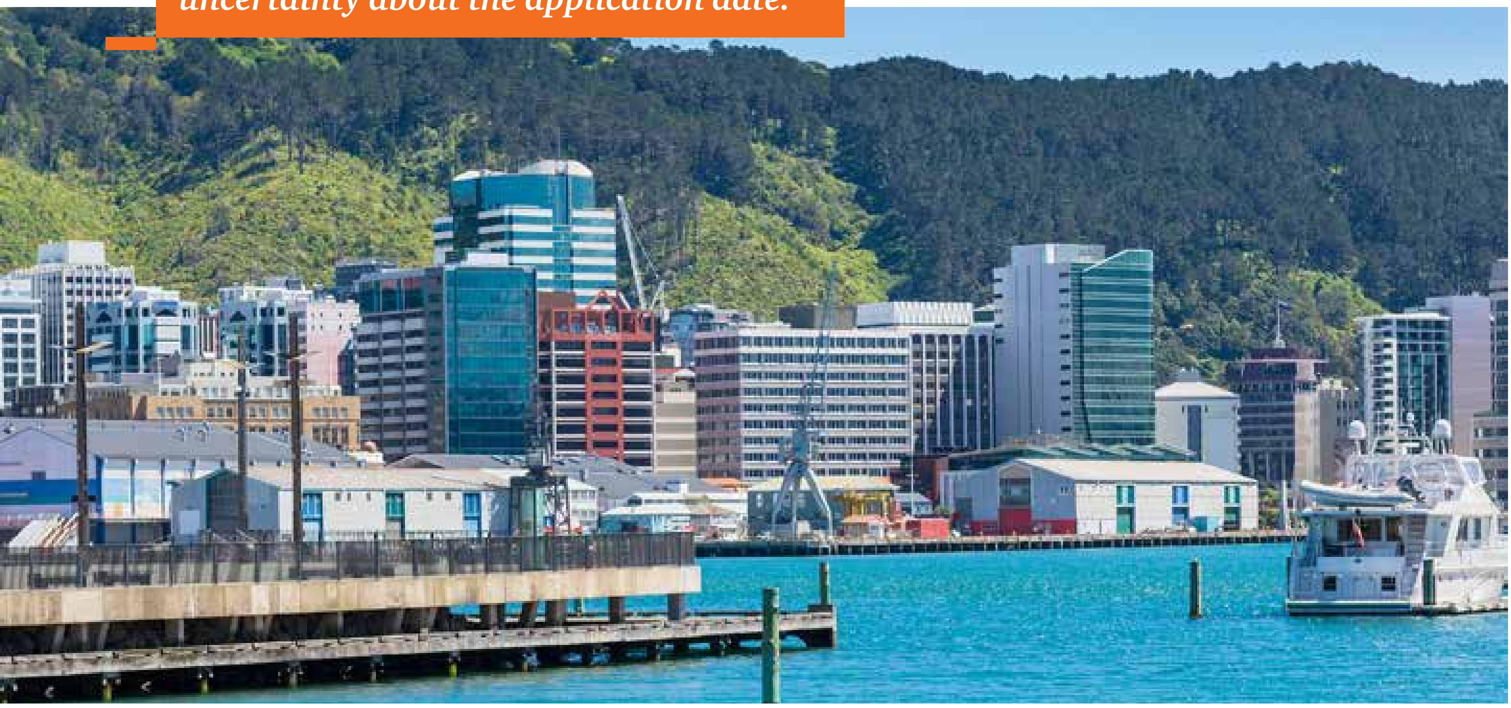
Now is the time to get prepared and be ready for the significant wave of changes

The anticipated changes to New Zealand's cross-border tax regime are now very close to becoming a reality. On 15 May, the Finance and Expenditure Committee (the FEC) reported back to Parliament on the *Taxation (Neutralising Base Erosion and Profit Shifting) Bill* (the Bill), which was released before Christmas last year. The FEC supports the proposed application date of 1 July 2018. If your business has a connection outside of New Zealand, now is the time to ensure you are up to speed with the changes and the effect they might have on your business. Your PwC team want to help, and can draw on our experts in this area to assist.

Our *December 2017 Tax Tips Alert* provides more detail on the proposed changes as first introduced. The FEC has recommended proceeding with the proposals largely unchanged, albeit with some important exceptions outlined in this Tax Tips Alert.

The new rules are expected to take effect for income years starting on or after 1 July 2018. This also includes the new PE rules where there was previously uncertainty about the application date.

We are pleased to see clarifications on some of the uncertainties identified during the consultation process. However, overall, it is disappointing to see the number of submissions rejected by the FEC. Despite some improvements in drafting and design in various areas, we consider that the Bill remains overly complicated, difficult to understand, and unworkable in some cases. We welcome the recommendation that further Inland Revenue guidance will be provided on some (but not all) of the changes. However, we question the timeliness of the guidance for taxpayers wanting to restructure their arrangements now to comply with the new rules before they take effect.



Pricing of related-party loans – proposals proceeding with limited amendments

The FEC has recommended proceeding with the proposed 'restricted transfer pricing rule', which will impose significant restrictions under the transfer pricing rules to the pricing of inbound related-party borrowing exceeding NZD $10 million.

The FEC's most notable recommended changes to the original proposals aim to reduce compliance costs associated with undertaking a credit rating analysis for related-party borrowing and include:

- removing the income-interest ratio from the high BEPS risk test. Whether a borrower is a high BEPS risk will instead be determined only by reference to the borrower's leverage ratio and the tax rate applicable to the corresponding interest income in the lender's jurisdiction
- allowing credit ratings for related party borrowings to be implied from significant, unsubordinated, and unsecured third party debt, where available, and
- allowing high BEPS risk borrowers that have an identifiable parent to use a credit rating equivalent to two notches (extended from one notch) below that of the member of the Group with the most debt, provided this does not result in a credit rating lower than BBB- (otherwise, the result needs to use one notch below). High BEPS risk borrowers with no identifiable parent will still be limited to a credit rating of BBB- in most instances for this pricing rule.

In addition to the above, the FEC has recommended redrafting the legislation to correct drafting errors and provide more clarity on its application. However, it is disappointing that the revised draft rules remain so extensive in scope and complicated. The changes will do little to reduce the additional compliance burden that will be imposed on taxpayers. We expect this rule will continue to result in cross-border interest rate mismatches (and double tax) in instances where the related party lender is required to price the loan based on the Organisation of Economic Cooperation and Development's (the OECD) arm's length principle. As no further changes to the 'restricted transfer pricing rule' are expected, we strongly recommend taxpayers consider the impact of these changes for their related-party borrowings now.

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Permanent establishments – significant extension to the proposals that cover travelling employees

The FEC has recommended a significant extension of the original proposals to specifically capture employees of large multinationals (group turnover exceeding EUR750m) with 'fly in, fly out' arrangements in New Zealand (e.g. travelling salespeople). These arrangements may be subject to the proposed domestic permanent establishment anti-avoidance rule irrespective of the time employees are physically located in New Zealand.

The FEC has also recommended proceeding with the original permanent establishment-related changes, and has provided clarity on some aspects of the legislation, including that existing advance pricing agreements will not protect taxpayers if the proposed domestic permanent establishment anti-avoidance rule is enacted.

Our comments

Non-residents operating under arrangements where employees fly in and out of New Zealand may previously have thought the new rules will not apply to them if there was no entity in New Zealand. Any non-residents in this situation should urgently consider the potential application of the proposed rule (and the prescribed criteria) to employees who travel to New Zealand.

In our view, the statutory language remains too broad. There is still significant uncertainty as to what specific sales-related activities will be caught within the proposed rules, although the FEC has recommended that further guidance in this area (including specific examples) should be issued in a Tax Information Bulletin (TIB) following enactment of the Bill.

Despite being an area of contention for a long time, the Officials' Report to the FEC on Submissions on the Bill unfortunately provides no further direction on how profit should be attributed to a permanent establishment. Comprehensive examples are expected to be published in the TIB. We welcome / urge comprehensive guidance and examples from Inland Revenue in this area as it is crucial to enable potentially affected taxpayers to accurately assess their tax outcomes under the proposed changes.

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Thin capitalisation – proposals proceeding as planned with some limited relaxations

The FEC has recommended proceeding with the thin capitalisation proposals as previously outlined, with several important changes:

- The requirement for taxpayers to reduce gross assets by deferred tax liabilities (as non-debt liabilities) has been amended to extend the exclusion criteria for deferred tax liabilities on assets such as buildings that are non-depreciable or depreciable at a rate of zero (provided the other exclusion criteria are met- which are aimed at deferred tax liabilities that will not create a cash tax liability if the asset is sold).
- The proposal to change the safe harbour to 100% of worldwide debt for taxpayers whose worldwide group is the same as their New Zealand group (such as taxpayers controlled by either a non-resident owning body or by a non-resident trustee) has been clarified, with grandparenting of the existing 110% worldwide debt threshold extended to 5 years.
- The NZD $1 million interest de minimis threshold seems to now only be available to taxpayers subject to the outbound thin capitalisation rules, and even then additional criteria will need to be met (this limitation does not seem to be intended).

With respect to the proposals for thin capitalisation for public private partnerships, the FEC's recommendations were limited to redrafting amendments (albeit significant) to ensure that the rules operate as the policy intended.

Our comments

We welcome the changes around the relevance of deferred tax liabilities (but were pushing for much wider exception criteria). However, the thin capitalisation provisions affecting the changes in the Bill remain difficult to understand and apply in practice overall. The FEC declined to accept the majority of submissions from taxpayers, industry groups, and professional advisers, with the exception of some proposals in respect of public infrastructure projects. The rejection of submissions to remove deferred tax liabilities from non-debt liabilities is of particular concern. We expect that, from a practical perspective, this will likely mean that most taxpayers will be required to include all deferred tax liability components as a reduction to assets along with other non-debt liabilities in their thin capitalisation calculations, subject to specific and limited exemptions e.g. certain buildings.

If your business is currently subject to the thin capitalisation regime, you need to understand the impact of these new rules as soon as possible. You may need to consider restructuring if your ratio is expected to exceed the safe harbour ratios.

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Transfer pricing proposal largely unchanged; with recommended restriction on 7 year time bar

The proposed changes to New Zealand's transfer pricing regime will be implemented largely as originally signalled. The most notable exception to this relates to the proposed extension of the time bar from 4 years to 7 years. The FEC has recommended that the time bar can only be extended to 7 years if Inland Revenue has commenced a transfer pricing tax investigation within 4 years of the relevant tax return being filed, and has notified the taxpayer of this investigation.

All other proposals in legislation remain, albeit with some recommended drafting amendments to:

- more clearly define which taxpayers are caught by the transfer pricing rules, by removing reference to 'control group', reinstating the reference to 'associated person' and adding specific reference to capture New Zealand companies owned by investors who act together, and
- more clearly set out the process for calculating an arm's length amount.

In effect, the proposed legislation will require legal arrangements to be commercially rational and consistent with their economic substance, and will shift the onus of proof to the taxpayer to prove that the arrangements are on arm's length terms (rather than Inland Revenue having to disprove it). The Officials' Report commented that this change to the onus of proof "will effectively require multinationals to analyse and prepare transfer pricing documentation for their related party transactions".

Our comments

While we welcome the minor amendment to the time bar, this does little to remove the significant uncertainty facing taxpayers in relation to transfer pricing. We recommend that you consider your business's current transfer pricing arrangements and prepare detailed and contemporaneous New Zealand-specific transfer pricing documentation in line with the new legislation and following closely the analysis as set out in the new OECD guidelines.

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Proposals to eliminate tax benefits arising from hybrid and branch mismatches proceeding

The proposals relating to hybrid and branch mismatches remain largely unchanged. The FEC's recommendations predominantly seek to clarify some aspects of the rules, such as the application of the proposals to tax consolidated groups and 'split ownership' arrangements, as well as provide a transitional rule for New Zealand taxpayers that are required to switch between secondary and primary rules during an income year.

The regime remains very complex to interpret and apply - in particular, the proposed imported mismatch rule. All submissions on the rule that sought clarification or safe harbours were declined, with the exception being that further guidance will be made available to assist taxpayers to comply with the rule, particularly in relation to the level of enquiry that should be made by New Zealand taxpayers.

The TIB is also expected to provide guidance on other areas such as (i) restructuring (which Officials anticipate will occur) in the light of the introduction of the hybrid and branch mismatch rules and (ii) whether a foreign country's tax rules are viewed to be the equivalent to New Zealand's hybrid mismatch legislation. However, such guidance has been signalled to be made available only after enactment, which is disappointing for taxpayers looking to restructure as the policy intends.

The Officials' Report mentioned that the hybrid and branch mismatch regime doesn't combat all concerns regarding perceived tax planning using cross border transactions, and that the Australian approach to introduce an integrity rule may be a proposal that is considered for debt funding to New Zealand taxpayers via low or no tax jurisdictions.

Inland Revenue is getting more power to investigate multinationals

Submissions made in relation to the extension of Inland Revenue's powers to investigate and collect tax from multinationals have also largely been rejected. However, the FEC did accept several of the submission points, including:

- removal of the proposed criminal penalty that could be imposed on New Zealand members of multinational groups for not providing information requested about an offshore group member, and
- New Zealand members within a wholly-owned group will only be treated as agents for the unpaid tax liabilities of non-resident group members if the New Zealand member is a New Zealand resident company or a permanent establishment in New Zealand. New Zealand members that are assessed as agents will be able to dispute those assessments, including in court proceedings.

Let's talk

The cumulative effect of the changes will, in many cases, be significant. With short lead times to effective dates, the potential impact of these proposals need to be considered now. Our team is available to help you assess the impact of the proposed new rules on your business. Please contact your usual PwC adviser to discuss the new measures further.

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