Taxation (Neutralising Base Erosion and Profit Shifting) Bill

Bill Number 3-1

Regulatory Impact Assessments

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Prepared by Policy and Strategy, Inland Revenue

December 2017

Coversheet: BEPS – transfer pricing and permanent establishment avoidance rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
There are international concerns about multinationals not paying their fair share of tax. This is because some multinationals use base erosion and profit shifting (BEPS) strategies to report low taxable profits in New Zealand and other countries in which they operate. These BEPS strategies include arrangements between related parties which shift profits out of New Zealand (usually into a lower taxed jurisdiction). They also include arrangements which are designed to ensure New Zealand is not able to tax any income from sales here despite there being a physical presence in New Zealand in relation to the sales. These particular BEPS strategies are known as transfer pricing and permanent establishment (PE) avoidance. Finally, Inland Revenue faces administrative difficulties in investigating large multinationals.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The proposed approach is to adopt the package of measures outlined in the Government discussion document *BEPS – transfer pricing and permanent establishment avoidance (March 2017),* with some changes resulting from consultation, as the measures will: • ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand; • stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and • make it easier for Inland Revenue to investigate such multinationals.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit by receiving an additional $50 million of revenue per annum. Compliant businesses will benefit because the multinationals involved in transfer pricing and PE avoidance activities will no longer be able to achieve a competitive advantage. Also, the measures will support voluntary compliance by protecting the integrity of the tax system.

Where do the costs fall?
Multinationals which currently engage in BEPS activities will face a medium level of compliance costs. These taxpayers may choose to transition into more tax compliant agreements which will require restructuring costs; or they may apply for advance pricing agreements (APAs). However, the majority of multinationals are compliant and should not be materially affected by the proposals.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is a risk that foreign companies investing in New Zealand will view the proposals as complex and onerous, incentivising them to remove their existing personnel from New Zealand or to cease operating in New Zealand altogether. However, most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is limited certainty of evidence in relation to the problem of transfer pricing and PE avoidance arrangements. This is because such activities are often not directly observable in the absence of specific audit activity. However, Inland Revenue is aware of about 16 cases involved in these types of BEPS arrangements which are currently under audit. While there are only 20 New Zealand-owned multinationals that earn over the threshold for some of the main proposals (over EUR €750 million of consolidated global revenue), the European Union (EU) has estimated that there may be up to 6,000 multinationals globally

that do. However, we do not know how many of these global multinationals operate in New Zealand.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed *the BEPS – transfer pricing and permanent establishment avoidance rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – transfer pricing and permanent establishment avoidance rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

Evidence of the problem

Our analysis has been limited somewhat by our inability to assess the exact size of the transfer pricing and PE avoidance structures in New Zealand. In common with BEPS activities generally, transfer pricing and PE avoidance is difficult to quantify as tax avoidance is often not directly observable. We consider that, while most multinationals are compliant, there is a minority that engage in transfer pricing and PE avoidance. Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not addressed. Furthermore, as New Zealand endorses the Organisation for Economic Co-operation and Development's (OECD) *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan), there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Range of options considered

Our analysis of options has been primarily constrained by New Zealand's double tax agreements (DTAs). Under its DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

Assumptions underpinning impact analysis

The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of transfer pricing and PE avoidance arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs, and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to the aggressive tax planning strategies used by some multinationals to pay little or no tax anywhere in the world. This outcome is achieved when multinationals exploit gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In 2013, the OECD published its BEPS Action Plan which identified actions needed to address BEPS (including transfer pricing and PE avoidance), set deadlines to implement these actions, and identified the resources needed and the methodology to implement these actions. In 2015, the OECD released its final package of recommended actions for countries to implement to counter BEPS.

If no action is taken to counter transfer pricing and PE avoidance arrangements, multinationals that are currently engaging in these types of arrangements will be able to continue, and the number of these types of avoidance cases will continue to increase.

New Zealand's BEPS work

New Zealand is a supporter of the OECD/G20 BEPS project to address international avoidance and is advancing a number of the OECD/G20 BEPS recommendations.

In September 2016, the Government released the BEPS discussion document *Addressing hybrid mismatch arrangements*. In March 2017, the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*; along with the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*.

The *BEPS – Transfer pricing and permanent establishment avoidance* discussion document consulted on the Government's proposal to introduce a new set of tax rules to counter BEPS activities involving transfer pricing and PE avoidance. Many of the proposals follow the OECD's BEPS Action Plan recommendations (such as updating our transfer pricing legislation to align with the OECD's new transfer pricing guidelines).

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework ensures the tax system is not generally used to deliver incentives or encourage particular behaviours.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge is to ensure that our tax rules are up to date and result in multinational firms paying a fair and efficient amount of tax in New Zealand. Base protection measures, such as transfer pricing and PE rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

New Zealand's PE rules

New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules in conjunction with our DTAs. Under our DTAs, New Zealand is generally prevented from taxing a non-resident's business income unless the non-resident has a PE in New Zealand. This is the case even if that income has a source in New Zealand under our domestic legislation.

In general, New Zealand can only tax a non-resident multinational group on its sales here if both of the following conditions are met:

- The multinational group has a sufficient taxable presence in New Zealand. This means the group must operate in New Zealand either through a New Zealand-resident subsidiary (in which case the subsidiary is taxable on its income) or through a PE of a non-resident group member. A PE is basically a place of business of the non-resident, but it also includes an agent acting for the non-resident.
- Where a multinational operates in New Zealand through a PE of a non-resident group member, some of the non-resident's net profits from its sales can be attributed to its taxable presence here. This involves determining:
    - o The amount of the non-resident's gross sales income which can be attributed to its PE here; and
    - o The amount of the expenses which can be deducted from that income to determine the net taxable profits in New Zealand.

The non-resident must also have a sufficient taxable presence in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

New Zealand's transfer pricing rules

"Transfer pricing" refers to the use of cross-border payments between associated entities such as a parent and a subsidiary. Transfer pricing rules are therefore concerned with determining the conditions, including the price (and therefore the tax liability), for transactions within a multinational group resulting in the allocation of profits to group companies in different jurisdictions.

New Zealand's transfer pricing legislation was first introduced in 1995 and is largely focused on the legal form of the transaction and adjusting the consideration that is paid to an arm's length amount (which can be zero). Due to the increased complexity and tax planning of cross-border intra-group trade over the last 22 years, New Zealand's existing transfer pricing rules are unable to adequately address some types of profit shifting.

General anti-avoidance rule (GAAR)

New Zealand also has a general anti-avoidance rule (GAAR) which effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. However, the GAAR is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own.

2.3 What is the policy problem or opportunity?

The problem of transfer pricing and PE avoidance

Some multinational companies operating in New Zealand exploit deficiencies in the current international tax system (both in New Zealand and abroad) by using transfer pricing and PE avoidance strategies to report low taxable profits in New Zealand despite carrying out significant economic activity here. Transfer pricing and PE avoidance can lead to unfairness and the substitution of low-taxed investors for tax-paying investors. This has the potential to reduce national income while doing little or nothing to reduce the overall pre-tax cost of capital to New Zealand or increase the overall level of investment. It also distorts the allocation of investment by favouring foreign investors who set out to game the system.

Transfer pricing avoidance

One of the major strategies used by multinationals to shift profits out of New Zealand and reduce their worldwide tax bills is transfer pricing. Related parties may agree to pay an artificially high or low price for goods, services, funding, or intangibles compared to the "arm's length" price or conditions that an unrelated third party would be willing to pay or accept under a similar transaction. By manipulating these transfer prices or conditions, profits can be shifted out of New Zealand and into a lower-taxed country or entity.

PE avoidance

Some multinationals reduce their New Zealand tax liability by structuring their affairs to avoid a PE arising, despite carrying on significant activity here.

Impacted population

These rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Many of the proposed measures will apply only to multinational groups with over EUR €750 million of consolidated global revenue. While there are only 20 New Zealand-owned multinationals that earn this much, the EU has estimated that there may be up to 6,000 multinationals globally that do. However, we do not know how many of these global multinationals operate in New Zealand.

Transfer pricing and PE arrangements in New Zealand

Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not strengthened. Furthermore, as New Zealand endorses the OECD's BEPS Action Plan, there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Inland Revenue's judgement is that the transfer pricing and PE proposals can expect to add $50 million a year of revenue to the forecasts. This $50 million per year estimate relates to the fact that the proposals will make it more difficult to avoid tax under the transfer pricing and PE rules and easier to find and assess any remaining avoidance cases. This should reduce future avoidance arrangements and free up investigator resources. The changes will also result in more revenue being able to be assessed from any multinationals which continue to use transfer pricing or PE avoidance arrangements.

2.4 Are there any constraints on the scope for decision making?

Our analysis of options has been primarily constrained by New Zealand's DTAs. Under our DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. The OECD guidance permits departure from this only in respect of tax avoidance. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

2.5 What do stakeholders think?

Submissions on the discussion document

The Government received 16 submissions on the discussion document from key stakeholders.[1] We also met with six of the main submitters to discuss their submissions in more detail.

Many submitters strongly opposed the proposals that increased Inland Revenue's power to investigate large multinationals. Others argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented.

However, most submitters accepted the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. Some submitters even welcomed the proposals as a positive step by the Government to ensure multinationals pay their fair share of tax.

Further consultation

Following Cabinet decisions in July 2017, we are planning to undertake further public

[1] Most of the submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

consultation on outstanding policy issues, technical design details, and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Officials have identified four mutually exclusive options to address the problem:

- Option 1 – Status quo
- Option 2 – MLI and the OECD's transfer pricing guidelines
- Option 3 – Diverted profit tax
- Option 4 – Discussion document proposals (as amended through consultation)

Option 1 is the only non-regulatory option. The other options involve implementing an international agreement or changing New Zealand tax legislation.

Option 1: Status quo

This option would retain the existing tax rules for multinationals (as described in the sections above). Under this option, Inland Revenue would continue trying to enforce the existing rules and/or apply the GAAR to challenge tax avoidance arrangements.

Option 2: MLI and the OECD's transfer pricing guidelines

Option 2 is to rely on the combination of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI)[2] and the OECD's transfer pricing guidelines without amending our domestic law. Under this option, any PE avoidance issues would be addressed under the OECD's new PE definition in the MLI, and any transfer pricing issues would be addressed by applying the OECD's new transfer pricing guidelines.

Option 3: Diverted profits tax

Option 3 is to adopt a diverted profits tax (DPT). A DPT is a separate tax on the "diverted profits" that arise from transfer pricing and PE avoidance. It is levied at a penal rate, compared with income tax, and has greatly enhanced assessment and collection powers. Both the UK and Australia have already implemented a DPT to target multinationals engaging in BEPS strategies. DPTs are intended to incentivise taxpayers to pay the correct amount of income tax under the normal rules rather than to raise revenue by themselves.

Option 4: Discussion document proposals (as amended through consultation)

This option involves adopting the package of measures proposed in the discussion document, with some changes resulting from consultation. The discussion document proposals have taken certain features of a DPT and combined them with the OECD's BEPS measures and some domestic law amendments to produce a package of measures that is tailored for the New Zealand environment. The intention is that this approach would be as effective as a DPT in addressing transfer pricing and PE avoidance in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. Under this option, we would introduce:

- an anti-avoidance rule that will prevent multinationals from structuring their operations

[2] The MLI allows countries to quickly and efficiently implement a number of the OECD's BEPS Action Plan measures that can only be implemented through changes to DTAs, without having to bilaterally renegotiate their existing DTAs.

to avoid having a PE (a taxable presence) in New Zealand where one exists in substance;

- 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; shift 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 extend the time bar for transfer pricing from four years to seven years;
- stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income; and
- a range of administrative measures that will 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 (such as allowing Inland Revenue to request information that is held by an offshore group member).

Consultation

These four options were identified prior to consultation. The discussion document proposed the adoption of a package of reforms combining elements of a DPT with the OECD's recommendations and some domestic law amendments (option 4). The discussion document discussed the status quo (option 1) and the DPT (option 3). Some submitters proposed that the better approach would be to sign the MLI and apply the OECD's transfer pricing guidelines without amending our domestic law (option 2).

In response to consultation we have refined the proposals so they are better targeted at BEPS arrangements with less compliance costs and fewer unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

Significant changes made as a result of consultation were:

- More narrowly targeting the PE avoidance rule at avoidance arrangements (we will consult further on how best to achieve this).
- Clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.
- The PE avoidance rule will only apply where an applicable DTA does not include the OECD's widened PE definition (as in cases where the OECD's new PE definition is included, the proposed PE avoidance rule will be unnecessary).
- 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 any tax which has been assessed.

The above changes are likely to be welcomed by submitters.

Evidence from Australia's reforms

Australia's recent experience updating their transfer pricing laws (in 2013) and introducing a new Multinational Anti-Avoidance Law (MAAL) demonstrates the effectiveness of tax reforms to address PE avoidance and transfer pricing issues.

Australia's MAAL came into effect on 11 December 2015 and prevents multinationals from structuring their affairs to avoid having a PE in Australia. It is very similar to our proposed PE avoidance rule.

As of 4 June 2017, the Australian Tax Office (ATO) had identified 221 taxpayers they believed to be shifting profits to a non-resident group member resident in a low-tax jurisdiction. Of these 221 taxpayers, the ATO has cleared 102. Furthermore, since the MAAL was introduced, 18 companies with PE avoidance structures have restructured their affairs to bring their sales onshore – and a further 11 are currently working with the ATO to restructure.

According to the ATO, as a result of the introduction of the MAAL, an additional AUS$6.4 billion worth of assessable income will now be reported in Australia. This translates into $100 million a year in additional tax revenue for Australia.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible;
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible;
- Neutrality – the tax system should bias economic decisions as little as possible;
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way; and
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality, and fairness impacts without some increase in compliance costs and so there are some trade-offs that were, and continue to be, considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

Two options were ruled out of scope due to their radical nature, namely:

- cancel New Zealand's DTAs; and
- prevent multinationals from selling products in New Zealand if they were suspected of involvement in BEPS activities.

The former would harm New Zealand exporters and outbound investors. The latter would not only harm New Zealand consumers (as they would no longer be able to import certain goods), but it would also violate New Zealand's trade agreements.

Section 4: Impact Analysis

	Option 1: Status quo	Option 2: MLI and the OECD's transfer pricing guidelines	Option 3: Diverted profit tax	Option 4: Discussion document proposals (as amended through consultation)
Efficiency of compliance	**0**	**-** Option 2 imposes increased compliance costs on taxpayers as a result of applying the MLI and the new transfer pricing guidelines.	**- -** Option 3 imposes ongoing compliance costs on taxpayers as it requires them to provide information or concede transfer pricing outcomes in transfer pricing audits.	**-** Option 4 imposes increased compliance costs on taxpayers as they will be required to conform to the additional administrative measures. See below for further details.
Efficiency of administration	**0**	**0** We do not expect there will be increased administrative costs under this option as the reforms largely change the way some taxpayers self-assess the income and deductions they report to Inland Revenue.	**-** We expect there will be increased administrative costs under this option as a DPT is a separate tax from an income tax.	**0** We do not expect there will be increased administrative costs under this option. The proposed administrative measures should also make it easier for Inland Revenue to investigate uncooperative multinationals. See below for further details.
Neutrality	**0**	**+** Option 2 will remove some of the tax benefit of currently observed transfer pricing and PE avoidance opportunities in New Zealand. See below for further details.	**+** Option 3 will remove the tax benefit of currently observed transfer pricing and PE avoidance opportunities involving New Zealand. However, it may have a negative impact on investment certainty for taxpayers.	**+ +** Option 4 will remove the tax benefit of all currently observed transfer pricing and PE avoidance opportunities involving New Zealand. See below for further details.
Fairness and equity	**0**	**+** Option 2 has some fairness benefits as it ensures that some taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	**0** Option 3 has some fairness benefits as it ensures that taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	**+** Option 4 has the most fairness benefits as it ensures that all taxpayers able to use observed transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others.
Sustainability	**0**	**+** Option 2 will remove some, but not all, of the current transfer pricing and PE establishment opportunities involving New Zealand.	**+** Option 3 will remove current transfer pricing and PE establishment opportunities involving New Zealand. See below for further details.	**+ +** Option 4 will remove current transfer pricing and PE establishment opportunities involving New Zealand and is well-targeted at the problems that have been observed by Inland Revenue in New Zealand.
Overall assessment	Not recommended	Not recommended	Not recommended	**Recommended**

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Option 2 (MLI and the OECD's transfer pricing guidelines)

- **Neutrality:** The effect of this option will be limited as the MLI will not cover many of our DTAs and New Zealand's current transfer pricing legislation does not allow us to apply some of the new transfer pricing guidelines.
- **Fairness and equity:** While option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements.

Option 3 (Diverted profits tax)

- **Fairness and equity:** While option 2 has some fairness benefits, it also has some significant fairness detriments owing to its penal tax rate, reduced taxpayer rights, and wide scope. Further, a DPT could also impact on the perception of the fairness of New Zealand's tax system for multinationals investing into New Zealand.
- **Sustainability:** Compared to the other options it would provide less certainty for, and impose more compliance costs on, taxpayers.

Option 4 (Discussion document proposals (as amended through consultation))

- **Efficiency of compliance:** It is also highly likely that a number of taxpayers will choose to restructure their affairs and/or apply APAs.
- **Efficiency of administration:** The proposals may place a higher demand on Inland Revenue's transfer pricing team and more transfer pricing specialists may be required to deal with this.
- **Neutrality:** This option will ensure multinationals engaged in BEPS activities are not tax-advantaged over more compliant domestic and non-resident businesses. This will provide some efficiency gains.

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?
We consider that option 4 (discussion document proposals (as amended through consultation)) is the best option to combat transfer pricing and PE avoidance. Option 4 will improve the neutrality of New Zealand's tax system by eliminating the ability for multinationals to engage in aggressive transfer pricing and PE avoidance schemes to receive tax benefits. Option 4 will: • ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand; • stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and • make it easier for Inland Revenue to investigate such multinationals. Option 4 will also improve the equity and fairness of New Zealand's tax system. Multinationals engaging in BEPS activities are currently able to structure their affairs to receive unintended tax benefits placing them at a competitive advantage over more compliant multinationals or domestic companies. As a result, these more compliant multinationals and domestic companies end up suffering a greater tax burden. Option 4 will therefore ensure that the tax burden is shared more equally among taxpayers. While option 4 will impose additional tax and compliance costs on some taxpayers, it is important to note that some of the measures will only apply to large multinational groups with over EUR €750 million of consolidated group turnover. Submitters on the discussion document argued that the imposition of higher tax payments may make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, as a number of like-minded countries throughout the OECD are undertaking similar BEPS measures, we believe that any impacts on foreign direct investment into New Zealand will not be material and that implementing the proposals in option 4 remains in New Zealand's best economic interests (see further discussion in section 5.3 below). Option 1 (status quo) was preferred by a number of submitters to the discussion document. However, retaining the current rules would mean that those multinationals engaging in aggressive transfer pricing and PE avoidance structures would be able to continue, and the number of these types of avoidance cases would continue to increase. While New Zealand has a GAAR (see above in section 2.2), it is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own. This is because applying the GAAR often leads to resource-intensive court cases and it may be difficult to show that certain avoidance structures fail the Parliamentary contemplation component of the GAAR. Option 2 (MLI and the OECD's transfer pricing guidelines) was the option suggested by many submitters. However, we consider that adopting the OECD's recommendations on their own (without corresponding domestic amendments) would not effectively address the issue of transfer pricing and PE avoidance. First, New Zealand's existing transfer pricing legislation does not contemplate an ability to apply some important aspects of the new OECD's transfer pricing guidelines. This means that Inland Revenue would only be able to

apply the guidelines to the extent that our current domestic rules allow. Domestic law changes would likely be needed to adequately address the issue. Second, while option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements. This is because the MLI will only apply where both countries choose to adopt it – and many of New Zealand's trading partners do not intend to adopt it. It is therefore important that New Zealand adopt its own PE avoidance measure to supplement the MLI, otherwise there would still be a gap for multinationals to exploit. Third, the OECD's BEPS measures do not address issues specific to New Zealand, such as issues with our current source rules and the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes).

Option 3 (diverted profits tax) is not recommended. This option would provide less certainty for, and impose significant compliance costs on, taxpayers. This is because a DPT is a separate tax at a much higher rate than the standard company tax rate and includes stringent enforcement mechanisms. This means an investor may find themselves being charged a much higher rate of tax (plus interest and penalties) that can be difficult to challenge or credit against prior year losses or taxes charged by other countries. This increased risk and uncertainty may reduce their willingness to invest in New Zealand (compared to more certain investments elsewhere).

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: increased costs understanding the rules and applying them to transactions and structures for multinationals which currently engage in BEPS activities. Such taxpayers may choose to restructure which will involve compliance costs and the demand for APAs may increase.	Medium. However, they should only affect multinationals currently engaged in BEPS activities.	Medium
	Revenue	**$50 million per year**	Low*

Regulators	Administrative costs: Inland Revenue staff, particularly investigators and transfer pricing specialists, need to develop their knowledge of the proposals.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Revenue	**$50 million per year**	Low*
Non-monetised costs	Compliance costs Administrative costs	Medium Low	Medium High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Tax payable: we are confident of collecting a significant amount of revenue from the proposals. Reduced administrative costs: More powers to both request multinationals' offshore information and to investigate uncooperative multinationals should make investigating these types of BEPS arrangements easier.	**$50 million per year** Low	Low* High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	**$50 million per year**	Low*
Non-monetised benefits	Reduced administrative costs Improved voluntary compliance by supporting the integrity of the tax system in a high profile area.	Low Low	Low Low

*Note that the evidence for the $50 million figure is a conservative estimate made in light of the behavioural uncertainty associated with introducing transfer pricing and PE avoidance rules together with the fact that the full extent of these types of avoidance arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be significantly higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?
During consultation on the discussion document, some submitters raised concerns that adopting the proposed measures would have a detrimental impact on New Zealand being an attractive investment destination. In particular, these submitters were concerned that the proposed measures introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, thereby reducing GDP and lowering employment levels. The higher tax payments and compliance obligations resulting from these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, at the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded countries throughout the OECD. Given this, we believe any impacts on foreign direct investment into New Zealand will not be material and implementing these measures remains in New Zealand's best economic interests. It is also highly unlikely that foreign companies will remove their existing personnel from New Zealand as a result of these proposals. Most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?
Yes, option 4 (to adopt the package of measures in the discussion document) conforms to Government's 'Expectations for the design of regulatory systems'.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin* (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018.

One exception is a grandparenting rule that exempts from application of the rules all advance pricing agreements (APAs) existing prior to the application date.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider the planned application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we plan on meeting with taxpayers and preparing detailed guidance materials.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
In general, Inland Revenue monitoring, evaluation, and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. When the MAAL was introduced in Australia, 18 companies restructured their affairs to bring their sales onshore (and a further 11 are currently working with the ATO to restructure). We envisage a similar response to our proposals whereby a number of taxpayers will restructure their affairs to report their sales in New Zealand. We also expect more taxpayers to apply for APAs as a result of the new transfer pricing rules. However, it will be difficult to assess the true impact of the transfer pricing proposals. Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?
The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP. If it became apparent that an aspect of the proposed rules is significantly unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

Coversheet: BEPS – strengthening our interest limitation rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*The analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The problem the proposals discussed in this impact statement seek to address is the use of debt financing by taxpayers to reduce their New Zealand income tax liability significantly.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The adoption of a restricted transfer pricing rule for determining the allowable interest rate (for tax purposes) on related-party loans from a non-resident to a New Zealand borrower will help ensure interest rates on such loans cannot be excessive. In addition, changing the way deductible debt levels are calculated under the thin capitalisation rules will ensure that taxpayers with little equity are unable to have large amounts of deductible debt. These changes will provide a solution that is sustainable, efficient and equitable, while minimising impacts on compliance and administration costs.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that the new interest limitation rules are forecast to produce approximately $80–90 million per year on an ongoing basis. There are also efficiency and fairness benefits to these proposals which cannot be assigned to particular beneficiaries.

Where do the costs fall?
The costs primarily fall on foreign-owned taxpayers operating in New Zealand (though there may be some minor impacts on New Zealand-owned taxpayers with international operations). Tax payments for affected parties are forecast to increase by approximately $80–90 million per year on an ongoing basis.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
As with all tax rules, there is some risk of taxpayer non-compliance. However, this is mitigated as the rules predominately apply to large companies – and the tax affairs of large companies are closely monitored by Inland Revenue.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is moderate evidence in relation to the problem of excessive interest rates on related-party debt, and good evidence in relation to allowable debt levels. Inland Revenue has some data on interest rates paid on related-party debts, as well as examples of structures that appear to have the effect of increasing the interest rate on such debt. However, this data is not comprehensive. Inland Revenue has data on the debt, asset and equity levels of significant foreign-owned enterprises, which allows an accurate estimation of the impact of the non-debt liability adjustment for those firms.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *BEPS – strengthening our interest limitation rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the Quality Assurance criteria.

Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – strengthening our interest limitation rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy changes to be taken by or on behalf of Cabinet.
Key Limitations or Constraints on Analysis
Evidence of the problem While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire. This dataset includes debt levels, related-party debt levels, and related-party interest payments of large foreign-owned firms. However, there are still limitations to that data – for example, data on interest rates on related-party debt (and the interest rates facing a New Zealand subsidiary's parent company) is not captured in the Questionnaire. Where possible, this information was obtained from other sources (such as credit ratings of parent companies and disclosed related-party interest rates in financial statements) or estimated (for example, estimating interest rates based on related-party interest payments and related-party debt amounts). However, this other data is less comprehensive and accurate. **Consultation** The preferred option in relation to limiting interest rates on related-party interest rates has not been subject to consultation. This was because it was developed in response to submissions on the original proposals. However, it is similar in many respects to the original proposal, which was subject to consultation. In addition, to ensure the rule operates effectively and to mitigate the risk of unintended outcomes, it will be subject to consultation with submitters on the technical detail.
Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to tax planning strategies used by some multinational enterprises (MNEs) to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over MNEs not engaged in BEPS and domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter BEPS.

BEPS using interest deductions

The use of debt financing is one of the simplest ways of shifting taxable profits from one jurisdiction to another. For example, because interest payments are deductible, a related-party cross-border loan from a parent to a subsidiary can be used to reduce taxes payable in the jurisdiction that the subsidiary is located.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations. This includes developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4).

If no further action is taken, MNEs that currently have high levels of debt in New Zealand, or highly-priced related-party debt, will be able to continue paying little tax in New Zealand. There is also a risk that additional MNEs would adopt similar structures.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

New Zealand's tax system has been the subject of numerous broad-based reviews – most recently the Victoria University of Wellington Tax Working Group in 2010. It is well regarded and generally functions well.

No other government agencies have a direct interest in the tax system. However, a good tax system is important for a well-functioning economy – many government agencies therefore have an indirect interest in the tax system.

Foreign investment in New Zealand is generally taxed under our company tax at 28 percent. New Zealand's tax system has rules that limit the deductible debt levels and interest rates for taxpayers with foreign connections. These rules affect only foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Thin capitalisation rules

New Zealand has "thin capitalisation" rules to limit tax deductions for interests that non-residents are allowed. These rules generally require an investment owned by a non-resident to have a debt-to-asset ratio of no more than 60 percent (interest deductions are denied to the extent the allowable debt-to-asset ratio is exceeded).

Thin capitalisation rules also apply to New Zealand-owned firms (frequently referred to as the "outbound thin capitalisation rules"). These rules generally require a debt-to-asset ratio of no more than 75 percent. They are designed to prevent a disproportionate portion of a New Zealand company's debt being placed in New Zealand.

Like the tax system as a whole, we consider that the thin capitalisation rules are serving us well. The rules are well understood and taxpayers subject to the rules generally have conservative debt levels and, for those with related-party debt, the debt is at conservative interest rates – as evidenced by the significant amount of tax paid by foreign-owned firms operating in New Zealand (foreign controlled firms paid 39 percent of company tax in the 2015 tax year).

Transfer pricing rules

It is important to limit not just the quantum of debt in New Zealand, but also the interest rate on that debt. For third-party debt, commercial pressures will drive the borrower to obtain as low an interest rate as possible. However, these pressures do not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates. Broadly speaking (and as they apply to related-party debt), these rules seek to ensure that the interest rate on a given loan contract is in line with what would have been agreed between unrelated parties.

NRWT

While payments of interest to related parties are deductible, they are subject to non-resident withholding tax (NRWT). NRWT applies at either 15 percent or 10 percent, depending on whether New Zealand has a Double Taxation Treaty with the interest recipient's home jurisdiction. This means that, while the use of debt can reduce tax payable in New Zealand, it does not completely eliminate it.

2.3 What is the policy problem or opportunity?

A simple way that non-residents can reduce their New Zealand tax liability significantly is by capitalising a New Zealand investment with debt instead of equity, because they can then take interest deductions in New Zealand. This is shown in the example below.

> ***Example***
> *Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.*
>
> *Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.*

Having a generally well regarded tax system does not mean that tax changes are unnecessary. An on-going policy challenge is to ensure that our tax rules are up to date and ensure that MNEs are paying a fair amount of tax in New Zealand. Base protection measures – such as rules for limiting the amount of debt allowable in New Zealand, and the interest rate on that debt – are therefore important.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

This impact statement considers two related policy opportunities:

- ensuring the rules for setting the allowable interest rates on related-party debt are sufficiently robust; and
- ensuring the basis for setting the allowable debt level in the thin capitalisation rules is appropriate.

Scale of the problem

The OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan) included developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4). We consider the fact that the OECD has included profit shifting using interest in its BEPS Action Plan as evidence that this is a significant policy issue internationally.

As mentioned above, most MNEs operating here have relatively low levels of debt and do not have interest rates considered to be excessive. However, there are a small number of taxpayers with either debt levels that are too high, or interest rates that are excessive. While small in number, the fiscal impact of these arrangements is significant – we estimate the tax revenue lost is $80–90 million per year.

2.4 Are there any constraints on the scope for decision making?

There are no constraints on scope.

2.5 What do stakeholders think?

Stakeholders

The stakeholders are primarily taxpayers (in particular, MNEs) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules.

Consultation already undertaken

In March 2017, the Government released the discussion document *BEPS – strengthening our interest limitation rules*. The discussion document consulted on two key proposals which are considered in this impact statement – new interest limitation rules and a non-debt liabilities adjustment to the thin capitalisation rules.

The Government received 27 submissions on the discussion document. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

In general, submitters acknowledged the need to respond to BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, many submitters did not support the specific proposals put forward.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Interest limitation

The discussion document proposed moving away from a transfer pricing approach for pricing inbound related-party loans. Instead, the allowable interest rate for such a loan would – in most instances – be set with reference to the New Zealand borrower's parent's borrowing costs (referred to as an "interest rate cap").

General reaction

Most submitters argued that the interest rate cap proposal was not necessary and should not proceed. They noted that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm's length standard, so would result in double taxation;
- will increase compliance costs;
- will apply to firms with a low BEPS risk; and
- has no international precedent.

Only two submitters wrote in favour of the proposed cap. However, the proposal did attract positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.

Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".

Allowable debt levels

The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand ("deductible debt"). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer's assets (generally, debt up to 60 percent of the taxpayer's assets is allowable).

The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest-bearing debts (a "non-debt liability adjustment"). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

General reaction

Several submitters indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

A number of other submitters argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

Stakeholders' views displayed no clear pattern. Two big accounting firms agreed with the proposal while two others disagreed. Similarly, of the three major stakeholder groups who submitted on the proposal, one supported and two opposed the change.

Deferred tax

To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future;
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

Further consultation

Following Cabinet decisions in July 2017, officials are planning to undertake further public consultation on outstanding policy issues, technical design details and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Related-party interest rates

We have identified five mutually exclusive options to the address the problem of excessive interest rates on related-party debts.

Option 4 (administrative guidance) is a non-regulatory option. The other options for change involve changing New Zealand's tax legislation.

Option 1: Interest rate cap (discussion document proposal)

As described in section 2.5.

Option 2: Restricted transfer pricing

Under a restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
  - o That the loan has no exotic terms that are generally not seen with third-party lending
  - o That the loan is not subordinated
  - o That the loan duration is not excessive
  - o That the debt level of the borrower is not excessive.

The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

This restricted transfer pricing rule would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable.

This option was developed following consultation to address some of the concerns raised by submitters; however, it has not itself been subject to consultation.

Option 3: Adopt EBITDA-based rule (OECD recommended approach)

This option would involve limiting the amount of interest deductions a taxpayer is allowed with reference to their earnings (specifically, their profits before deductions for interest, depreciation and amortisation are taken into account, also known as their EBITDA). This new approach would completely replace the thin capitalisation rules, becoming the new method for limiting interest deductions for taxpayers with international connections.

This approach would constrain the tax effectiveness of highly priced debt, since it directly limits interest deductions rather than limiting the amount of debt; a taxpayer with highly priced debt would be more likely to exceed their EBITDA limit and face interest denial.

Almost all submitters did not support the adoption of an EBITDA-based rule.

Option 4: Administrative guidance

This option would involve Inland Revenue issuing administrative guidance on how it will assess the risk of related-party lending transactions – similar to what has recently been released by the Australian Taxation Office (ATO) (discussed below).

Under this option, related-party loans with certain features (such as having an interest rate in line with the interest rate facing the borrower's foreign parent) would be given a low risk rating and be unlikely to be challenged by Inland Revenue. Taxpayers with higher interest rates would be more likely to have their related-party loan investigated.

Several submitters suggested this option be adopted in place of the interest rate cap. They argued that it would provide certainty for taxpayers who desired it, but taxpayers who value certainty less would be free to breach the guidelines.

Option 5: Status quo (ordinary transfer pricing)

This option would involve continuing to price related-party debt under the transfer pricing rules. As discussed above, the Government proposed strengthening these rules in the discussion document *BEPS – transfer pricing and permanent establishment avoidance.* Many submitters argued that this should be sufficient to address any concerns over related-party interest rates.

Relevant experience from other countries

The ATO has released draft guidelines regarding the interest rates of cross-border related-party loans.[1] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

Allowable debt levels

We have identified three mutually exclusive options relating to setting the allowable debt level under the thin capitalisation rules.

The options (other than the status quo) involve changing New Zealand's tax legislation.

Option 1: Proceed with non-debt liabilities adjustment (as proposed in the discussion document)

As described in section 2.5.

Option 2: Proceed with non-debt liabilities proposal excluding deferred tax

Under this option, a taxpayer's deferred tax would be ignored for the purposes of the non-debt liability adjustment. That is, a taxpayer's allowable debt level would be set with reference to the result of the formula: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Of submitters who supported the proposed non-debt liability adjustment in principle, this was the preferred option.

Option 3: Status quo (do not proceed with non-debt liabilities adjustment)

Under this option, maximum deductible debt levels would continue to be calculated under the thin capitalisation rules with reference to assets, ignoring non-debt liabilities.

As mentioned in section 2.5, this was the preferred option of some submitters.

Relevant experience from other countries

Australia has thin capitalisation rules that are broadly similar to New Zealand's. Australia's rules currently require a non-debt liability adjustment, but deferred tax is carved-out. That is, Australia's rules are consistent with option 2.

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[1] ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions, PCG 2017/D4.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?
The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria: • *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible; • *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way; • *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible; • *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible; and • *Sustainability* – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved Efficiency, fairness and sustainability are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these three criteria.

3.3 What other options have been ruled out of scope, or not considered, and why?
No options were ruled out of scope.

Section 4: Impact Analysis

	Option 1 (interest rate cap)	Option 2 (restricted transfer pricing)	Option 3 (EBITDA-based rule)	Option 4 (administrative guidance)	Status quo
Efficiency and neutrality	+ Option 1 will provide a strong limit on related-party interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains. However, for some firms the interest rate allowed under the cap may be too low, which lowers the efficiency benefits.	++ Option 2 will provide a reasonably strong limit on related-party debt interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains.	**0** Option 3 will provide an effective limit on all interest expenses (including related-party interest expenses). However, it also increases the uncertainty of returns on New Zealand investment, since whether or not interest is deductible turns on a taxpayer's EBITDA, which can be very variable.	+ Some taxpayers would benefit from the certainty provided by the administrative safe harbour. However, for taxpayers willing to exceed the safe harbour, this option is no different than the status quo – excessive interest rates on related-party debt would still be possible.	**0**
Fairness and equity	++ Option 1 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	++ Option 2 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	**0** On the one hand, option 3 would be somewhat effective at preventing excessive interest rates. On the other hand, it could result in interest denial for firms with very conservative interest rates and debt positions (say, for example, if a taxpayer is in loss).	**0** Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. For taxpayers willing to exceed the administrative safe, harbour this option is no different to the status quo.	**0**
Efficiency of compliance	++ Option 1 would reduce compliance costs for many taxpayers – the allowable interest rate on related-party debt would be set on a clear objective factor (the credit rating of the foreign parent). However, in some cases – where the non-resident parent has no credit rating – compliance costs will stay the same or could potentially increase.	+ Option 2 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo)	**0** Compliance costs in some instances would reduce under option 3, as there would be fewer transfer pricing disputes about related-party debt. However, an EBITDA-based rule would be a fundamental shift in our interest limitation rules – taxpayers and agents would have to come to grips with an entirely new regime.	+ Option 4 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo).	**0**

Efficiency of administration	++ Option 1 would avoid the need for potentially complex and expensive disputes over whether the interest rate on related-party debt is set appropriate.	++ Option 2 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. For the remaining taxpayers, the restrictions (e.g. striking out exotic terms) would simplify the transfer pricing analysis.	+ Option 3 would reduce administration costs because there would be less need to review and challenge related-party loans under transfer pricing.	+ Option 4 would reduce the need to review the interest rates of taxpayers utilising the safe harbour.	**0**
Sustainability	+ Option 1 would apply to taxpayers that have structured their affairs to strip the maximum profits out of New Zealand; however, it could also affect the interest rates of less aggressive taxpayers.	++ Option 2 should generally only affect taxpayers with more aggressive debt structures.	**0** Option 3 could result in interest deduction denial even if a taxpayer has conservative debt levels.	+ Option 4 would not prevent firms from achieving excessive interest rates on related-party debt.	**0**
Overall assessment	+	++ **Recommended option**	**0**	+	**0**

Key:

++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Allowable debt levels

	Option 1 (non-debt liability adjustment)	Option 2 (adjustment with no deferred tax)	Status quo
Efficiency and neutrality	+ Option 1 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, submitters have argued that in some instances deferred tax (a type of non-debt liability) does not represent real liabilities; to the extent this is correct, reducing allowable debt levels in relation to these liabilities could hamper efficiency.	+ Option 2 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, this option carves out all types of deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option would allow some taxpayers to have too high a debt level.	**0**
Fairness and equity	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, submitters have argued that in some instances deferred tax does not represent a real liability. To the extent this is correct, including deferred tax in the non-debt liability adjustment could be seen as unfair.	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, this option excludes all deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option will not treat taxpayers in the same situation the same.	**0**
Efficiency of compliance	**0** Neither option will have a significant impact on compliance costs. The result of both options is just a change to how the existing thin capitalisation calculations are carried out. However, there may be some one-off compliance costs if the changes mean taxpayers breach their thin capitalisation limits and, as a result, decide to restructure their borrowing.		**0**
Efficiency of administration	**0** Neither option has a significant impact on administrative costs. Thin capitalisation calculations are carried out by taxpayers – this change has no substantive impact on Inland Revenue.		**0**
Sustainability	+ Both options similarly target firms with debt levels that are too high relative to their levels of equity and are therefore well targeted. Firms with low levels of debt, or with reasonable levels of debt relative to equity, will be largely unaffected by either option.		**0**
Overall assessment	+	+	**0**

Key: ++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Interest limitation

We consider that option 2 – developing a restricted transfer pricing approach – is the best option to limit interest expenses in relation to inbound related-party debt.

Following consultation and further analysis, we consider that if the Government pursued the interest rate cap (option 1), adjustments would be needed to the original discussion document proposal which would make it more complex. For example, to address some of the concerns expressed by submitters, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

The difficulty is, however, that simply relying on transfer pricing, as suggested by some submitters, will not achieve the desired policy outcomes. It is clear that the international consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. In addition, as noted in section 2.5, commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

Accordingly, we consider that the restricted transfer pricing rule is the best approach. Like the interest rate cap, it will ensure the policy objective – ensuring there is a robust mechanism for determining the interest rates for inbound related-party debt; however, since the restricted transfer pricing rule has more flexibility (compared to the interest rate cap – the other option that would most effectively achieve the policy objective) it is both more efficient and fairer.

Owing to the time available (and since it was developed subsequent to the initial consultation), this option has not been subject to consultation with stakeholders. This modification will address many, but not all of, submitters' concerns – it is still a departure from using ordinary transfer pricing. Nevertheless, we expect that it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur frequently because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

Allowable debt levels

At this stage, we do not have a preference between option 1 (non-debt liability adjustment as originally proposed) and option 2 (non-debt liability adjustment with deferred tax carve-out). Option 3 (status quo) is not preferred.

Both options 1 and 2 have similar impacts in terms of efficiency and fairness (and have no significant impacts in terms of compliance and administration costs). The non-debt liability adjustment in option 1 is potentially too extensive because of the inclusion of *all* types of deferred tax, but, on the other hand, the adjustment in option 2 is too narrow because of the exclusion of all deferred tax.

We consider that the best approach is to recommend neither options 1 or 2 at this stage, but instead consult further with stakeholders on whether there is another feasible option (since this is a minor technical detail, more consultation on this matter is feasible). For example, it might be possible to identify deferred tax liabilities that are the least likely to result in a future tax payment, and restrict the carve-out of deferred tax to just that identified group.

5.2 Summary table of costs and benefits of the preferred approach

Related-party interest rates

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40m per year	Medium
Regulators	Administration costs: There will be a one-off cost to Inland Revenue in developing guidance on how the new rules will operate.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40m per year	Medium
Non-monetised costs	Administration costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Reduction in compliance costs for firms that utilise safe harbour.	Medium	High
Regulators	Revenue: Tax collected will increase. Administration costs: Reduction in costs for ensuring related-party interest rates are appropriate.	Approximately $40m per year Medium	Medium High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40m per year	Medium
Non-monetised benefits	Compliance and administration cost reduction	Medium	High

Allowable debt levels

While a preferred option is not recommended, the costs and benefits of any option that is selected will be similar

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40–50m per year (depending on option)	High
Regulators			
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40–50m per year	High
Non-monetised costs			

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Tax collected will increase.	Approximately $40–50m per year (depending on option)	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40–50m per year	High
Non-monetised benefits			

5.3 What other impacts is this approach likely to have?
As discussed above, allowing BEPS through interest deductions is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take use interest deductions to reduce their New Zealand (and possibly worldwide) tax liability is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders. It is something that is fundamental to the tax system itself, which all of the stakeholders already discussed have an interest in preserving.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?
Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Implementation of both reforms (relating to related-party interest rates and allowable debt level) will be given effect through a combination of legislation and Inland Revenue administrative guidance. The legislative changes proposed will be progressed (subject to Cabinet approval) as part of a BEPS taxation bill to be introduced in late 2017. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin*.

In relation to the allowable debt level proposal, we will consult further with stakeholders on whether a preferred option can be identified. The Minister of Finance and Minister of Revenue will make the final decision on which option should be progressed (option 1, option 2, or a potential new option) following this consultation.

These reforms are expected to apply from income years beginning on or after 1 July 2018, subject to legislation progressing to enactment before this date.

Some submitters on the discussion document argued that transitional relief or grandparenting should be provided to give taxpayers sufficient lead-in time to restructure their affairs if necessary. We consider that the planned application date of 1 July 2018 is sufficiently prospective because:

- the interest rate proposal applies only to related-party transactions (which are more easily altered compared to transactions with third-parties); and
- in relation to the allowable debt level proposal, debt and asset levels under the thin capitalisation rules can be measured as at the end of the relevant income year, meaning taxpayers would have until at least 30 June 2019 to rearrange their affairs.

In addition, in response to consultation, we propose that advanced pricing agreements

(APAs) existing prior to the application date of these changes will be grandparented.

Once the proposals are implemented, Inland Revenue will be responsible for the ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

6.2 What are the implementation risks?

There is the risk that the relevant transfer pricing legislation could contain unintended errors or have unintended consequences. However, this risk can be efficiently managed by way of remedial amendments.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. Inland Revenue closely monitors the tax affairs of New Zealand's largest companies (which are, in general, the affected population of these proposals). For example, Inland Revenue currently collects data from these firms on their debt levels (including levels of related-party debt) through its International Questionnaire. This will allow how the proposals have impacted debt levels and related-party interest payments to be analysed.

More generally, Inland Revenue is considering the appropriate level of information that should be collected to support the proposed rules for all the BEPS measures being implemented. Any additional information may be collected via a disclosure statement that must be provided to Inland Revenue or it may be collected using existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTTP involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, following enactment, any changes identified as necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

Coversheet: BEPS - Hybrid mismatch arrangements

Advising agencies	*Inland Revenue, The Treasury*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
A tailored adoption of the OECD's BEPS Action 2 recommendations will comprehensively deal with the problem of hybrid mismatch arrangements while making modifications and variations to take into account what is appropriate for the New Zealand context. This tailored solution is sustainable and achieves gains to efficiency and fairness, while minimising compliance costs where possible. There will be a significant benefit in adopting a solution which is adopted by other countries and which will therefore be easier for multinational businesses to understand and comply with.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis. There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

Where do the costs fall?
Taxpayers that use hybrid mismatch arrangements will face a medium level of compliance costs. These may be up-front, in the form of restructuring costs to transition to more straightforward (non-hybrid) arrangements, or they may be ongoing in the case of taxpayers that keep their hybrid mismatch arrangements in place and must apply new tax rules in order to comply with the law.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is some risk of taxpayer noncompliance with the proposed rules. However, the risk of taxpayers being inadvertently caught by the proposed rules has been minimised due to the design of the preferred regulatory option which seeks to exclude the most simple offshore structures (foreign branches). More generally, the impacts have been reduced through the proposals taking into account the New Zealand context and adjusting the OECD-recommended rules as needed.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Not every type of hybrid arrangement that would be countered by the proposals has been observed in New Zealand. However, Inland Revenue is aware of some historic and current hybrid arrangements, and there is a very high likelihood there are others that relate to New Zealand and will be affected by this regulatory proposal.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the BEPS – hybrid mismatch arrangements Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS - Hybrid mismatch arrangements

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem Our analysis has been limited somewhat by our inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand. Inland Revenue is aware of some mismatch arrangements, but the full extent of the problem is unknown. This is because evidence of the problem primarily comes from Inland Revenue's investigations staff. Under current law these staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals. **Range of options considered** Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations. **Assumptions underpinning impact analysis** The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of hybrid mismatch arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.
Responsible Manager (signature and date):
   Paul Kilford Policy Manager, Policy and Strategy Inland Revenue 12 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinational groups to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter base erosion and profit shifting (BEPS).

Hybrid mismatch arrangements

Hybrid mismatch arrangements arise when taxpayers exploit inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. The OECD's BEPS package includes Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. Hybrid mismatch arrangements are prevalent worldwide and are an important part of the base erosion and profit shifting strategies used by multinational companies. If no action is taken by the international community to counter these types of arrangements they are likely to continue to be used to avoid worldwide taxation and drive economic inefficiencies and unfairly distributed tax burdens.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations.

In September 2016 the Government released a BEPS discussion document: *Addressing hybrid mismatch arrangements* which proposed adoption of the OECD Action 2 recommendations in New Zealand and sought submissions on how that should be done. In March 2017 the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*.

As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand. This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions.

At the same time, Cabinet noted that the reforms proposed in the BEPS documents would be progressed, subject to modification in consultation, for implementation from 1 July 2018. Cabinet also noted that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later in 2017.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

Company tax and international rules

The company tax system is designed to be a backstop for taxing the personal income of domestic investors. Company tax is deducted at 28%, but New Zealand based investors can claim imputation credits for tax paid by the company when the income is taxed upon distribution at the personal level. At the same time, the company tax is designed as a final tax on New Zealand-sourced income of foreign investors and foreign-owned companies earning New Zealand-sourced income.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge in the area of international tax is to ensure that multinational firms pay a fair and efficient amount of tax in New Zealand. Anti-avoidance rules and base protection measures are important part of ensuring that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

2.3 What is the policy problem or opportunity?

The problem of hybrid mismatch arrangements

Businesses can use hybrid mismatch arrangements to create tax advantages through exploiting inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. For example, using a hybrid entity or a foreign branch, a single expense may be deducted in two different jurisdictions, potentially reducing the tax payable on two different streams of income. Another example is a payment that is tax-deductible in one jurisdiction with no corresponding taxable income in the jurisdiction where the payment is received. However it is achieved, the result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates when compared with a straightforward arrangement that is seen consistently by both relevant countries. Hybrid mismatch arrangements also have the effect of subsidising international investment relative to domestic investment, which distorts the efficiency of global markets.

Since releasing its final recommendations on hybrid mismatch arrangements, the OECD expanded the scope of BEPS Action 2 to include branch mismatches. Branch mismatch arrangements are a result of countries approaching the allocation of income and expenses between a branch and a head office in different ways. Branch mismatch arrangements can also result in a reduction in the overall taxation of a corporate group, so are similar in effect to hybrid mismatch arrangements.

It is important to note that the policy problem is limited to circumstances when global tax is reduced as a result of a hybrid mismatch. This project does not address other mechanisms that taxpayers may use to lower their global tax liability, such as the use of low-tax jurisdictions to trap income.

Hybrid mismatch arrangements in New Zealand

New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the effects of a hybrid mismatch arrangement. However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way. Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements.

New Zealand also has some specific rules in its domestic law that go some way to addressing particular recommendations made by the OECD in relation to hybrid mismatch arrangements.

Inland Revenue is aware of a significant volume of hybrid mismatch arrangements involving New Zealand. For example, the amount of tax at issue in recent litigation for a prominent type of hybrid financial instrument was approximately $300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to the most prominent hybrid entity structure results in approximately $50 million less tax revenue for New Zealand per year.

2.4 Are there any constraints on the scope for decision making?

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Consistent with the OECD approach, the analysis has been focused on arrangements between related parties or where a hybrid mismatch has been created through a structured arrangement between unrelated parties.

We have also chosen to restrict the policy thinking to cross-border activity. Purely domestic hybrid mismatches (some of which are contemplated by the OECD Action 2 final report) are outside the scope of this regulatory proposal.

2.5 What do stakeholders think?

Stakeholders

Stakeholders of this regulatory proposal are primarily taxpayers (typically multinational businesses that have hybrid mismatch arrangements) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules. The proposed rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

Another stakeholder of this regulatory proposal is the OECD, which is aiming to eradicate hybrid mismatch arrangements to the extent possible. This goal can only be achieved through countries adopting hybrid mismatch rules of some kind and neutralising the mismatches that arise when different sets of rules apply to the same transaction or entity. In addition, other countries that have enacted or are proposing to enact hybrid mismatch rules (for example, Australia and the United Kingdom) will be interested in the interaction between their own hybrid mismatch rules and any rules that New Zealand introduce into law.

The Reserve Bank of New Zealand (RBNZ) is interested in the regulatory proposal to the extent that it affects bank regulatory capital.

Submissions to discussion document

There were 20 submissions made to the September 2016 Government discussion document. Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions of some variety. However, a greater number of submitters were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

Further and ongoing consultation

We have engaged in approximately a dozen workshops (with the Corporate Taxpayers Group and Chartered Accountants Australia and New Zealand) and attended various other meetings with private sector submitters (including the New Zealand Bankers' Association) in order to discuss specific design issues relating to hybrid mismatch arrangements.

We have also consulted with officials representing Australia and the United Kingdom, as well as the OECD secretariat, on an ongoing basis to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation.

We have also consulted with the Reserve Bank.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Section 3: Options identification

3.1 What options are available to address the problem?

Four options were considered in the development of this regulatory proposal. These options are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) New Zealand aligns itself with the OECD recommendations in dealing with hybrid mismatch arrangements.

None of the options (with the exception of the status quo option) are non-regulatory options. This is because our judgment is that the policy problem of hybrid mismatch arrangements cannot be addressed without changing tax rules, and that is something that can only be done through the use of legislation (as per section 22(a) of the Constitution Act 1986).

These options are what we consider other countries dealing with hybrid mismatch arrangements will consider in their policy development process. The United Kingdom and Australia can both be said to have chosen their own version of option 2. Some other countries have had rules to deal with hybrid mismatches that predate the OECD's work in this area.

Status quo: No action

This option relies on New Zealand's existing law (including the GAAR) to counter hybrid mismatch arrangements and avoids the increased compliance costs and administrative costs of the other options. The status quo option also contemplates that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to New Zealand.

Option 1: Strict adoption of OECD recommendations

The OECD recommendations as set out in its BEPS Action 2 report are a comprehensive set of principle-based rules to counteract all types of hybrid mismatch arrangements. Option 1 is to strictly adopt those recommendations as described by the OECD into New Zealand domestic law. This option would deal with the range of hybrid mismatch arrangements targeted by the OECD to the extent they are found in or affect New Zealand. It would have the advantage of interacting well with other countries that similarly adopt the OECD recommendations into their domestic law.

Option 2: Tailored adoption of OECD recommendations

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the New Zealand context. This option bears close relation to Option 1 as it involves introducing OECD-consistent hybrid rules unless there is a compelling reason to depart from the OECD approach. Thus, this option would solve the policy problem while ensuring that particular New Zealand issues are addressed.

Option 2 also recognises that there are some instances where New Zealand's existing tax laws are sufficient (or can be made sufficient with relatively minor amendment) to achieve the effect intended by an OECD recommendation.

Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid enacting rules targeted at arrangements which are not currently seen in New Zealand.

Consultation

These four options were identified prior to consultation. The September 2016 discussion document proposed adoption of the OECD recommendations (options 1 and 2) and sought feedback on how that should be done. The document stated the Government's alternative options as option 3 and maintaining the status quo and concluded that they were not the best way forward. Consultation has affected the nature of option 2 in particular and has been helpful for options analysis generally.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible
- Neutrality – the tax system should bias economic decisions as little as possible
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality and fairness impacts without some increase in compliance costs and so there are some trade-offs that were and continue to be considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

We ruled out designing a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This is for reasons of international compatibility and to save compliance costs.

Section 4: Impact Analysis

	Status quo: No action	Option 1: Strict adoption	Option 2: Tailored adoption	Option 3: Targeted rules
Efficiency of compliance	**0**	- - Option 1 has a significant compliance burden because some of the OECD recommendations as drafted would not mesh well with New Zealand's existing tax laws.	- Option 2 imposes increased compliance costs on taxpayers and advisors, but is focused on reducing those costs where possible.	- Option 3 imposes increased compliance costs on taxpayers and advisors, but by its nature it reduces those costs in proposing rules that only address currently observed exploitation of hybrid mismatches.
Efficiency of administration	**0**	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.
Neutrality	**0**	++ Option 1 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	++ Option 2 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	+ Option 3 will remove the tax benefit of currently observed hybrid mismatch opportunities involving New Zealand. This will likely provide some efficiency gains. However, other hybrid mismatch arrangement opportunities will remain available. This means that, depending on the extent to which taxpayers respond to an option 3 approach by simply moving into "uncovered" tax-efficient hybrid structures, there will still be some inefficient allocations of investment due to ongoing hybrid mismatch arrangements.
Fairness and equity	**0**	+ Option 1 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 2 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 3 has fairness and equity benefits as it ensures that taxpayers able to use currently observed hybrid mismatch arrangements cannot reduce their tax liability. However, this option's fairness impact depends on the behavioural effects of introducing these rules to a greater extent than options 1 and 2.
Sustainability	**0**	++ Option 1 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	++ Option 2 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	+ Option 3 will remove currently known hybrid mismatch arrangement opportunities involving New Zealand. However, this option's sustainability is limited. It will leave some hybrid mismatches unaddressed, which may be exploited at a later date by opportunistic taxpayers.
Overall assessment	Not recommended	Not recommended	**Recommended**	Not recommended

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 2 is the best option for addressing the problem of hybrid mismatch arrangements. It is an internationally consistent, proactive option which delivers net benefits to New Zealand greater than that of the other options considered.

Option 2 will improve the neutrality of New Zealand's tax system. Businesses that are able to exploit hybrid mismatch arrangements can currently operate at lower effective tax rates when compared with other businesses. This can result in a 'hybrid' business crowding out more productive investment and making international investment decisions based on whether a mismatch is available rather than commercial grounds. In addition, the imposition of higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrid mismatches is likely to be less efficient than imposing more moderate taxes across all economic actors. By eliminating the tax benefit of hybrid mismatch arrangements in a comprehensive way, these inefficiencies can be removed.

In a related sense, option 2 will help to improve the equity and fairness of the New Zealand tax system. Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally.

Option 2 will also have revenue collection benefits. The New Zealand tax revenue loss caused by the use of hybrid mismatch arrangements is difficult to estimate because the full extent of arrangements involving New Zealand is unknown and because the behavioural effects of introducing hybrid mismatch rules are difficult to ascertain. However, the tax revenue at stake is significant in the cases that Inland Revenue is aware of.

Importantly, the case for New Zealand to adopt the OECD recommendations is strengthened by the fact that other countries have enacted, or are proposing to enact, hybrid mismatch rules. This is because a hybrid mismatch arrangement involving a New Zealand counterparty may still be neutralised by the other country if they have a 'secondary' right to counteract under OECD principles. In that case, the tax benefit of the hybrid mismatch would be eliminated, but the tax collected would be by the counterparty country. In these circumstances, New Zealand would be better off having its own hybrid mismatch rules so that it can collect revenue when it has the priority to do so under the OECD recommendations. Whether New Zealand or the counterparty country collects any additional revenue as a result of implementing the rules depends on the actions taken by the affected business.

Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as "unstructured imported mismatches". This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

Accordingly, the compliance costs of the regulatory proposal are to be minimised to the extent possible, while still introducing a comprehensive set of rules to deal with the range of OECD-identified hybrid mismatches. This is where option 2 shows its advantage over option 1 which we view as having similar efficiency, fairness and revenue benefits. Option 1 would result in relatively higher compliance costs because the OECD recommendations are designed as a general set of best-practice rules and, in regards to their detail, are not necessarily optimal for individual countries such as New Zealand. When compared with option 1, option 2 ensures that the rules are workable and appropriate for the New Zealand tax environment.

It is also important to note that the ongoing compliance costs relating to this regulatory issue are expected to be optional in the majority of cases. The proposed rules will apply to taxpayers who use a hybrid mismatch arrangement after the rules become effective. Those taxpayers will generally have the option of incurring one-off costs to restructure into non-hybrid arrangements and remove themselves from the scope of the proposed rules.

Any higher tax payments resulting from the non-status quo options will make cross border investment less attractive for taxpayers using hybrid mismatch arrangements. However, these taxpayers should not be allowed to exploit hybrid mismatches to achieve a competitive advantage over taxpayers that do not use hybrid mismatch arrangements (such as purely domestic firms). Further, a significant number of New Zealand's major investment partners have introduced or will introduce hybrid mismatch rules. Other countries adopting these rules means that in many cases the tax efficiency of hybrid mismatch arrangements in New Zealand will be negated through the operation of the other country's rules on the counterparty, As a result, we believe that any impacts on inbound and outbound cross border investment from introducing hybrid mismatch rules in New Zealand will be low.

The status quo option would involve the least complexity and lowest compliance costs. However, similar to the cross-border investment discussion above, taxpayers whose groups deal with New Zealand's major trading partners that are adopting hybrid mismatch rules would have to understand the impact of those rules. The additional complexity of New Zealand having hybrid mismatch rules would therefore be lessened by the international momentum in this area.

Option 3 is an option that was preferred by many submitters to the Government discussion document on hybrid mismatch arrangements. Submitters pointed out that many of the structures considered by the OECD to be problematic have not been seen in New Zealand and therefore do not need to be counteracted. They also argued that the OECD recommendations are complex and have the potential for overreach. We do not think a targeted approach would serve New Zealand well when compared with option 2. The OECD recommendations are a coherent package intending to deal to the problem of hybrid mismatch arrangements exhaustively. Deliberately omitting aspects of the recommendations from New Zealand's response may cause taxpayers to exploit those remaining hybrid mismatch opportunities (which may even be seen as tacitly blessed). To the extent that happens, the efficiency, revenue, and fairness benefits of option 3 would be eroded. In

addition, other countries such as the United Kingdom and Australia have introduced or are intending to introduce a relatively comprehensive set of hybrid mismatch rules. If New Zealand does the same it will ensure our rules are internationally comparable and that they interact well with the rules of other countries without significant compliance issues. By favouring option 2, we also have consulted extensively on the OECD recommendations and how they should best be introduced into New Zealand law. This consultation has enabled us to design suitable modifications to the OECD recommendations to reduce complexity and compliance costs, limit overreach, and in some cases, increase the efficiency of the outcomes.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Increased costs from understanding the rules and applying them to taxpayers' transactions and structures. Or, restructuring costs of transitioning to non-hybrid arrangements to fall outside the scope of the rules.	Medium	Medium
	Tax payable: Foreign hybrid entity double deduction structures are included in the rules and we are confident of collecting a significant amount of revenue from the disallowance of that type of hybrid mismatch arrangement.	Approximately $50 million per year on an ongoing basis	Low*
Regulators	Administrative costs: Inland Revenue staff, particularly investigations staff, need to develop their knowledge of the hybrid mismatch rules.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised	Compliance costs	Medium	Medium

costs	Administrative costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Revenue collected from tax payable item described above.	Approximately $50 million per year on an ongoing basis	Low*
	Reduced administrative costs: Less investigations and disputes resources spent on hybrid mismatch arrangements using the general anti-avoidance law (GAAR).	Low	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised benefits	Reduced administrative costs	Low	High

*Note that the evidence for the $50 million figure is strong, but it is a conservative estimate made in light of the behavioural uncertainty associated with introducing hybrid mismatch rules together with the fact that the full extent of hybrid mismatch arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?

As discussed above, allowing the use of hybrid mismatch arrangements is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders as it is something that is fundamental to the tax system itself.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 2 (tailored adoption of OECD recommendations) conforms to the expectations for the design of regulatory systems document.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its Tax Information Bulletin (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018. The major exceptions are:

- the proposed rule for "unstructured imported mismatch arrangements", which we recommend be delayed until income years starting on or after 1 January 2020; and
- the proposed rules applying to New Zealand "reverse hybrids", which we recommend be delayed until income years starting on or after 1 April 2019.

Another exception we recommend is a grandparenting rule that exempts from application of the rules (until the next call date) hybrid financial instruments issued by banks as regulatory capital (in Australian or New Zealand) to third party investors before the discussion document release date of September 2016.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider an application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. Audit staff will need to familiarise themselves with the proposed rules and how they operate in practice. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their hybrid mismatch arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we are minimising compliance costs where possible under our tailored adoption of the OECD recommendations. For example, and as mentioned above, we have delayed the application date of the unstructured imported mismatch rule contained in the OECD recommendations to acknowledge that it would be significantly more difficult and costly to comply with than the other rules if it applied at the outset.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. However, it may be difficult to assess the true impact of this regulatory proposal. This is because many taxpayers using hybrid mismatch arrangements may rearrange their affairs to fall outside the scope of the proposed rules. It will be difficult to measure the full extent of this behavioural effect. Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?
The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP. If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

Impact Summary: Hybrids/NRWT issue

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
This analysis has been limited by the following factors: • The scale of the problem (in terms of its fiscal costs) has not been accurately identified because it will depend on the behavioural response of taxpayers, which may in turn be informed by work currently being undertaken by Inland Revenue. • No consultation with external stakeholders (including those who would be affected by the proposed action).
Responsible Manager (signature and date):
Paul Kilford Policy and Strategy Inland Revenue 22 November 2017

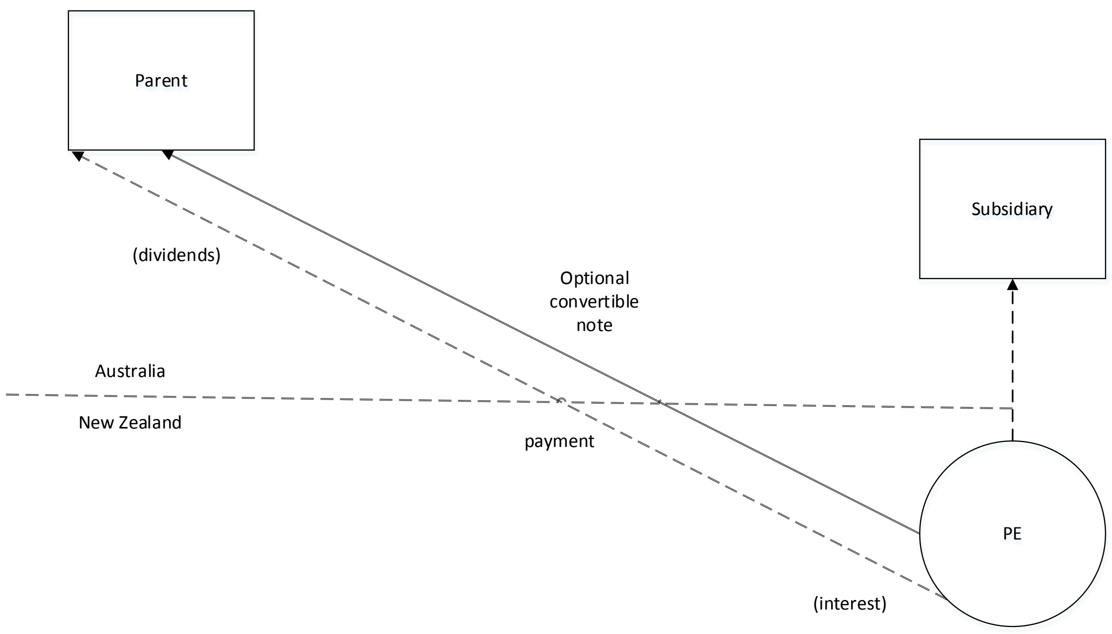
Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

The problem identified arises only in a very specific set of fact circumstances:

- There is a New Zealand branch or "permanent establishment" (PE) of a non-resident company;
- That PE borrows money from another non-resident in the same overseas jurisdiction as the PE's corporate residence;
- The borrowing takes place under a "hybrid" instrument which means it is treated as one form of financing (debt) by New Zealand, but another form of financing (equity) by the other country.

An example is set out in the diagram below.



The view until now of Inland Revenue and many taxpayers has been that New Zealand can withhold non-resident withholding tax (NRWT) on the payments. However, some taxpayers have disputed this view and as a consequence Inland Revenue is currently reconsidering whether it is legally correct. Inland Revenue has sought Crown Law's advice, and has indicated that it may well decide the law does not permit NRWT to be withheld. This interpretation is based on a view that the payments are dividends for the purposes of our double tax agreements (DTA).

Because double tax agreements over-ride domestic law, this view would, if adopted, mean that the taxpayer would be entitled to an interest deduction in New Zealand for the payments (because New Zealand treats the payments as interest), but the payments would not be subject to NRWT (because the other country and the DTA treat them as dividends). This is contrary to the intent of the provisions, as deductible outbound interest should always have

NRWT (or its alternative, approved issuer levy (AIL)) withheld unless there is a specific exemption providing otherwise.

The hybrid mismatch measures already proposed and approved by Cabinet (and covered by the regulatory impact analysis: http://taxpolicy.ird.govt.nz/sites/default/files/2017-other-beps-20-ria-hybrids-july-2017.pdf) would ensure that payments made under such hybrids could not be both deductible in New Zealand and non-assessable overseas. In some circumstances the measures would still allow a deduction in New Zealand for the payments. However the measures do not cover whether NRWT must be withheld from such payments. Consequently, the currently proposed hybrid measures would still permit payments under a hybrid financial instrument to be deductible in New Zealand, but not subject to NRWT. This contrasts with the tax treatment of dividends, which are not deductible. It also contrasts with the tax treatment of ordinary interest, which is deductible but subject to NRWT (or AIL).

As a result of this, the currently proposed hybrid mismatch measures would remove the incentive to use these types of hybrids in most, but not all cases. The hybrids could still be attractive if the non-resident was not concerned about the assessability of the payments in its home jurisdiction. For example, if the non-resident had tax losses, was tax exempt, or simply preferred to pay tax in its home jurisdiction (as most Australian companies do due to their imputation system).

If no action is taken, Inland Revenue's changed interpretation could therefore expose the New Zealand tax base to significant risk. It is difficult to estimate the fiscal risk, as it depends in part on taxpayers' behaviour, and in part on whether section BG 1 would apply to counteract the arrangements (section BG 1 may apply to some arrangements but not others). The risk is in two parts: a risk that $60 million of previously paid NRWT or AIL might be refunded in the near term, and an ongoing risk that $15 million per annum of NRWT or AIL might no longer be payable. Both risks could materialise as a fiscal cost against existing baselines. Addressing the problem will increase baselines by $1 million per annum on a go forward basis, relative to the status quo.

2.2 Who is affected and how?

The only taxpayers affected are those that enter into the structure illustrated in the response to question 2.1 above. However, as far as Inland Revenue is aware, many of the taxpayers that use these structures already pay NRWT or AIL in accordance with the policy intent. As a result, for most affected taxpayers, any change in the law to align with the policy intent would only reaffirm Inland Revenue's pre-existing legal interpretation – and so would not involve the imposition of additional tax or compliance costs compared with their current position. However, the proposed approach would stop some of these taxpayers from claiming a tax refund for the NRWT or AIL they paid in previous years if Inland Revenue's interpretation changes. It would also stop some of them from ceasing to pay AIL or NRWT in future years.

A small number of taxpayers have disputed Inland Revenue's current legal view and not paid NRWT or AIL. These taxpayers would be affected by the proposed change, as they would now be required to pay NRWT or AIL. However, this is the outcome we want to achieve with the proposed change, as the policy intent is for all taxpayers to be subject to NRWT or AIL on cross border deductible interest payments (unless there is a specific exemption providing otherwise).

2.3 Are there any constraints on the scope for decision making?

Limitations in respect of stakeholder engagement are set out in section 5, below.

The scope of this problem is limited by the extremely narrow fact-pattern identified.

The proposed regulatory action has two major interdependencies:

BEPS and hybrids

The current problem with the NRWT rules only arises for hybrid mismatch arrangements.

Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that create a tax advantage by exploiting differences in the tax treatment of an entity or instrument under the laws of two or more countries. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

In July 2017 the Government announced that it would comprehensively adopt the OECD's hybrid mismatch recommendations, with suitable modifications for the New Zealand context. In addition to the regulatory impact analysis referred to in response to question 2.1, the relevant Cabinet papers can be found at:

- http://taxpolicy.ird.govt.nz/sites/default/files/2017-other-beps-13-cabinet-paper-overview-july-2017.pdf (which covers the BEPS package more broadly); and

- http://taxpolicy.ird.govt.nz/sites/default/files/2017-other-beps-19-cabinet-paper-hybrids-july-2017.pdf (which is specific to the hybrids proposals).

The hybrids work is a relevant interdependency because it establishes that Cabinet wished to "… send the clear message that using hybrid mismatch arrangements should not produce a tax advantage …" (see paragraph 7 of the hybrids-specific Cabinet paper linked above).

Therefore, we consider that addressing the problem identified in this Impact Summary is consistent with bringing into effect the outcome clearly desired by Cabinet for hybrid mismatches.

As explained in 2.1 above, however, the existing hybrids measures still allow for cross border financial instruments to carry payments which are deductible in New Zealand, but not subject to NRWT. Accordingly, the proposed measure would supplement the existing hybrids measures by cancelling a further hybrid mismatch tax advantage.

NRWT amendments

New Zealand has recently reviewed and updated its rules related to NRWT and its alternative, AIL.

These reforms were enacted as part of the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017. The relevant Regulatory Impact Statement can be found at: http://taxpolicy.ird.govt.nz/publications/2016-ris-archcrm-bill/nrwt-related-party-and-branch-lending-nrwt-changes

As set out in paragraph 26 of that document, the objective of the reforms was to "… ensure the return received by a non-resident lender from an associated borrower (or a party that is economically equivalent to an associated borrower) will be subject to NRWT and, at a time, that is not significantly later than when income tax deductions for the funding costs are available to the borrower."

In the structure that is the subject of this Impact Summary, the potential outcome is that a taxpayer will (absent the proposed measure) be entitled to a deduction but have no corresponding NRWT liability. This is contrary to the stated policy objective.

Accordingly, the proposed measure supplements the previous NRWT amendments by ensuring that NRWT cannot be avoided for deductible interest payments on hybrid instruments.

Section 3: Options identification

3.1 What options have been considered?
We have considered four options, three of which involve addressing the identified problem by ensuring that NRWT applies in all instances where a deduction is allowed in New Zealand for an interest expense and for this outcome to occur notwithstanding the effect of our double tax agreements (the "policy solution"). However, they differ in their proposed application date. The four options are: • *Option 1:* The status quo, which would allow Inland Revenue to finalise its legal view and allow that view to prevail on all existing and future arrangements. This would likely result in the problem identified in 2.1 continuing. • *Option 2:* Provide that NRWT or AIL applies to any deductible interest payment with a New Zealand source (the policy solution). The policy solution would have prospective effect. • *Option 3:* Enact the policy solution retrospectively to the earliest date from which taxpayers can claim refunds for AIL or NRWT overpayments. • *Option 4:* Enact the policy solution retrospectively to the earliest date from which taxpayers can claim refunds for AIL or NRWT overpayments, but also include a "savings" provision for taxpayers that have already adopted the position that NRWT or AIL is not payable prior to the Bill containing the policy solution being introduced. Currently the potential non-applicability of NRWT or AIL arises under New Zealand's DTAs. DTAs are incorporated into New Zealand law under the Income Tax Act 2007, which states that DTAs have effect notwithstanding any other provision of that Act (subject to some exceptions). Accordingly, the policy solution would need to expressly override our DTAs in the amending legislation. We note that Australia already has a rule that legislates the policy solution, including an express DTA override. **Criteria** The four options are assessed in this Impact Summary against the following criteria: • **Economic efficiency** - the tax system should, to the extent possible, apply neutrally and consistently to economically equivalent transactions. This means the tax system should not provide a tax preferred treatment for one transaction over another similar transaction or provide an advantage to one business over another. This helps ensure that the most efficient forms of investment which provide the best returns to New Zealand as a whole are undertaken. At the same time there is a concern that taxes should not unduly raise the cost of capital and discourage inbound investment. • **Fairness** - the options should ensure that the law is seen as treating people fairly and consistently and should not allow people to avoid their tax obligations (including any foreign tax obligations). • **Integrity of the tax system** – the options should collect the revenue required in a transparent and timely fashion while not providing opportunities for tax avoidance or arbitrary tax reductions

Analysis

In the following options analysis, an option having a fiscal risk is seen as a negative. However, this will not automatically disqualify the option. There are times when changing the law will have a fiscal cost or risk for the Government, but this is nevertheless desirable because of the gains in one or more of the other assessment criteria.

Option 1 – not preferred

We consider that the policy solution is preferable to the status quo.

The status quo will likely mean that a PE would be entitled to an interest deduction in New Zealand for payments on certain hybrid instruments (as the payments are characterised as "interest" under New Zealand domestic law), but the payments would not be subject to NRWT (as the payments are characterised as "dividends" under the DTA). This is contrary to the intent of the relevant DTA provisions, as outbound interest, which is deductible in determining the profits of a PE, should always have NRWT withheld unless there is a specific exemption providing otherwise (e.g. the sovereign wealth fund exemptions provided in some of our DTAs). It also exposes the New Zealand tax base to a fiscal risk, as it allows a deduction from New Zealand tax for a payment without a corresponding tax liability for the recipient. Accordingly, the status quo negatively affects the integrity of the tax system.

The general anti avoidance rule in section BG 1 might still apply to some of the arrangements using these kinds of hybrid instruments, in which case NRWT or AIL would still need to be paid. However, there is a high risk that section BG 1 would not apply to other arrangements we are aware of.

In addition, the status quo option negatively affects both fairness and economic efficiency. This is because it would give a competitive advantage to a multinational firm that uses the relevant funding structure over a domestic firm or another, more compliant, multinational. This is contrary to the objectives of the BEPS work more generally and the hybrids project in particular.

Under the status quo option, Inland Revenue's changed interpretation could expose the New Zealand tax base to significant risk. It is difficult to estimate the fiscal risk, as it depends in part on taxpayers' behaviour, and in part on whether section BG 1 would apply to counteract the arrangements (section BG 1 may apply to some arrangements but not others). The risk is in two parts: a risk that $60 million of previously paid NRWT or AIL might be refunded in the near term, and an ongoing risk that $15 million per annum of NRWT or AIL might no longer be payable. Both risks could materialise as a fiscal cost against existing baselines. Addressing the problem will increase baselines by $1 million per annum on a go forward basis, relative to the status quo.

Option 2 – not preferred

This option would address the policy issue identified in 2.1. It would also have advantages in terms of fairness, economic efficiency and the integrity of the tax system compared with the status quo option (by eliminating the status quo's disadvantages in these regards). However, these advantages would only arise for future income years. Taxpayers who used the relevant hybrid structure in previous income years may be entitled to request a refund of the

NRWT or AIL they previously paid.

We consider that it would be unfair to allow taxpayers to claim refunds of their previously paid AIL or NRWT in these circumstances. It would also reduce the integrity of the tax system. It is clear that NRWT / AIL was intended to be payable on cross border interest payments. This was also Inland Revenue's interpretation of the law until now, which was followed by many taxpayers. The ability of some taxpayers to avoid NRWT AIL through the use of a hybrid instrument is a clear loophole in the current rules, and taxpayers aware of the issue would have perceived it as such. Accordingly, we consider there should be no legitimate expectation for taxpayers to obtain a refund for any AIL or NRWT previously paid in respect of these hybrid instruments.

We estimate that there is a potential one-off fiscal risk of $60 million under this option. This is because taxpayers that are known to use this structure may be able to obtain refunds of their previously paid AIL/NRWT under this option if Inland Revenue changes its current legal interpretation (and the previously paid NRWT or AIL has been included in the fiscal baseline),.

This option would also give rise to a potential $1 million per annum fiscal benefit compared with the current baseline. This is because taxpayers in active disputes would be required to pay $1 million of NRWT in future tax years if the policy solution was implemented (and this $1 million has not been included in current fiscal baselines).

Option 3 – not preferred

Option 3 would address the policy issue in 2.1. As a retrospective measure, it would also stop taxpayers from claiming a refund for any previously paid NRWT or AIL. Accordingly, it is preferable to option 2 as it has advantages in terms of fairness, economic efficiency and integrity of the tax system, over the status quo option in respect of both future and past income years. This option also has the lowest potential fiscal risk of all the options (equal with option 4).

This option also has the largest potential fiscal benefit. This is because, in addition to the fiscal benefit of option 2 in respect of future income years, this option would also require the taxpayers that have disputed Inland Revenue's current legal interpretation to pay NRWT in respect of past tax years in the event that Inland Revenue's current legal interpretation changes. This NRWT has not been included in the current fiscal baselines. Accordingly, this gives rise to an additional potential one-off fiscal benefit of approximately $5 million.

However, this option would also retrospectively change the law for those taxpayers who have already taken the position that NRWT or AIL was not payable and entered into disputes with Inland Revenue. This would be fair, as different taxpayers in the same position would be treated the same. In addition, excluding taxpayers who have taken an aggressive tax position from the retrospective application of the rules seems to reward them for their aggressive behaviour.

However, there is a wider issue of legal certainty involved. If Parliament retrospectively changes a law taxpayers have relied on, then this means taxpayers can never fully rely on the law (as stated at the time) in any dispute with the Government. This would erode the integrity of the tax system from a wider perspective. It would also erode perceptions of fairness, in that the Government might be perceived as misusing its legislative power to win a dispute with taxpayers.

Option 4 – preferred

This option addresses the policy problem set out in 2.1. It also has fairness, economic efficiency and integrity of the tax system advantages over the status quo option in respect of both future and past income years. Although this option is slightly less fair than option 3, it best supports the integrity of the tax system. This is because it prevents taxpayers from claiming refunds for previously paid NRWT or AIL, while preserving the legal position of taxpayers that previously adopted the position that NRWT or AIL was not payable prior to the introduction of the Bill containing the policy solution.

This option would also give rise to a potential fiscal benefit of $1 million per annum compared with current baseline. This is because taxpayers that are still disputing Inland Revenue's current position would be required to pay $1 million of NRWT in future tax years (and this $1 million has not been included in current fiscal baselines).

We note that this option does have a smaller potential fiscal benefit than option 3, as it does not require taxpayers disputing Inland Revenue's current legal interpretation to pay NRWT in respect of past tax years. We estimate the reduced potential fiscal benefit to be approximately $5 million.

3.2 Which of these options is the proposed approach?

We consider Option 4 to be the best option. This option addresses the policy problem set out in 2.1. It also has advantages, in terms of fairness, economic efficiency and the integrity of the tax system, over the status quo option in respect of both future and past income years. Although this option is less fair than option 3, it best supports the integrity of the tax system. This is because Option 4 prevents taxpayers from claiming refunds for previously paid NRWT or AIL, while preserving the legal position of taxpayers that previously adopted the position that NRWT or AIL was not payable prior to the introduction of the BEPS Bill. Accordingly it addresses the policy problem without the drawbacks of options 2 and 3.

Option 4 also has the lowest equal fiscal risk. However, it lacks Option 3's potential one-off $5 million fiscal benefit. Even so, we consider the lack of this fiscal benefit is outweighed by the importance of protecting the integrity of the law from a wider perspective.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties	The proposed approach removes the ability of taxpayers to avoid NRWT or AIL for future periods. It does not change the previously adopted position for past periods. We are aware of several taxpayers who have entered into the hybrid structure set out in 2.1. We have calculated the fiscal costs based on these taxpayers. If there are further taxpayers, then the impact will be increased. We do not expect there to be other taxpayers with a significant value of such hybrid structures, but we cannot confirm this. We note that many taxpayers already pay NRWT and AIL under the current rules. Accordingly the proposed approach will not increase their costs compared with their current position. However it will deprive them of a future cost saving if compared with the status quo option if Inland Revenue changes its legal view.	A potential $16m per annum cost arising from additional NRWT or AIL for future years compared with doing nothing if Inland Revenue changes its legal view. A potential one off $60m cost arising from the denial the NRWT or AIL refunds which taxpayers may be entitled to for past years if Inland Revenue changes its legal view and no action is taken.
Regulators	No material administrative costs for Inland Revenue.	-
Wider government	No costs.	No costs
Other parties	Not applicable	Not applicable
Total Monetised Cost		For regulated parties, a potential cost of 16m of NRWT or AIL per annum plus a potential cost of $60m in respect of possible refunds for past years compared with doing nothing.
Non-monetised costs	None we are aware of.	None

Expected benefits of proposed approach, compared to taking no action		
Regulated parties	The regulated parties will be required to pay NRWT or AIL regardless of whether they enter into hybrid structures. This will be a cost for taxpayers that have entered into such structures. However it will be a benefit for other taxpayers, as it will ensure that taxpayers who have entered into such structures cannot obtain a competitive advantage over domestic firms and more compliant multinationals. Accordingly the proposed approach will improve economic efficiency.	No monetary value
Regulators	With the proposed law change, Inland Revenue will not need to consider whether the general anti-avoidance rule in section BG 1 applies to any of the arrangements (other than taxpayers not subject to the retrospective application of the rule). It can be difficult and resource intensive to consider the application of section BG 1. Accordingly the proposed approach will save Inland Revenue administrative costs, and potentially court costs. However these are impossible to quantify at this stage.	Too difficult to quantify
Wider government	The Government will be able to collect NRWT or AIL from all deductible cross border interest payments, in accordance with the policy intent. This will potentially save the Government up to $60m in one off costs for past years (in respect of refunds for previously paid NRWT or AIL), and 16m per annum for future years.	A potential $60m one off benefit. A potential $16m benefit per annum going forward.
Other parties	Not applicable	Not applicable
Total Monetised Benefit	The total monetised benefit for the Government mirrors the total monetised cost for taxpayers.	A $60m one off potential benefit for the Government, plus a potential $16m per annum benefit for the Government going forward.
Non-monetised benefits	Administrative savings, as the Government will not have to consider the application of section BG 1 to most arrangements. Economic efficiency benefits from an equal application of NRWT to all cross border interest payments.	Medium

4.2 What other impacts is this approach likely to have?

The proposed approach involves the third explicit override of New Zealand's DTAs in recent years. Accordingly, it may arouse concern that New Zealand does not respect its DTAs.

However, the proposed approach confirms the interpretive approach previously adopted by NZ, and currently adopted by some of our DTA partners and mirrors a rule already in place in Australia. It also closes a clear loophole if Inland Revenue were to change its legal interpretation. Accordingly, we do not expect disagreement over the policy outcome.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Because this problem poses a base-maintenance risk, Inland Revenue and Treasury officials have not consulted with the private sector. This means that the problem identification and options have been generated by officials based on the information available. It is recognised that private sector input is an important part of the generic tax policy process.

In saying this, it is not unusual for base-maintenance changes to be made without consultation because there is a risk that publicising the existence of a perceived loophole may incentivise taxpayers to take advantage of its existence in the short term. In addition, the measure only legislatively confirms the tax treatment Inland Revenue has been applying to date. It also closes what would be a clear loophole if Inland Revenue were to change that tax treatment. Further, there will be an opportunity for the public to submit on the measure during the Select Committee process and feedback will be considered at that point.

There may be some private sector concern about the amendment, given that it applies retrospectively and will be the third explicit override of our DTAs in recent years. However, we do not expect disagreement over the policy outcome.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposed solution will be given effect by inclusion in the Taxation (Neutralising Base Erosion and Profit Shifting) Bill 2017, which is scheduled to be introduced into the House in December 2017. Inland Revenue will be responsible for ongoing operation and enforcement of the new arrangements. We do not have any concern about our ability to do so. The new arrangements will have retrospective effect, except for taxpayers that have, prior to introduction of the Bill, taken the position that NRWT or AIL is not payable. We consider that this allows sufficient preparation time for regulated parties, as: • the proposed approach will only affect a small number of taxpayers that have disputed Inland Revenue's current legal interpretation and not settled the dispute; • the taxpayers that have maintained their position that NRWT or AIL is not payable are aware that Inland Revenue historically does not agree, and so are on notice that their current practice may not be acceptable; • many of those currently take the view that NRWT or AIL is payable, and so they will not need to change their current practice. We will mitigate implementation risks by publicising the proposed approach as part of the Commentary on the Bill. We will also inform the taxpayers who currently take the view that no NRWT or AIL is payable of the proposed law change.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
The new arrangements will be monitored through Inland Revenue's normal risk review and audit function. This will check whether taxpayers are complying with the proposed approach. If any follow-up legislative action is required it will go through the Generic Tax Policy Process (GTPP).

7.2 When and how will the new arrangements be reviewed?
The proposed approach simply closes a potential loophole and confirms the Government's intended tax treatment for cross border interest payments. Accordingly, we consider that no specific review of the arrangements is necessary. Stakeholders will have the opportunity to raise concerns during the Select Committee process. The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.