

Economic Growth and Infrastructure Committee

**MEASURES TO STRENGTHEN TRANSFER PRICING RULES AND
PREVENT PERMANENT ESTABLISHMENT AVOIDANCE – A
GOVERNMENT DISCUSSION DOCUMENT**

Proposal

1. This paper seeks the agreement of the Economic Growth and Infrastructure Committee to prepare and issue a Government discussion document primarily on measures to strengthen transfer pricing rules and prevent permanent establishment (PE) avoidance. Public feedback on the discussion document will be used to help develop the best policy for these measures.

Executive summary

2. 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 that allow them to report low taxable profits in New Zealand and many other countries in which they operate.
3. The OECD has recommended various courses of action to address BEPS strategies in their BEPS Action Plan. Along with other OECD countries, New Zealand is implementing a number of these OECD recommendations.
4. Another overseas response has been to impose a separate tax on the diverted profits that arise from the transfer pricing and PE avoidance related BEPS strategies. This is known as a diverted profits tax (DPT), and has been adopted by Australia and the UK. A DPT is levied at a penal rate compared to income tax and has greatly enhanced assessment and collection powers. A DPT is intended to incentivise multinationals to pay the correct amount of income tax under the normal rules rather than to raise revenue by itself.
5. The aim of a DPT is to tax profits that multinationals divert offshore (rather than allocate to their New Zealand operations). While it is likely to achieve greater taxation of these profits, it could impact on perceptions of the predictability and fairness of New Zealand's tax system for foreign investment. We currently consider that a better approach is to take certain features of a DPT and combine them with the OECD's BEPS measures and some domestic law amendments to produce a package that is tailored for the New Zealand environment. This approach should be as effective as a DPT in addressing transfer pricing and PE avoidance related BEPS strategies in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. However we do not wish to rule out the adoption of a DPT at this early stage of policy development.

6. Similar to the DPT adopted by the UK and Australia, our package would be an anti-avoidance measure. It would not change the fundamental basis on which non-residents are taxed. For this reason, our package (like the Australian and UK DPTs) would not tax non-resident suppliers without a material physical presence in New Zealand. Such non-resident suppliers include multinationals that have been the focus of some public concern in New Zealand and internationally.
7. The proposed discussion document would outline our package as the currently preferred method of addressing transfer pricing and PE avoidance (TP and PE avoidance), while noting that a DPT has not been ruled out. Public feedback on the package would be invited. The proposed discussion document would be released in early 2017.

Background

8. Through the use of TP and PE avoidance strategies, some multinationals are able to report low taxable profits in New Zealand despite carrying on significant economic activity here. These avoidance strategies involve:
 - a. **Tax structuring:** In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (ie. a PE) in New Zealand. However non-residents can structure their affairs to avoid such a taxable presence, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).
 - b. **Creating enforcement barriers:** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.
9. While the majority of multinationals operating here are compliant there is a minority that engage in aggressive tax practices. This kind of aggressive tax planning may increase if it is left unchecked. In addition, incentives to engage in these practices could increase as we address other profit shifting techniques through hybrid mismatch arrangements and excessive interest deductions (among other things).
10. Addressing TP and PE avoidance is as much a revenue integrity measure as a revenue raising measure. For New Zealanders to have confidence in our tax system, it is important that everyone is seen to pay their fair share of tax, including multinationals.

Comment

Possible responses to TP and PE avoidance

11. There are several possible ways to address TP and PE avoidance.
12. The OECD has recommended various courses of action to address BEPS activities associated with TP and PE avoidance (as well as other matters) in their BEPS Action

Plan. These recommendations address BEPS concerns under existing tax frameworks (source / PE rules and transfer pricing rules).

13. However, both the UK and Australia have gone beyond the OECD recommendations by introducing unilateral measures to address the diverted profits arising from TP and PE avoidance in the form of a special diverted profits tax (DPT).

UK and Australian DPTs

14. The DPTs that have been proposed in Australia and enacted in the UK tax the diverted profits of large multinationals. Their DPTs are an entirely separate tax which is levied at a penal rate compared with income tax. They apply to large multinationals that sell goods or services into a country and try to avoid income tax by either:
 - a. using a structure to avoid having a taxable presence in the country, even though they have significant economic activities carried on for them in that country; or
 - b. shifting profits out of the country to a low tax jurisdiction through arrangements which lack economic substance.
15. A DPT taxes the profit a multinational has avoided reporting for income tax purposes using these methods. A DPT is thus intended to incentivise large multinationals to pay the correct amount of income tax under the normal rules, rather than to raise revenue by itself.
16. A DPT has greatly enhanced assessment and collection powers. For example, the DPT must be paid up front, and the taxpayer then has to demonstrate to the revenue authority why its assessment is wrong and by how much (although the assessment can still be challenged in Court).
17. Importantly, a DPT is an anti-avoidance measure. It does not change the fundamental basis on which non-residents are taxed. For this reason, a DPT would not tax non-resident suppliers without a material physical presence in New Zealand. Such non-resident suppliers include multinationals that have been the focus of some public concern in New Zealand and internationally.

Is a DPT good for New Zealand?

18. A DPT would counter non-residents who try to avoid having a taxable presence in New Zealand or who use transfer pricing strategies to reduce the tax payable. Its assessment and collection features would also address some of the practical difficulties of taxing multinationals.
19. Introducing a DPT would mean that there would be a new type of tax, separate to income tax, to deal with a minority of aggressive multinationals. It could impact on foreign investor's perceptions of the predictability and fairness of New Zealand's tax system for foreign investment. As a separate tax from our general income tax it may produce unintended adverse consequences for taxpayers – especially with regard to normal grouping of tax attributes (for example income tax losses would not be able to be set off against diverted profits). A DPT may also have an unintentional negative impact on compliant taxpayers. The more we get into imposing arbitrary taxes the greater the risk of other countries doing the same to our exporters. Overall, a DPT chips

away at the consistency, neutrality and relative simplicity of our tax system from a global perspective.

20. Finally, the DPTs that have been proposed in Australia and enacted in the UK respond to particular problems with the application of their own income tax rules to multinationals. While a DPT may be appropriate for the issues Australia and the UK face, it seems more straightforward for us to fix New Zealand's problems with our income tax rules rather than implement a new tax.

A tailored package is better for New Zealand than a DPT

21. Given the above, we currently consider that a better approach for New Zealand is to take certain features of a DPT and combine them with the OECD's BEPS measures and some domestic law amendments to produce a package that is tailored for the New Zealand environment. This approach is consistent with New Zealand's preference for a coordinated international response to an international problem. This package should be as effective as a DPT in countering TP and PE avoidance in New Zealand, but it will do so within our current frameworks and with fewer drawbacks.

22. The package would include:

- a. measures to prevent the avoidance of a PE in New Zealand, which would be similar in effect to this aspect of the Australian/UK DPT (including a possible override of our Double Tax Agreements) and consistent with the OECD's BEPS measures;
- b. amendments to our transfer pricing legislation so we can collect better information, tax multinationals more in accordance with the economic substance of their activities here (in accordance with the OECD's new transfer pricing guidelines), and so that Inland Revenue does not have the burden of proof in transfer pricing cases;
- c. adoption of other OECD BEPS measures relating to TP and PE avoidance, which includes strengthening our tax treaties so they cannot be used for this purpose; and
- d. other domestic law amendments to address issues specific to New Zealand.

23. We would also like to consider whether there are any administrative aspects of the DPT (or other alternatives) which are worth exploring to make it easier to assess and collect tax from uncooperative multinationals in practice (particularly in relation to transfer pricing).

24. While the current preference is not to adopt a DPT, we have not ruled it out. If following consultation on the discussion document (or at any other time in the future) we consider that our proposed package would not be effective in addressing TP and PE avoidance, we will revisit the adoption of a DPT.

Existing BEPS measures

25. It is important to note that New Zealand is already progressing a number of other measures to address BEPS. In particular:

- a. The Finance and Expenditure Select Committee is currently considering legislation to strengthen non-resident withholding tax rules, limit the use of look-through companies as conduit vehicles, and clarify that New Zealand's general anti-avoidance rule overrides tax treaties;
- b. a Bill has recently been introduced to strengthen the foreign trust disclosure rules and implement automatic exchange of information with other tax authorities;
- c. GST now applies to cross border services – including e-books, music, videos and software purchased from overseas websites;
- d. the Government has recently released a Discussion Document on hybrid mismatch arrangements. These proposals are designed to prevent taxpayers from exploiting technical differences in countries' tax rules on cross-border transactions;
- e. there is on-going work on strengthening the interest limitation rules. These rules limit the levels of debt (and associated interest deductions) that multinationals can load into their New Zealand operations.

Consultation

26. Inland Revenue and the Treasury were consulted on the Cabinet paper and support the preparation of the discussion document setting out the package. The discussion document will be used as a basis for consultation on the package with the public. Inland Revenue and the Treasury will consult with other interested Government agencies in preparing the discussion document, such as the Ministry of Foreign Affairs and Trade. The proposed discussion document would be released in early 2017. We will report back to Cabinet with a draft of the proposed discussion document prior to its release.

Financial implications

27. There are no financial implications for the release of the discussion document. The introduction of the package would be fiscally positive, although it is hard to know by how much at this time. We will have a better idea of this after reviewing some recently received information collected through our annual international tax survey. Advice on financial implications will be provided when approval on the finalised package is sought.

Administrative impacts

28. Officials will consider administrative impacts when they draft the discussion document. Advice on administrative impacts will be provided when approval on the finalised package is sought.

Human rights

29. There are no human rights implications associated with the release of the discussion document.

Legislative implications

30. The publication of the discussion document does not have any immediate legislative implications. However legislative change will be necessary if Cabinet subsequently decides to implement the policy recommendations developed out of the discussion document.

Regulatory impact analysis

31. Elements of the regulatory impact analysis will be included in the discussion document at a level that is appropriate given the stage of policy development. A full regulatory impact analysis will be carried out later in the policy process, once officials have finalised their policy recommendations.

Publicity

32. We will arrange the appropriate publicity for the release of the discussion document.

Recommendations

33. We recommend that the Cabinet Economic Growth and Infrastructure Committee:
1. **Note** that in addition to adopting the OECD's BEPS Action Plan, both the UK and Australia have introduced a unilateral measure, known as a diverted profits tax (DPT), which is designed to counter transfer pricing (TP) and permanent establishment (PE) avoidance.
 2. **Note** that our preference at this stage is to counter TP and PE avoidance through a package of measures tailored to the New Zealand environment rather than a DPT. However we have not ruled out the introduction of a separate DPT.
 3. **Agree** that Inland Revenue and the Treasury should develop a package of measures to counter TP and PE avoidance. The package should include:
 - measures to prevent the avoidance of a PE in New Zealand, which would be similar in effect to this aspect of the Australian/UK DPT (including a possible override of our Double Tax Agreements) and consistent with the OECD's BEPS measures;
 - amendments to our transfer pricing legislation so we can collect better information, tax multinationals more in accordance with the economic substance of their activities here (in accordance with the OECD's new transfer

pricing guidelines), and so that Inland Revenue does not have the burden of proof in transfer pricing cases;

- adoption of other OECD BEPS measures relating to TP and PE avoidance, which includes strengthening our tax treaties so they cannot be used for this purpose;
 - other domestic law amendments to address issues specific to New Zealand; and
 - administrative measures to make it easier to assess and collect tax from uncooperative multinationals in practice (particularly in relation to transfer pricing).
4. **Agree** that Inland Revenue and the Treasury should prepare a Government discussion document setting out this package.
 5. **Note** that we propose releasing a Government discussion document on this package in 2017 and will report back to Cabinet with a draft of the discussion document prior to its release.
 6. **Note** that New Zealand is already progressing a number of other measures to address BEPS.

Hon Bill English
Minister of Finance

Hon Michael Woodhouse
Minister of Revenue

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Date

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Date