

BEPS – transfer pricing and permanent establishment avoidance

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to prevent permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue investigate uncooperative multinationals. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Some large multinationals are currently using tax arrangements which allow them to report low taxable profits in New Zealand despite carrying on significant economic activity here.

3. In March this year, the Government released a discussion document called *BEPS – Transfer pricing and permanent establishment avoidance* to consult on proposals to combat these arrangements. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

4. Submissions and workshops with the private sector were used to refine the proposals and better target them at the BEPS activities we are concerned about, whilst reducing the compliance costs and other unintended impacts on taxpayers engaging in ordinary, commercial dealings.

5. We recommend that nearly all of the proposals in the discussion document proceed, subject to some changes following consultation. The most significant changes made to the original proposals as a result of consultation were:

- The proposed permanent establishment (PE) avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.
- Clarification of the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.
- The proposal to require disputed tax to be paid earlier should not proceed. This is because we consider it to be unnecessary in light of the current "use of money" interest rate regime.

6. These changes are likely to be welcomed by submitters and do not reduce the overall effectiveness of the proposed reforms.

7. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

8. The forecast tax revenue from implementing the transfer pricing and PE avoidance measures is \$25m in 2018/19 and \$50m per annum from 2019/20. Some of this revenue has already been included in the Budget 2017 forecasts.

Background

9. In February this year, Cabinet agreed to release the Government discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (CAB-17-MIN-0041 refers).

10. The discussion document, which was released in March 2017, consulted on proposals to combat aggressive tax strategies which allow some multinationals to report low taxable profits in New Zealand despite carrying on significant economic activity here. These strategies involve:

- ***Tax structuring:*** In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (a permanent establishment or “PE”) in New Zealand. However, non-residents can structure their affairs to avoid such a taxable presence, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).
- ***Creating enforcement barriers:*** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.

11. The OECD and the G20 are also concerned about these kinds of BEPS strategies, and have recommended measures to address them in their 15 point BEPS Action Plan. These include:

- a widened definition of “permanent establishment” for double tax agreements (DTAs), to counter PE avoidance (however this will only be included in a DTA if both countries agree); and
- updated transfer pricing guidelines, to counter profit shifting.

Comment

12. We have developed a package of proposed tax law changes to combat transfer pricing and PE avoidance. The main elements of the proposed reform package are:

- The introduction of a new PE avoidance rule that will prevent multinationals from structuring their operations to avoid having a PE in New Zealand where one exists in substance.
- Stronger “source rules” so New Zealand has a greater ability to tax New Zealand-sourced income.
- Stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational’s economic activities. We also

propose shifting the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length, and extending the time bar (the period of time which Inland Revenue has to reassess a taxpayer) from four years to seven years for transfer pricing.

- A range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues). These are similar to some of the administrative powers provided under the UK and Australia's Diverted Profit Taxes but New Zealand's administrative measures are more targeted at the practical barriers faced by tax investigators as they will only apply when a multinational does not cooperate with a tax investigation.

13. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment to address issues that Inland Revenue has identified when investigating multinationals.

Private sector consultation

14. 15 submitters provided written submissions on the discussion document. The Treasury and Inland Revenue also met with six of these submitters to discuss their submissions.

General reaction

15. Overall, most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more certain and better targeted.

16. Two of the 15 submitters welcomed the proposals as a positive step by the Government to ensure that all large multinationals are paying their fair share of tax.

17. The other 13 submitters were tax advisors or represent multinationals that could be negatively affected by the proposals. Their submissions were critical of some of the measures.

18. Some submitters argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. As noted in the accompanying covering Cabinet Paper (*Tax measures to prevent base erosion and profit shifting*), there will be additional tax and compliance costs for some investors but these additional costs will mostly be borne by taxpayers engaging in BEPS activities and the overall benefits to New Zealand of addressing BEPS outweigh these costs.

19. As expected, most of the submitters opposed the administrative proposals to increase Inland Revenue's powers to investigate multinationals. However, we consider these new powers are necessary to ensure Inland Revenue can effectively enforce the new rules. These new powers include:

- Expanding Inland Revenue's ability to request information that is held by a related group member offshore. Submitters considered this proposal could unfairly penalise a New Zealand entity that may not be able to get the information from their multinational group members. However, we consider it is unacceptable for Inland Revenue's investigations to be frustrated because a multinational group fails to provide information that is under its control.

- Shifting the burden of proof for transfer pricing onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length. Submitters considered Inland Revenue had information regarding comparable transactions and should bear the burden of proof. However, shifting the burden of proof is consistent with the fact that the taxpayer holds the relevant information on their own transfer pricing practices. The burden of proof is already on the taxpayer for other tax matters and is also on the taxpayer for transfer pricing matters in most other OECD and G20 countries, including Australia. Because most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries, the additional compliance costs from this change are not expected to be substantial.
- Extending the time bar (the period of time which Inland Revenue has to adjust a taxpayer's transfer pricing position) from four years to seven years for transfer pricing. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have a special seven year time bar for transfer pricing) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Changes made as a result of consultation

20. In response to submissions, we have updated the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.
21. Many submissions focused on when the PE avoidance rule would apply. Submitters considered the proposal outlined in the discussion document applied too broadly and could have unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.
22. We consider the PE avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.
23. Submitters also pointed out that the OECD has updated their model DTA to address PE avoidance and New Zealand is currently in the process of adopting this into some of our tax treaties by signing the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* and through negotiating new tax treaties. We agree that the domestic law PE avoidance rule will only be necessary when the relevant tax treaty does not yet include the OECD's new recommendation and propose narrowing the application of rule accordingly.
24. The PE avoidance rule would apply notwithstanding the relevant DTAs (that don't yet include the OECD's new model PE rule). We consider that this is acceptable for two reasons:
- The OECD's commentary to their model DTA contemplates that countries can adopt anti-avoidance rules and states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. An existing example of this is New Zealand's General Anti-Avoidance Rule which explicitly overrides our DTAs to allow New Zealand to combat tax avoidance arrangements. The PE avoidance rule would be a specific anti-avoidance rule, which would also be consistent with the principle in the OECD's commentary.

- The UK and Australia have already implemented similar PE avoidance rules in their domestic laws which override their DTAs and their treaty partners have not challenged this.

25. Another major point raised by submitters was the need to clarify the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

26. Other significant changes made as a result of consultation were:

- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money" interest rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay tax that is in dispute.

27. The above changes will make the rules more certain and better targeted and are likely to be welcomed by submitters.

28. We also recommend widening the scope of the original proposal to deem an amount of income to have a New Zealand source under our domestic legislation if we have a right to tax the income under a DTA. The rule proposed in the discussion document was limited to income covered by the PE and royalty articles of our DTAs. We should extend the rule to all types of income that we can tax under a DTA – as Australia does. This ensures we can exercise a taxing right that we have negotiated under a DTA. We will consult further on this wider proposal in the next round of consultation.

29. These recommended changes will not affect the originally forecast revenue from implementing the transfer pricing and PE avoidance measures, which is \$25m in 2018/19 and \$50m per annum from 2019/20 (some of this revenue has already been included in the Budget 2017 forecasts).

30. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

Agency consultation

31. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, publicity

32. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

33. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

34. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

35. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.
2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing the overall effectiveness of the proposed reforms.
3. **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure their businesses to avoid having a PE (taxable presence) in New Zealand.
4. **Agree** to expand and strengthen the rules for taxing New Zealand-sourced income by:
 - deeming certain amounts of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA;
 - introducing an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source; and
 - addressing a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand, including where the income is not subject to New Zealand tax by operation of a DTA.
5. **Agree** to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. This involves amending New Zealand's transfer pricing rules so that:
 - they disregard legal form if it does not align with the actual economic substance of the transaction;
 - they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;
 - the legislation specifically refers to arm's length conditions;

- they refer to the latest OECD transfer pricing guidelines as guidance for how the rules are applied;
 - the new legislation codifies the requirement for large multinationals to provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative;
 - the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased to seven years (in line with Australia);
 - the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters); and
 - in addition to applying to transactions between related parties, the transfer pricing rules will also apply when non-resident investors "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.
6. **Agree** to strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation by amending the Tax Administration Act 1994 to allow Inland Revenue to:
- more readily assess the multinational's tax position based on the information available to Inland Revenue at the time;
 - collect any tax owed by a member of a large multinational group from any wholly-owned group member, provided the non-resident fails to pay the tax itself;
 - use section 17 of the Tax Administration Act 1994 to request information that is held offshore by another group member of the large multinational group;
 - use section 21 of the Tax Administration Act 1994 to deem an amount of income to be allocated to a New Zealand group member or PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand sourced income (currently the existing power only applies in respect of deductible payments); and
 - impose a new civil penalty of up to \$100,000 for large multinational groups which fail to provide requested information (which replaces the current \$12,000 maximum criminal penalty).
7. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).
8. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.
9. **Agree** that the results of the decisions in recommendations 3-6 and 8 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue