

SUBMISSIONS

BEPS – Transfer pricing and permanent establishment avoidance

Submissions received for the Government’s discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (March 2017).

Number	Submitter
001	KPMG
002	Oxfam New Zealand
003	New Zealand Council of Trade Unions Te Kauae Kaimahi
004	TP EQUilibrium AustralAsia
005	Chartered Accountants Australia and New Zealand
006	Ernst & Young Limited
007	PricewaterhouseCoopers
008	AMP Capital Investors (New Zealand) Limited
009	Deloitte
010	Russell McVeagh
011	National Foreign Trade Council
012	American Chamber of Commerce in New Zealand Inc.
013	Digital Economy Group
014	Corporate Taxpayers Group
015	Deloitte
016	New Zealand Law Society



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Private and confidential

BEPS – PE and transfer pricing strengthening
C/- Deputy Commissioner, Policy and Strategy
PO Box 2198
Wellington 6140

13 April 2017

Dear Madam

We have attached our submissions on the deemed PE and transfer pricing strengthening proposals.

Fairness

Our approach has been to consider whether the proposals achieve some measure of making the tax system “fair”. We refer to our submissions on the Hybrids consultation where we noted that “fairness” remained undefined. We further noted the apparent reliance on a global consensus for implementing the OECD’s hybrids actions.

The current document proposes a number of changes which do not apply the global consensus. It is possible that the proposals will produce an unfair result. In particular, there are opportunities for double taxation and in the context of a global allocation of taxable profits, over-taxation for the economic activity carried out in New Zealand.

Resource intensive nature of transfer pricing

We have tried to make sense of the Officials concerns regarding the resourcing requirements of transfer pricing. These are used as justification for reversing the burden of proof and increasing the statute bar period.

The current rules are:

- taxpayers document their transfer pricing in accordance with OECD guidelines and methods. If Inland Revenue disagrees with that result, Inland Revenue must prove the taxpayer is wrong. This creates work (because invariably the taxpayer disagrees).
- taxpayers do not document their transfer pricing. Inland Revenue disagrees. The onus of proof is with the taxpayer who will need to document compliance with OECD guidelines and methods. If Inland Revenue continues to disagree, Inland Revenue must do sufficient work to show the taxpayer is wrong.

The proposals will not in our view change this. If taxpayers have carried out the work, they will consider they have discharged the onus of proof. To show that is not the case, Inland Revenue will need to show why that is wrong. This will require the same work from Inland Revenue as currently. (Inland Revenue will not be able to simply make an assessment as otherwise the taxpayer will have discharged the onus of proof through the work they have done.)

It is difficult to see Inland Revenue’s complaint as no more than taxpayers disagree/do not accept Inland Revenue’s position.



BEPS

13 April 2017

Our submissions take these two perspectives as starting points.

We would be happy to discuss our submissions. Please do not hesitate to contact John (on 04 816 4518) or Kim (on 09 363 3532).

Yours sincerely

A handwritten signature in blue ink that reads 'John Cantin'.

John Cantin
Partner

A handwritten signature in blue ink that reads 'Kim Jarrett'.

Kim Jarrett
Partner

Permanent establishment avoidance

Proposal

Under the proposed rules (for both DTA and non-DTA countries), a non-resident will be deemed to have a PE in New Zealand (among other conditions) if there is an arrangement under which a related entity carries out an activity in connection with the particular sale made by a non-resident to a person in New Zealand for the purpose of bringing it about.

As an indication of a deemed PE under the definition above, the paper provides an example of a non-resident located in a low-tax jurisdiction selling computer equipment to New Zealand customers, with its subsidiary undertaking certain sales related activities. These activities include locating customers, promoting the non-resident's products to them, discussing their needs and tailoring equipment packages for them, and indicating likely pricing/delivery dates and other key terms subject to the non-resident's approval (which is rarely withheld).

Submission

KPMG considers that the PE avoidance rule should be explicitly limited in legislation to those arrangements which are artificial or contrived.

If Inland Revenue is concerned that tax leakage is occurring in the digital and technology industries (e.g. through their ability to service a New Zealand customer base remotely), we consider that the PE mechanism is not the appropriate way to address this. Rather we suggest Inland Revenue consider refinements to the GST system, or work with the OECD to address taxation of the digital economy.

Comment

KPMG is concerned that Inland Revenue may not take into account modern commercial practice, particularly for technology based businesses. In our experience these companies often operate sales activities in a highly integrated manner across borders, with New Zealand based employees only performing a part of the sales function with New Zealand customers.

Attribution of all sales revenue to a New Zealand PE, in circumstances where the core value-adding sales functions are performed outside of New Zealand, would not reflect the true economic situation of the arrangement and would likely lead to double taxation. A nuanced and fact-specific approach needs to be taken to all such analyses, ensuring that Inland Revenue does not penalise completely commercial (non-tax driven) transactions.

We are concerned that the example provided in the paper may indicate the Commissioner making assumptions based on incomplete industry knowledge. Specifically we comment as follows:

- 'Well paid employees': In the technology sector it is common to have highly paid employees at multiple points in the supply chain, given the qualifications, scarcity of skill set and industry experience needed. This will not be limited to employees that work to build local demand for products in New Zealand, but will generally be a common feature of employees in technology roles across the organisation as a whole. Looking at the salaries of New Zealand employees in isolation provides a false impression of the level of 'value add' provided in New Zealand.
- Use of third party channel providers: In our experience, third party channel providers will almost always be independent agents, and are fully compensated for their role in the sale of products to New Zealand customers under their commercial arrangements with the

supplier. New Zealand income will arise on these transactions, and will be subject to income tax. The use of a third party channel provider, or reseller, should not ordinarily be relevant in considering whether a non-resident has a PE in New Zealand.

- Furthermore, third party channel providers often bundle products from multiple suppliers in order to provide a solution to their New Zealand customer. Again, this is not reflective of an arrangement where a PE could be said to exist for a specific non-resident supplier.
- The term 'specialised services' is not defined or clear.

The labelling of the proposals for DTA countries does not clearly achieve the desired override

Submission

The override of DTAs may not be effective and will at best be uncertain and subject to dispute and cross country disputes. The proposal should be deferred until the effect of the MLI is determined.

Comment

The basis of the DTA anti-PE avoidance proposal is that an anti-avoidance rule is accepted as overriding a DTA. Given that New Zealand and its DTA partners have the opportunity to enter into the MLI and to accept the MLI's proposals to amend the relevant DTAs PE rules:

- It is not clear how the proposed avoidance rule will interact with DTAs which are amended in the same way as the deemed PE rules propose. It would be an odd result if the proposed rule continued to apply despite the DTA allowing New Zealand to tax the profit.
- It is not clear that the substance of the rule is an anti-avoidance rule for those DTAs which are not amended in line with the MLI. Simply, if two countries have not agreed to amend their DTA PE rule, it cannot be contemplated that the structures covered by the deemed PE rule avoid the PE rule in the relevant (un-amended) DTA.
 - We expect this position to be a point of contention between taxpayers, their home jurisdiction and Inland Revenue.
 - This is because the New Zealand proposal is inconsistent with the OECD global proposed approach.
 - The labelling of the proposal as a "deemed PE" rather than a "diverted profits tax" is a mere labelling. It has similar terms to Australia's Multi-National Anti-Avoidance Legislation and parts of the UK diverted profits tax.
 - New Zealand does not follow the OECD authorised approach to attributing profit to a PE.

See our submission on the MLI for further comment and discussion.

The authorised approach to profit attribution

Proposal

New Zealand will continue to apply its position that a PE is not a separate entity.

Submission

The proposals will put pressure on New Zealand's reservation to the OECD's authorised approach to profit attribution to a PE so that the rules will not apply with certainty

The proposals require further clarification of New Zealand's position.

Comment 1

The Issues Paper notes that New Zealand does not accept that a PE should be treated as a separate entity. This means that New Zealand does not accept that a margin can be added to deductible costs of a PE.

This difference is in part the reason why the Issues Paper notes that significant revenue can be expected from the proposals.

A potential outcome of applying the deemed PE proposals to DTAs, which are not amended in accordance with the MLI, is that those countries dispute New Zealand's position on profit attribution. Given the push to have a global consensus, this would put pressure on New Zealand to amend its position.

We acknowledge that this pressure may have been previously successfully resisted by New Zealand in the past. This may have been accepted in part because both parties have the same view of what New Zealand can tax. That constraint would no longer apply under the deemed PE proposal if the DTA is not amended.

Further, if the other party has accepted the MAP, without accepting the PE changes, New Zealand's position will be in the hands of an arbitrator. The status of the reservation in the context of an arbitration is in our view unclear.

Comment 2

We note that in practice Inland Revenue has accepted an implied margin for core functions. For example, in attributing income to New Zealand, a reduced amount may be allocated because an offshore manufacturer is entitled to a profit.

The Issues Paper implies that no margin is allowed at all under the proposed rules. This conflicts with past positions that Inland Revenue has allowed.

Supply chain restructures**Proposal**

None

Submission

That the acceptability of supply chain restructures be explicitly confirmed

Comment

The expected reaction to the Australian and UK diverted profits taxes (due to their penal nature) is that taxpayers restructure their agreements and supply chains to create actual PEs or to ensure that their sales are made in either Australia or the UK via buy-sell subsidiaries. This is

likely to be a natural reaction to New Zealand's proposals as well. (Particularly as an abusive tax position penalty is proposed).

Such a restructure is likely to have the effect of eliminating:

- The full profit margin from the sale, that would arise in a deemed PE, reducing this to the appropriate transfer pricing margin under transfer pricing rules for the activities actually carried out in New Zealand; and
- Removing the New Zealand source for expenses incurred offshore (as these will be captured in the price of goods sold to New Zealand).

Alternatively, the restructure may move sales to a higher tax jurisdiction (see further below).

As these would have the effect of "avoiding the deemed PE rule", explicit confirmation that these are contemplated results is required to ensure that the desired and expected restructure is not subject to section BG 1.

Low tax jurisdiction

Proposal

That a deemed PE arises if a low tax jurisdiction is involved.

Submission

Clarity on what is a low tax jurisdiction is required.

Comment

We assume that it is not intended that the statutory tax rate should be used to determine whether a country is a low tax jurisdiction. The BEPS project has shown that the effective tax rate can be lower than the statutory tax rate. We assume that is not the test that will be applied.

Determining the effective tax rate will be a complex matter. As an example we understand that the USA is considering tax reform which, simply, would deny a deduction for expenses paid offshore while exempting foreign sales. Understanding how and whether the particular aspects of such a reformed system applied to New Zealand transactions would not be either simple or clear.

Appropriate and clear rules are required to make this an objective test that can be applied by taxpayers.

Strengthening the transfer pricing rules

Proposal # 1

The Government proposes that New Zealand's transfer pricing legislation should include an explicit reference to the latest OECD Transfer Pricing Guidelines.

Submission

KPMG agrees that New Zealand's transfer pricing legislation should include an explicit reference to the OECD Transfer Pricing guidelines.

Comment

KPMG considers that an explicit reference to OECD Guidelines will provide better certainty to taxpayers, Inland Revenue and the Courts.

We consider this is required because in our view it is Inland Revenue that does not consistently apply the OECD Guidelines in disputed transactions. Legislating the OECD Guidelines will reconfirm to Inland Revenue the tests that it should be applying.

Proposal # 2

It is proposed that New Zealand introduce reconstruction rules based on those in Australia's transfer pricing legislation.

Consistent with Australia's rules, the proposed reconstruction rules would not be explicitly limited to "exceptional circumstances".

Submission

An exceptional circumstances clause should be explicit and included in legislation.

Comment

In the revised version of Chapter I of the OECD Guidelines, the OECD strongly cautions against the hasty application of a reconstruction provision noting that,

"Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult."

The OECD Guidelines state further,

"Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement."

The OECD has clearly stated that recharacterisation should be undertaken in exceptional circumstances only. KPMG considers that this should be explicit in the legislation, to avoid any suggestion that these powers may be used arbitrarily or because pricing a transaction is 'difficult'.

An exceptional circumstances clause could ideally include specificity around what would be considered exceptional circumstances similar to what has been outlined in the OECD Guidelines Chapter I. To address one of the concerns raised by Inland Revenue, the clause could specify that even if the arrangement is not unique, the "exceptional circumstances" test may be satisfied.

However, we note that the Government and Inland Revenue should respect and recognise that just because a transaction is not seen between independent parties does not mean it should be subject to reconstruction. This is outlined in the OECD Guidelines,

"Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons."

Proposal #3

It is proposed that the burden of proof should be shifted onto the taxpayer rather than the Commissioner of Inland Revenue. This would align the burden of proof in transfer pricing cases with the standard for other tax matters. As transfer pricing is driven by specific facts and circumstances and involves comparisons with similar arm's length transactions, the taxpayer is far more likely to hold the relevant information to support its pricing than Inland Revenue or any other party.

Submission

KPMG acknowledges that the taxpayer bearing the burden of proof is consistent with other jurisdictions globally. However the burden of proof should be with Inland Revenue when the Commissioner uses information that is available to her and not the taxpayer.

If the proposal proceeds, it should be clear that an Inland Revenue proposed transfer pricing assessment meets a threshold level of reasonableness so that arbitrary and unsupported positions are not taken by the Commissioner.

Comment

KPMG submits that, should the change in the burden of proof occur, then there should be legislated limits to the ability of the Inland Revenue to leverage what is referred to as "secret comparables" or information pertaining to other companies that are privately held when determining its transfer pricing position.

This is even more important given the depth of information that will soon be at Inland Revenue's disposal with the Business Transformation project, the automatic sharing of information with treaty partners, Country-by-country reporting and other taxpayer information collection mechanisms. In order to ensure a fair and reasonable determination of transfer prices, the comparable information to be used should be limited to what would reasonably be at the company's disposal whether its internal data or data in the public domain. This requirement is of the utmost importance and therefore should be legislated.

We note that currently the burden of proof is only shifted if the taxpayer has applied a transfer pricing method i.e. undertaken the transfer pricing work necessary in relation to their transactions. We consider that this is an appropriate encouragement, in a self-assessment regime, for taxpayers to do the work necessary in order to take a tax position.

A better solution to Inland Revenue's concerns would be to consider either:

- a requirement to disclose the existence of the work at the time of filing the return; or
- filing of the transfer pricing reports and documentation with the returns

to justify the change in the burden of proof. This should assist Inland Revenue with its risk assessment.

In the alternative, if the burden of proof is changed proposed adjustments by Inland Revenue should be capable of being reasonably arguable. This is to prevent Inland Revenue proposing arbitrary or unreasonable adjustments. (We assume that information requested by Inland Revenue, providing that request is itself reasonable, has been provided to allow the Commissioner to propose a reasonable adjustment.)

Proposal #4

There is currently no explicit statutory requirement in New Zealand to prepare and maintain transfer pricing documentation.

Rather than making it mandatory for all arrangements to be documented, the Government proposes shifting the burden of proof onto the taxpayer to encourage higher quality documentation.

Submission

While KPMG does not support legislating that taxpayers prepare mandatory contemporaneous transfer pricing documentation, we submit that a general requirement to prepare transfer pricing documentation, appropriate for demonstrating that a taxpayer has complied with its obligations to undertake related party transactions in accordance with the arm's length standard, should be legislated.

We further note that retaining the current burden of proof in these circumstances would encourage that this be done. This would assist Inland Revenue with its risk assessment and therefore with its efficient deployment of resources.

Comment

Transfer pricing compliance obligations are increasing in nearly every other jurisdiction around the world, and with the introduction of Country-by-country reporting, multinational groups are needing to allocate their resources amongst these compliance requirements. As a result, KPMG is seeing instances of some multinational groups choosing to only prepare formal transfer pricing documentation for countries with an explicit, legislated, transfer pricing documentation requirement.

The need to prepare documentation is implicit in the current transfer pricing legislation. However KPMG considers that this should be an explicit legislated requirement in order to ensure appropriate documentation standards are met by the taxpayer, providing greater assurance of compliance with transfer pricing rules for Inland Revenue, and better certainty for taxpayers.

The preparation of transfer pricing documentation provides an opportunity to reassess whether the pricing of a group's related party transactions are continuing to meet the requirements of the arm's length standard. KPMG is therefore concerned that continuing to operate under an 'implicit' and somewhat looser documentation standard in New Zealand, which is increasingly out-of-step with other jurisdictions, may result in poorer transfer pricing outcomes for New Zealand.

Proposal #5

The Government proposes increasing New Zealand's time bar for transfer pricing matters to seven years.

Submission

Increasing the statutory time bar for transfer pricing matters to 7 years is inconsistent with the need to provide certainty to taxpayers on tax positions taken. It is also unnecessary in light of the increasingly timely information gathering mechanisms at the disposal of Inland Revenue, enabling Inland Revenue to undertake transfer pricing risk assessments promptly once a tax position is taken for any given year.

Comment

- Providing certainty for taxpayers is one of the primary purposes of the time bar. This purpose is as important and relevant for transfer pricing matters as it is for any other provision in the Income Tax Act. Taxpayers require certainty that, after a reasonable period of time has passed to enable Inland Revenue to audit their related party

transactions if considered necessary, no reassessment will be sought by Inland Revenue on transfer pricing matters. We consider the current time bar is fully adequate and sufficient for Inland Revenue to perform any necessary audit procedures and reassessments on transfer pricing matters.

- The rationale provided by Inland Revenue for the extension of the time bar is that it is difficult for tax authorities to adequately identify transfer pricing risk, apply the arm's length principle and amend an assessment within four years, given the need to undertake a detailed analysis of facts and circumstances, comparable data and arm's length arrangements.
- KPMG considers that Inland Revenue now has access to significant amounts of information on the intercompany transactions undertaken by multinationals, and receives this in a very timely manner after the completion of an income tax return for any given income year. Specifically this information includes:
 - Information provided by taxpayers as part of the Basic Compliance Package process
 - Information provided by taxpayers completing the International Tax Questionnaire
 - Information provided by taxpayers who complete transfer pricing questionnaires
 - Information that will begin to be received by Inland Revenue in the short to mid-term through information received from overseas tax jurisdictions through the automatic exchange of Country by Country reporting information and Advance pricing Agreements

Given this, Inland Revenue is able to perform risk assessment procedures within a very short time of a tax position being taken by a taxpayer.

Furthermore, given that most, if not all, larger multinationals with a significant level of intercompany transactions, will have already been subject to Inland Revenue risk assessments, reviews and/or audits of their transfer pricing practices, Inland Revenue's focus should be on new or significantly changed transactions. A full reassessment of a taxpayer's transfer prices should not be required every year.

Given the vast amount of information at Inland Revenue's disposal, and its receipt of that information in short order after a tax position has been taken for a given income year, KPMG considers that it is entirely reasonable for a taxpayer to expect Inland Revenue to have completed any necessary audit procedures and reassessments within 4 years.

- The discussion document references the Australian and Canadian statute bar on transfer pricing matters as support for longer statute bar on transfer pricing matters. Inland Revenue's own data however demonstrates that both the US and UK have 3 or 4 year time bars for both Transfer Pricing and other tax matters. In addition, most of the other jurisdictions listed have the same time bar for both transfer pricing and other income tax matters. This isolated focus on Australia and Canada does not show the broader position.
- The whole focus of Business Transformation is that taxpayers are able to be provided certainty more quickly and more robustly. There is no reason to separate transfer pricing from other matters for which Inland Revenue and taxpayers desire finality.

General comment on transfer pricing and interest limitation rules

A number of references are made in the Discussion Document to the demands that transfer pricing matters place on Inland Revenue resources. KPMG considers that this is an area where

Inland Revenue should be looking to increase the level of specialist staff that it employs, in order to address this complex, and globally significant, area of tax law.

We submit that Inland Revenue should consider this as part of its repositioning its workforce, post Business Transformation, into those skill sets that will be most necessary in addressing increasingly complex tax issues arising from commercial changes in global businesses, and an international tax landscape that increasingly complex and prone to double taxation. This is consistent with changes made in other Revenue Authorities, most notably the Australian Tax Office which has publically announced significant recruitment of international tax and transfer pricing specialists.

Administrative measures

Proposal #1

The Government proposes introducing a new administrative measure to address “non-cooperation” by multinationals.

Submission #1

If such an administrative practice is considered necessary, then KPMG agrees that it should be explicitly legislated for, without reliance on internal administrative practice within Inland Revenue. This should include legislation explicitly stating when a taxpayer will be considered non-cooperative, the threshold at which this will be found and the process that will be used by Inland Revenue before making such a finding (e.g. notice requirements).

Comment #1

The Discussion Draft notes that the non-cooperative administrative measure is not intended to impose unreasonable demands on multinationals. As such, KPMG considers it important that all material aspects of a non-cooperation rule be explicitly legislated for in order to provide certainty, and clear guidance on what is considered by Inland Revenue to be an unacceptable practice or delay, to taxpayers.

Proposal #2

The Government proposes bringing forward the time at which tax in dispute must be paid. There are two potential payment dates being considered for this purpose:

- Within 90 days of Inland Revenue issuing an assessment for the tax (which would only occur at the end of Inland Revenue’s current dispute process); or
- Within 12 months of Inland Revenue issuing a NOPA in respect of the tax, if Inland Revenue and the taxpayer have not been able to resolve the dispute.

Submission #1

KPMG considers that there is no reason to have a different rule for the payment of tax in dispute in a transfer pricing matter than for any other tax matter.

Comment #1

The general rules for tax in dispute is that this tax becomes payable on the day of final determination. We see no reason why this should be any different for transfer pricing matters.



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BEPS - PE and transfer pricing strengthening
C/- Deputy Commissioner, Policy and Strategy
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19 April 2017

Dear Madam

Supplementary submission

We have provided submissions on the deemed PE and transfer pricing strengthening proposals. We have a further submission on the proposals to amend the life insurance rules.

The Document notes that under New Zealand's double taxation agreements ("DTAs") with Russia, Japan, and Canada that New Zealand is unable to tax the life insurance business if a resident of those countries does not have a permanent establishment in New Zealand.

Briefly, New Zealand's framework for taxing insurance business of a non-resident is:

- For life insurance, to tax all business offered or entered into in New Zealand;
- For non-life insurance to tax 10% of the premium income if there is no fixed establishment in New Zealand.

New Zealand's DTAs typically preserve New Zealand's entitlement to tax insurance business in this way whether or not a permanent establishment exists.

The document does not say why these DTAs have not followed this approach.

We have only been able to determine two possibilities:

- New Zealand accepted a proposal by those countries to change its standard approach to taxing insurance business;
- The change in these DTAs was inadvertent, mostly likely due to a change in drafting of the relevant provision.

Neither of these reasons support the proposals. In fact, they indicate that the proposal is unprincipled. The proposals unilaterally alter the basis of taxation. The correct approach would be to renegotiate the relevant provision with the other country.

We do not accept a technical response that the proposals do not tax the non-resident insurer. The denial of the deduction for a premium (albeit offset by not taxing claims received), makes the policyholder a proxy taxpayer for the non-resident insurer. This change is likely to lead the policyholder to try to alter the terms of the agreement so the non-resident insurer is effectively bearing the tax. The substance of the proposal is the non-resident's profit is taxed.

Further, the proposal to amend the FIF rules potentially creates double taxation.

19 April 2017

For completeness, we note our objection to the proposals is one of principle. We are not aware of insurers using the relevant DTAs. However, we consider the proposals unprincipled in their unilateral change. As we note in our submissions on Interest Rate Limitations, it is also a worrying trend that the substance of a proposal is not made transparent. In this case, the proposal seems to be directed to correcting an error rather than addressing a matter of principle.

Further information

Please do not hesitate to contact us – John Cantin, on 04 816 4518, and Nick Hope, on 09 363 3210 – if you would like to discuss our comments in more detail.

Yours sincerely



John Cantin
Partner



Nick Hope
Director



Deputy Commissioner Policy and Strategy
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Taxation of Multinationals - Discussion Documents

Dear Madam,

Oxfam welcomes positive steps by this Government to address the unfair situation where the world's richest and most powerful companies and people are avoiding paying their fair share of tax. Tax is key to making sure everyone has vital public services. It is an essential tool to ending extreme inequality, and could help lift millions of people out of poverty. It is estimated that poor countries are losing at least \$170 billion every year because of tax avoidance - this is more than the total amount that these same countries are receiving in aid. When taxation works fairly, the majority benefit.

New Zealand could be missing out on up to \$500 million a year in tax from multinational companies - money that could be spent on health, education and housing. On a broad level we support the proposals in the documents however we are concerned that **they do not go far enough**;

- in ensuring that New Zealand receives its fair share of tax from multinationals operating in New Zealand
- in committing New Zealand to collaborate on issues of greater transparency around tax practices globally.

Our comments on proposed rules and recommendations are below.

BEPS - Transfer Pricing and Permanent Establishment Avoidance

Oxfam has long been concerned about multinationals not paying tax in the countries they operate in and trade with as it deprives the host countries of tax revenues to spend on desperately needed social services for the local populations.

Diverted profits tax

To that end Oxfam has been supportive of and has called for a Diverted Profits Tax to counter such behaviour. We are supportive of the government's moves to bring in an equivalent measure. We note however that the tests suggested include a consideration of whether the structure is contrary to the purpose of the respective double tax agreement.

Recommendation: Oxfam recommends that the proposed diverted profits tax equivalent does not reference any double tax agreement but focus simply on the other objective tests.

- a non-resident supplies goods or services to a person in New Zealand;
- a related entity (either associated or commercially dependant) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about;
- some or all of the sales income is not attributed to a New Zealand permanent establishment of the non-resident;

Recommendation: Oxfam recommends that New Zealand's double tax agreements are reviewed to ensure New Zealand can receive its fair share of tax revenue from multinationals and if favourable renegotiation is not possible then the double tax agreements should be rescinded.

BEPS - Interest Limitation Rules

Interest deductions

Oxfam notes that the government has chosen not to implement the earnings stripping rules recommended by the OECD. We are comfortable with this only if the government can assure the people of New Zealand that what it is proposing is equally effective.

On that basis we support the proposals in this document as interest deductions are a very straightforward way of reducing profit by multinationals. For this reason we particularly support:

- The removal of non-debt liabilities from the assets component of the debt to assets test. Such a move will level the playing field between multinationals that would commercially use debt to fund fixed assets and those that wouldn't. For this reason Oxfam strongly supports this move.
- The other proposal we particularly support is the removal of the 10% related party debt allowance for conglomerates including Public Private Partnerships (PPP). Currently PPPs are allowed to deduct all unrelated party debt plus 10% of their related party debt. As related party debt is a "profit stripping" device Oxfam does not see the logic of this and we are pleased to see the proposal to remove it.

Excessive interest rates

Oxfam is aware of the current loophole where high levels of debt can feed into a high interest rate for transfer pricing purposes. We therefore support the intent of the proposals to eliminate this. We note that the proposals are to:

- apply the credit rating of senior unsecured debt for multinationals with an identifiable parent;

- assess the level of arms-length debt and then the applicable interest rate when there is not an identifiable parent.

It is the second option that causes us concern. Multinationals without an identifiable parent include Private Equity (who are known to take a tax aggressive approach to investment). To find a comparable level of arms-length debt our understanding is that you need to find the debt level of a comparable New Zealand owned firm. Given the high levels of foreign ownership in all our major industries, Oxfam would question whether identifying such a comparable firm was possible. We note that even iconic New Zealand firms such as Spark and Fletcher Building have significant levels of foreign ownership. Even in industries that still have some level of New Zealand ownership such a move will incentivise full foreign ownership so that high levels of interest deduction can become the norm.

Recommendation: It is not our first preference to require all related party interest to be disallowed but if these are the only options available, they have to be taken to ensure entities such as Private Equity pay their fair share of tax. We suggest that if related party interest disallowance is considered excessive; earning stripping rules must be reconsidered for this group.

Omissions on current proposed rules

Global collaboration on tax

Oxfam is an international development agency and our mission is to eliminate poverty globally. We see progressive tax systems (spent progressively) as one of the levers to be able to achieve this goal. While there is a lot that governments can and are doing on their own to improve the progressiveness of their tax systems, such as this consultation on tax policy in New Zealand, there is a limit to what countries can do unilaterally.

Earlier this year, Oxfam released a report that revealed that 8 men own the same wealth as 3.6 billion people who make up the poorest half of humanity. Tax havens are part of this problem. In order to end poverty and inequality; we have to end tax avoidance globally.

Recommendation: Oxfam is calling on all countries to allow for greater collaboration on taxation. A fair and level playing field on corporate tax requires transparency measures, including full public country by country reporting, transparency on beneficial owners and transparency by governments on the tax incentives they grant and in particular on tax rulings.

Non-resident finance companies

Another omission is any move to apply specific interest limitation rules to non-resident finance companies. The issue is they currently only have the on-lending concession apply to them meaning they can have unlimited and unconstrained interest deductions (as was the case with the Australian banks before the specific bank rules were implemented).

We understand that there is currently not a high level of non-resident finance companies operating in New Zealand. Oxfam accepts that this may be currently the case but this can change very quickly (as was the situation with the banks).

Recommendation: While all the other measures are correcting issues that have been in place for some time, we suggest that it would be preferable to fix identified issues before they become a 'significant drag' on the tax base thereby affecting the government's ability to provide social services.

Oxfam welcomes these consultation documents and we recognise that this a positive first step to ensure multinational companies pay their fair share of tax from profits earned in New Zealand. As stated above we do strongly recommend the inclusion of policies that promote greater collaboration on tax globally to tackle the growing issue of inequality.

Oxfam wishes to acknowledge the significant assistance provided by Andrea Black, adviser to Oxfam, in the research and analysis of the Tax Consultation Documents. Oxfam also greatly appreciates the access to your officials and the open and insightful discussions they had with Andrea Black.

We would be happy to discuss any of these points in more detail. Please contact Paula Feehan-Advocacy and Campaigns Director at paula.feehan@oxfam.org.nz.

Yours sincerely,



Rachael Le Mesurier
Executive Director
Oxfam New Zealand



NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

**Submission of the
New Zealand Council of Trade Unions
Te Kauae Kaimahi**

to the

Inland Revenue Department

on the

**Proposals to strengthen New Zealand's
rules for taxing large multinationals
(BEPS)**

P O Box 6645
Wellington
18 April 2017

- 1.1. This submission is made on behalf of the 30 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With 320,000 members, the CTU is one of the largest democratic organisations in New Zealand.
- 1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.
- 1.3. Thank you for the opportunity to comment on the three discussion papers on “Base erosion and profit shifting” (BEPS):¹
 - BEPS – Transfer pricing and permanent establishment avoidance
 - BEPS – Strengthening our interest limitation rules
 - New Zealand’s implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.
- 1.4. We have read these and support their general directions. We make this brief submission in order to indicate our ongoing interest in these matters and our wish to be consulted as this area of policy progresses.
- 1.5. The loss of revenue from tax avoidance and evasion has a direct impact on our members in loss of revenue for public services which we value, and in higher taxes than otherwise necessary on working people.
- 1.6. One area is of special concern: the avoidance of tax by multinational internet-based corporations such as Google and Facebook puts local carriers of advertising such as newspapers and broadcast television and radio at a competitive disadvantage. The business model of conventional news media is already severely weakened by changes in technology brought largely through the internet and other forms of digital media and communications. The advertising revenue on which the conventional media depend is undermined by these new technologies, which they are struggling to respond to. It makes it even more difficult if their competition can lower their costs by avoiding paying tax on their activities.

¹ <http://taxpolicy.ird.govt.nz/consultation>

- 1.7. This is a matter of public interest: the conventional media are still the principal originators of the content on which we largely depend for reliable news, and particularly for news about New Zealand. The steady loss of capacity through layoffs of journalists and other media staff is creating a major failure in the news media market.
- 1.8. There is therefore a strong public interest case to ensure that provision of advertising services and platforms is tax neutral. We are gravely disappointed that the proposals do not address the tax avoidance of Google, Facebook and others. We urge IRD to address this.
- 1.9. The only other matter we would like to comment on is that it would be very valuable for IRD to regularly publish summary information on the taxation of multinationals in the New Zealand. This would give the public the information that is necessary and sufficient for informed discussion of such matters and to judge whether measures such as those discussed in the present documents are effective. We urge IRD to do so.

TP EQUilibrium | AustralAsia LP

A Duff & Phelps Transfer Pricing Alliance Partner

To: Deputy Commissioner of Taxation, Policy and Strategy, New Zealand
Inland Revenue

From: Leslie Prescott-Haar, Stefan Sunde / TP EQUilibrium | AustralAsia
LP

Subject: BEPS – Transfer Pricing and PE Avoidance

Date: 18 April 2017

TP EQUilibrium | AustralAsia (“TPEQ”) has prepared this submission in respect of the New Zealand Government’s discussion document, *BEPS – Transfer Pricing and PE Avoidance*, published in March 2017.

TPEQ has prepared these comments on the discussion document specifically, and selectively, from a transfer pricing perspective. Our comments are based on our transfer pricing experience with Australian and New Zealand transfer pricing matters. In this regard, we have limited our comments to certain proposals contained in Chapters 5 and 6 of the discussion document. As such, TPEQ has not commented on all aspects of the various proposals. Our comments with respect to Chapter 5 are substantive, whereas our comments with respect to Chapter 6 are practical.

We are comfortable discussing these points raised further with the Inland Revenue or Treasury officials, as may be requested.

The submission is generally structured in alignment with the structure of the discussion document, unless otherwise indicated.

Overall ‘General’ Comments

Whilst we welcome alignment with the most current OECD guidance, and we recognise the importance of trans-Tasman trade flows, we caution against a desire for alignment with Australia’s transfer pricing rules, simply for the sake of alignment.

Australia’s revised transfer pricing regime is exceptionally burdensome, excessive in terms of compliance costs, over-steps the OECD Guidelines in various respects, will likely result in a materially increased number of disputes, and remains unchallenged in the Australian courts. Therefore, we urge caution against interpreting that legislation as “a good way” to challenge situations where legal form does not match economic substance.

Moreover, the discussion document appears to misinterpret Section 815-130 of Australia’s revised transfer pricing regime as a reconstruction provision, rather than a provision to identify the arm’s length conditions of a transaction.

Proposals to consider reconstruction of transactions are unduly aggressive, and such should be avoided unless in exceptional circumstances

The proposals contained in the discussion document relating to the reconstruction of a transaction where its form does not align with the economic substance must be considered carefully. In particular, Para. 5.39 notes that, under the proposals, New Zealand’s rules would not restrict reconstruction to only “exceptional circumstances”. We also note that, contrary to the OECD Guidelines, there appears to be an intent (para. 5.29) to target transactions only rarely occurring between third parties. Per the revised OECD Guidelines¹:

*The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. **The non-recognition of a transaction that possesses the commercial rationality of an arm’s length arrangement is not an appropriate application of the arm’s length principle.** Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement.*

The structure that for transfer pricing purposes, replaces that actually adopted by the taxpayers should comport as closely as possible with the facts of the actual transaction undertaken whilst achieving a commercially rational expected result that would have enabled the parties to come to a price acceptable to both of them at the time the arrangement was entered into.

Any New Zealand legislative and/or IRD approach which is inconsistent with the OECD guidance would be unsatisfactory in New Zealand’s transfer pricing framework, having regard to the evidential burden placed upon multinationals to disprove hypothetical reconstructions; this would result in excessive compliance costs for operations that are insignificant (for most multinationals); and would likely materially increase in the number of disputes, Competent

¹ Final OECD BEPS Reports – Actions 8-10, paras. 1.123 – 1.124.

Authority cases, and instances of economic double taxation. In this regard, the New Zealand avoidance regime and case law are already highly effective deterrents against aggressive taxation arrangements, as the Commissioner already has broad discretion to reconstruct tax avoidance arrangements appropriately, and adequately address such ‘problematic’ structures. Given the effective workings of New Zealand’s anti-avoidance regime, it is not necessary for New Zealand to introduce separate reconstruction provisions within the transfer pricing rules. As such, it is inappropriate for the Inland Revenue to “re-write” the terms and conditions of multinational transactions for a variety of reasons, except in exceptional avoidance circumstances. Instead, a provision making reference to the OECD Guidelines, as the most current internationally accepted guidance, would appear to suffice with regards to alignment of substance with legal form.

Per Para. 5.29, we caution against ‘risk shifting’ as an indicator for any recharacterisation. We note that, for example, there is limited rationale to establish a low-risk distributor, other than to create a stable, low-risk entity, which for a multinational reflects a commercial arrangement that may simply not be available to independent parties. The limited risk distributor approach is a common and well accepted inbound and outbound structure which minimises transfer pricing risk for the distributor and its group, including by the Inland Revenue in APAs. Conversely, the financial results of full risk marketer-distributors are often highly variable (as a result of market/economic conditions, currency exchange rates, etc.) and such variability of distribution profitability inevitably attracts the scrutiny of revenue authorities around the world. This is only one example of various possible structures that apportion risk in a particular way, with sound commercial basis, but do not indicate aggressive profit shifting.

Further, risks are contractually transferred globally every day in uncontrolled transactions. Hence, risk shifting should not be a primary factor considered as part of a potential recharacterisation. We note that section 815-130 of Australia’s Income Tax Assessment Act 1997 does not address risk in such a granular fashion.

Further to the above, the nature of the New Zealand dollar as a ‘commodity’ currency, making NZS exchange rates typically more volatile, provides further justification for limited risk approaches in respect of controlled transactions with New Zealand, to improve stability, certainty and long term profitability of New Zealand businesses.

Administrative Measures

The comments below are based on TPEQ’s practical audit experience.

In our experience, audit delays are typically not attributable to taxpayer non-cooperation. In this regard, multinationals would [almost always] prefer to respond to audit queries and resolve audits as quickly as reasonably possible, with a view to progressing the matter to its final conclusion, achieving certainty over the outcome at the earliest opportunity. Audit issues experienced by the Inland Revenue may, to a large extent, reflect requests for information that simply does not exist within multinationals, or is not prepared in the normal course of business management and / or decision-making. It is inevitable that there would be some delay in providing such information, as it may take considerable time to collate or prepare, this having to be balanced with other commercial imperatives. The necessity for broad administrative legislative changes is therefore lacking.

Instead, we believe a flexible process facilitating ‘open discussions’ with the Inland Revenue relating to their audit information requests would be more effective and should be implemented, to balance the Inland Revenue’s information needs with multinationals’ compliance costs. Per the general USA IRS procedures, information requests are initially

provided to taxpayers in draft form, providing an opportunity to discuss the nature and extent of the information requested as compared to what is available, and tailor the request to the specific circumstances and risk profile of the taxpayer.

On Para. 5.71, should the 7-year statute bar for transfer pricing assessments become law, then the Inland Revenue should, as a practical matter, become more open to longer term APAs.

We note the intent that the proposed measures would leave co-operative multinationals largely unaffected (para 6.13), but we have concerns in practice that this would not be the case. We also note the intention to implement internal review processes to ensure such measures could not be applied lightly (para. 6.18), but the discussion paper remains vague on what would be considered “reasonable in the circumstances” (para. 6.17).

On Para 6.19, for non-cooperative major multinationals, it could presumably be evidentially unfavourable for the Inland Revenue to issue NOPAs that are based on incomplete evidence and / or insufficient analysis, as well as being procedurally inefficient for both the Inland Revenue and multinationals. Whilst we understand the Inland Revenue’s need to address the minority of taxpayers that are non-compliant, we believe that the existing provisions represent an adequate and effective arsenal available to the Commissioner.

On Para 6.26, it is unfair to penalise all multinationals for the sins of a few, by requiring all taxpayers to make upfront ‘pay to play’ tax payments based on insufficiently evidenced NOPAs. Also, limiting repayment of disputed tax only in the event of a successful court challenge (para. 6.25) excludes the possibility of other dispute resolution mechanisms. Payment of disputed tax should be made upon resolution of the matter by any means.

Para 6.35 appears quite draconian and punitive, as a New Zealand person could potentially be convicted for the directions and/or actions of others, or alternatively, in connection with an information request covering information that does not actually exist. In relation to the latter point, the proposed approach does not recognise that, even where the relevant person is willing to co-operate, it may be difficult for them to prove that the requested information simply does not exist.



BEPS – Transfer pricing and permanent establishment avoidance

Submission, 18 April 2017

Chartered Accountants Australia and New Zealand

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18 April 2017

BEPS – Transfer pricing and PE avoidance
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Dear Cath

BEPS – Transfer pricing and permanent establishment avoidance

Thank you for the opportunity to comment on the Government Discussion Document on transfer pricing (TP) and the permanent establishment (PE) rules.

In summary our submissions are as follows:

General comments

- We accept that the Government is concerned about BEPS and committed to introducing appropriate measures to combat BEPS.
- We agree that BEPS is detrimental to the public perception of our tax system; and may also be detrimental to New Zealand's economy.
- We are concerned that by implementing unilateral measures outside the OECD BEPS Action Plan the Government could harm our relationships with treaty partners.
- We are not convinced that the PE model will always be appropriate for digital business models and suggest another model is needed.
- We believe any new rules must be clear and specific to give certainty to taxpayers, particularly foreign investors.
- We believe any recommendations adopted as a result of this Discussion Document should be factored in to Inland Revenue's Business Transformation project so that the Commissioner can develop specialist teams to meet changing customer demands.

Permanent establishment avoidance

- It is unclear why, if the proposed rule is to counteract an entity avoiding the application of a relevant treaty, that the Commissioner cannot apply section BG 1 currently.
- It is unclear how the proposed avoidance rule will fit into our existing treaty framework.
- An uncertain rule will discourage foreign investment so it is critical that, if a rule is required, the rule is targeted and clear.

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- The Commissioner should specify all of the relevant factors she considers indicate the presence of avoidance. For example she should be specific about which countries the Government considers to be “low tax jurisdictions”, and how other indicia will be considered, including what is meant by a “well paid employee”.
- Guidance should be given as to how the Commissioner will attribute any resulting profit.

Amendments to the source rules

- The Government should provide examples to explain how the proposed PE source rule would apply and to which foreign income.
- The anti-avoidance source rule goes further than the BEPS measures proposed by the OECD and we do not believe this is appropriate.
- We agree that there is a discrepancy in tax treatment for life insurance businesses depending on the particular DTA but believe this discrepancy should be resolved by amending the particular DTAs.
- We agree that it is not necessary to have a royalty substitution rule.

Transfer pricing

- A legislative reference to the OECD transfer pricing guidelines should state that the guidelines apply only to the extent they have been adopted by New Zealand – or the guidelines should be put into regulation with reservations specified in a separate schedule or appendix.
- We are concerned that an “economic substance” test would be uncertain and difficult to administer and believe the test needs to be clearer and more tightly defined.
- If a reconstruction provision is introduced, the standard should be whether a taxpayer would be “more likely than not” to have agreed such an arrangement with a third party and an “exceptional circumstances” type test should be explicit. The same test should be adopted if a criterion of arm’s length “conditions” is introduced into legislation.
- We do not believe the burden of proof should simply be reversed. If the burden is to be shifted to the taxpayer then, at the least, the burden should be on the Commissioner in situations where she is using data that is not available to the taxpayer.
- We understand most multinational enterprises of this size provide the proposed documentation already and we do not have a problem with the requirements being formalised in legislation.
- Moving the time bar to seven years for transfer pricing issues is inconsistent with Inland Revenue’s move to customer centric, real time service and should not proceed. If resourcing is an issue, more resource should be allocated.
- As a practical matter, many investors with minor interests will not be involved in transfer pricing decisions and will not have access to transfer pricing documentation so the rule needs to have some flexibility to allow for this.

Administrative measures

- We question whether the new administrative measures are needed when most multinational enterprises cooperate with Inland Revenue.
- Any increase in administrative sanctions should be accompanied by corresponding measures to encourage and assist taxpayers to comply.
- We do not believe the Commissioner should have the power to impose fines. If this proposal

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were to proceed, we believe any imposition of a fine should need the signoff of an independent third party such as a TRA judge or the Attorney-General.

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General comments

The OECD has issued the BEPS Action Plan in order to reset the global consensus on how to tax cross-border commercial activities.

We believe the New Zealand Government must first be clear on its desired international tax policy settings and then the extent to which these are already achieved through current legislation, including an anti-avoidance rule, and adoption of the Multi-lateral Convention (MLC). If not, the Government must then determine the extent to which any further legislative reform might be needed.

We understand the Government is concerned about BEPS activities in New Zealand and we agree that BEPS is undesirable, in particular, because it affects the public perception, and thus the integrity, of our tax system. It may also be detrimental to New Zealand's tax take.

It is not clear whether the Government has developed the current proposals because it has decided to unilaterally act, outside of the MLC, to achieve its international policy settings; or whether it has developed them to deal with perceived issues with the public perception of the tax system.

Existing treaty framework

It is unclear how the proposed rules will fit into our existing treaty framework.

The proposal is stated to be a new avoidance rule. However it is not clear in the discussion document as to what the Government asserts is the test that, if avoided, will cause the proposal to be applied.

We presume that if a foreign jurisdiction implements the MLC then the proposed avoidance rule would not apply as the treaty should apply to any suggested avoidance. However it seems unclear what could occur if the relevant treaty partner does not implement the MLC in full. Is it proposed that New Zealand will apply the avoidance rule notwithstanding the negotiation with the treaty partner concluded on a different basis?

If another country does not accept the relevant MLC it is more difficult to make the argument that the proposal is an anti-avoidance rule. The parties will contemplate that a PE (and, therefore, a taxing right) would not arise.

A unilateral action also creates a risk that our other treaty partners may respond in a similar way. A similar response from other countries could limit New Zealand's tax take, rather than increase it, by having the reverse impact for New Zealand businesses trading overseas.

We suggest Officials consider delaying the application of the deemed PE rule for DTA countries until after the implementation of the MLC.

Effect on foreign investment

In our view, many of the proposed rules seem to be directed towards perceived problems. The proposed rules are framed widely and in many cases the boundaries are unclear. We are pleased that Officials first developed an overarching inbound investment framework and believe that has been a

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useful reference for New Zealand's policy settings. We believe Officials must now develop a coherent and cohesive set of rules within this framework that target only those arrangements that are of real concern.

If the rules are not sufficiently clear, they will have a significant effect on taxpayer certainty, particularly for overseas companies looking to conduct business here. In our specific submissions, we have made suggestions for areas where we believe explicit criteria are needed.

Relevance of the PE model

In our view, the proposals in chapters three and four attempt to force the PE model on to a type of business that does not fit into this model. It is a natural consequence of the information age and the sharing economy that, for many businesses, the value will be in its operational model, network and/or customer list. Its business may be conducted from a website rather than from bricks and mortar premises. We do not believe that the traditional concept of a PE is useful for taxing digital age businesses in all cases.

It is not the subject of the discussion document, however we consider that the OECD needs to develop a new model that will be more appropriate for taxing new economy businesses.

In the absence of a new model, the Government runs the risk that anti-BEPS measures will disadvantage taxpayers with new or innovative business models in the future. Encouraging growth and innovation is firmly on the Government's agenda. New and innovative businesses, including those from overseas, will be critical in growing the economy. In order to encourage foreign investment it is critical that we have clear and workable tax rules that are fit for purpose

Implementation

Inland Revenue has embarked on a Business Transformation programme which, we understand, will include a significant re-allocation of resources and restructure of many roles.

This presents an opportunity to develop specialist teams to resource the initiatives outlined in this Discussion Document.

For example, the Discussion Document assumes that Inland Revenue will need to audit to discover the relevant transactions and corresponding transfer pricing documentation. The transformation project provides an opportunity for Inland Revenue to establish customer service teams to assist taxpayers at the time the transactions occur and provide real time signoff on compliance.

Such an approach would give greater certainty to taxpayers and as a consequence would not require the Government to change the statute bar or the burden of proof as currently proposed.

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Chapter 3: Permanent establishment avoidance

The Government proposes to deem a PE to exist where a non-resident makes sales into New Zealand, a related entity carries out activities in relation to the sale and the sales income is not all attributed to a New Zealand PE of the non-resident.

Application of the rule

The proposed rule is outlined at paragraph 3.21 of the Discussion Document. Paragraph 3.24 outlines the factors that will be relevant in determining whether the test is met.

We do not believe it will always be clear when an arrangement “ought to” result in a PE. Therefore it is imperative that the rule is clearly articulated with particular attributes clearly specified. It is important that the rule is crafted using language using specific criteria and is neither vague nor emotive in terminology.

While the proposed rule is touted as an avoidance rule it is not clear that in fact the typical indicia of avoidance are in fact required before the rule is implemented. Further it is not clear what PE test the Government is concerned with.

Any application of avoidance in New Zealand would typically include the consideration of the economic reality of the arrangement and whether there are the relevant indicia, such as artificiality, circularity, or non-commercial features that lead to the conclusion that the arrangement was an avoidance arrangement. It appears that in this instance the Government is suggesting that the existence of certain factors could trigger the rule notwithstanding these could be commercial activities.

Paragraph 3.25 states that the legislation may specify some of the factors. We agree and believe that, if possible, it should specify all of the factors. But more so the Commissioner should be required to show that the non-resident had in fact entered into a tax avoidance arrangement.

At para 3.2 the Government suggests that “The proposed rule is an anti-avoidance measure. It is intended to apply where the non-resident’s economic activities in New Zealand should result in a PE here, but the non-resident has been able to restructure its legal arrangements to avoid one arising”.

However what test of a PE is to be applied in this instance? What PE test is to be considered to have been avoided? In para 3.45 it is proposed that no reference will be had with the particular PE test in the relevant DTA. It is perhaps implied in paras 3.40 and 3.41 that reference is to be had to the PE test that is in the Model Convention, which will presumably mirror the MLC. If this is to be the case is the Government suggesting that it would seek to apply the proposed test to a taxpayer of a foreign jurisdiction that has not accepted the MLC PE test?

This has the potential to result in large and time consuming MAP disputes.

“Low tax jurisdiction”

Of the factors listed, the most significant is the last bullet point and, in particular, the “involvement of a low tax jurisdiction”. We believe the Government must give concrete guidance on the meaning of “low

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tax jurisdiction”.

One of the issues for all involved is whether “low tax” criterion refers solely to the corporate tax rate, or to preferences in the tax system more broadly. For example, we understand the US proposes to allow income from sales to non-residents to remain untaxed. Would this qualify it as a “low tax jurisdiction”? If not, what more would be needed?

We believe the Government should publish lists of countries whose tax systems it considers to have the features of a “low tax jurisdiction” and a list of those whose it does not. This was an approach used successfully for many years under New Zealand’s former Foreign Investment Fund (FIF) rules. Specific lists would provide certainty for taxpayers as to the Government’s concerns.

“Well paid employee”

The Discussion Document also states one of the factors to consider would be an entity that is allocated a low amount of profit, on the basis that it is carrying out low value services, while having a number of “well paid employees”.

In our view any legislation must be specific about what is meant by “well paid employee”. This is an example of vague and emotive terminology and should be replaced by or elaborated by reference to specific criteria.

Abusive tax position penalty

The Discussion Document states (paragraph 3.38) that, if the proposed rule is applied, an abusive tax position penalty would also apply. We are not convinced that this is appropriate, as the proposals seem intended to target arrangements that would not meet the criteria of “tax avoidance”.

In addition, if a taxpayer may be subject to an ATP penalty (and thus double their tax bill), there is an onus on Inland Revenue to clearly articulate the rule. In addition, we believe IR must give greater access to binding rulings, within commercial time frames, to allow taxpayers certainty for their transactions.

“But for” test

The Discussion Document also proposes a “but for” test (paragraph 3.26). The rule will deem a PE to exist only if the non-resident would have had a PE but for the arrangement with the related party. The “but for” test is intended to prevent a PE being created where one does not exist in substance – consistent with paragraph 3.22, which states that preparatory or auxiliary activities would not be sufficient. We believe this test will be useful and should be specifically included in the legislation.

We note that the definition of “preparatory or auxiliary” activities will change once the MLC is implemented but assume the reference is to the current definition.

Consequences of application

The Discussion Document states (at paragraph 3.36) that Officials expect that the application of the principles will result in a “fairly significant” amount of the sales income being attributable to the deemed

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PE and a “material amount” of net profit to remain.

It is important to clarify what is meant by “fairly significant” and “material amount”. We would like to discuss this further with you and work through some examples to clarify. We believe any legislation should also be accompanied by specific guidance as to how profit is to be attributed.

In the absence of a clear statement, taxpayers are more likely to err on the side of caution and decide not to place any personnel in New Zealand. Such a decision to exit employees from New Zealand would be motivated not by a desire to pay no tax in New Zealand, but by the uncertainty inherent in a profit attribution.

Moreover, future inbound investment into New Zealand depends on foreign investors being able to cost future commercial arrangements accurately. Foreign investors are generally willing to budget for a New Zealand tax liability but the calculation method must be clear.

Interaction with New Zealand’s double tax agreements

It is not clear how these proposed rules will fit into our existing treaty framework.

The Discussion Document states (paragraph 3.42) that the proposed rule is an anti-avoidance rule that will apply only to an arrangement which defeats the purpose of the DTA’s PE provisions.

However, as the Discussion Document acknowledges at paragraph 5.45, there is an increasing variety of commercial arrangements in multinational enterprises. We believe it will not always be obvious when a Government may consider an arrangement is intended to defeat the purpose of the DTA’s PE provisions. The concept of “commercial and economic reality” is not defined and is often problematic in practice. An unusual arrangement may be undertaken for genuine commercial reasons. It is critical that the proposed rule allows for a distinction between “novelty” and “avoidance”. The focus should be on artificial arrangements.

If the proposals are implemented in the form proposed, they will leave taxpayers and advisors with a lack of clarity as to when an employee of an overseas company located in New Zealand would have function and responsibility sufficient to give rise to a PE. For example, would a person located in New Zealand who plays a principal role but does not conclude contracts constitute a PE here?

The Discussion Document states (paragraph 3.39) that the ultimate aim of the proposed rule is to “discourage non-residents from entering into PE avoidance structures in the first place”. We understand this objective but believe there needs to be a balance between discouraging investors who would engage in avoidance behaviour and encouraging genuine foreign investment.

The resulting lack of certainty may result in taxpayers and advisors taking a conservative approach and not basing employees in New Zealand, so that there is no risk of inadvertently creating a PE. This outcome does not seem sensible and would stifle growth and investment.

We agree with the statement (paragraph 3.45) that taxpayers should not be able to rely on DTAs to protect tax avoidance arrangements. However, we believe that taxpayers should otherwise be entitled to rely on DTAs.

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Chapter 4: Amendments to the source rules

Permanent establishment source rule

The permanent establishment source rule would give income a New Zealand source where the income is attributable to a PE in New Zealand, whether or not the income has a New Zealand source under any other source rule.

We assume this rule is intended to refer to foreign income created by activities of the New Zealand PE that was hitherto not taxable here. We would appreciate some examples to illustrate how the rule would work in practice.

Anti-avoidance source rule

The Government proposes that a non-resident's income would have a source in New Zealand if it would have a source, treating the non-resident's wholly owned group as a single entity.

This would effectively introduce a "force of attraction" type of rule into New Zealand legislation. Such a rule – where a country can impose tax on the total income of a business with a PE there, even if the income is not earned by that PE – would be out of step with New Zealand's international tax framework, which taxes on PE and source, and goes further than the rules to be adopted via the MLC. We do not agree with this.

The Discussion Document refers to section CV 1 in support of the proposal.

It is our understanding that section CV 1 is a recharacterisation rule intended to prevent income splitting. For example, if a share dealer were to establish fifty different companies, each owning shares in a different company, in order to suggest that none of the companies are dealers. Section CV 1 would apply and consider the position of the group as a whole.

We believe a recharacterisation rule to target fragmentation and contract splitting could be appropriate, however, this would be a significant extension of our current PE rules.

Life insurance source rule

We agree that the combination of section DR 3 and the wording of Article 7 in the DTAs with Canada, Russia and Singapore results in a more favourable tax treatment for life insurance businesses operating out of those countries.

In our view, this would best be rectified by agreeing a protocol as part of the DTAs involved, rather than imposing a domestic law override. We also wonder whether there could be wider foreign policy implications of creating a domestic law override to a negotiated agreement.

Royalty substitution rule

We agree that a royalty substitution rule is not necessary in New Zealand. We already have an "in substance" royalty definition.

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Chapter 5: Strengthening the transfer pricing rules

Including an explicit reference to the OECD transfer pricing guidelines

In our view, most businesses and advisors, as well as Inland Revenue investigators, generally apply the latest OECD transfer pricing guidelines. We do not believe the proposals will result in a significant change in practice.

However, the amendment will make any New Zealand reservations more important (for example, we do not view a branch as a separate entity). The legislative provision should specifically state that the guidelines apply domestically only to the extent that New Zealand has adopted those guidelines and do not apply to the extent of any reservations we have made.

We suggest the guidelines we have adopted are put into regulations, with a separate schedule detailing the areas where New Zealand has entered reservations.

It will be more imperative than ever that the Government remain engaged in the negotiations to ensure that the guidelines are adopted only to the extent that they are consistent with our domestic law and that the Government is able to enter reservations if that is not the case.

Aligning the transfer pricing rules with economic substance

We understand the rationale behind the proposal to introduce an “economic substance” test.

However, we have concerns about how the test will be implemented in practice. The concept is a matter of judgement and, inevitably, there will be grey areas.

By its nature transfer pricing documentation reflects an agreement between related parties. It is possible that a taxpayer would request a different arrangement, or different terms, if they were negotiating with a third party.

We were recently given an example of a multinational entity with related entities in many countries. The MNE decided to enter into a new country and to license a third party in the new country to perform the services there. The same services were undertaken by related parties in all other countries. The presence of the new third party agreement immediately raises the issue of whether all related party agreements must now have the same terms as the third party agreement.

We believe Inland Revenue should explain to interested parties how it intends to administer the concepts in practice (and how this administration will be resourced). For example, in the above situation, would all related party agreements need to have the same terms and conditions as the new third party agreement? What factors would the Commissioner take into account in making her decision?

The Discussion Document states (paragraph 5.30) that the OECD guidelines focus on funding, intangible assets and legal risk. If the New Zealand Government also intends to focus on these three areas they should also be included in the legislation or, at the least, referred to in guidelines or a policy special report.

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Reconstruction

The document states at paragraph 5.35 that the reconstruction should “make the related party dealing align with a commercially rational arrangement that would be agreed by independent businesses operating at arm’s length”. It goes on to say that “if the commercially rational alternative is that an independent business would not enter into a similar arrangement, then the arrangement may be disregarded”. We agree that prices should be arm’s length but do not agree that this proposed threshold is appropriate.

In our view the appropriate test is whether a taxpayer would be “more likely than not” to have agreed such an arrangement with a third party. This should be specified in legislation.

Paragraph 5.39 states that the reconstruction rules would be limited to “exceptional circumstances”, although not explicitly so. We believe the legislative provision should legislate for the “exceptional circumstances” if this is the intention. If the words “exceptional circumstances” are not appropriate then another description should be used. The description in paragraph 5.40 of “aggressive and commercially irrational” arrangements may be appropriate if these terms were defined.

Paragraph 5.40 of the Discussion Document encourages taxpayers to seek APAs to increase certainty. We appreciate the Government seeking to provide certainty to taxpayers given the inherent uncertainty of a reconstruction provision. However, for many taxpayers, obtaining an APA is not realistic. We understand from our members that securing an APA does not happen at the speed of commercial business – it is a long process, and often expensive. We understand from speaking to our members that many attempts to procure APAs are abandoned due to the length of time taken and none we spoke to had succeeded in obtaining a bilateral APA. If Inland Revenue wishes taxpayers to obtain greater certainty through APAs we believe it must act to make the process as streamlined as possible, including resourcing a large team dedicated to performing this work.

Arm’s length conditions

We understand the reasons for the proposal to amend the legislation to refer to arm’s length “conditions” rather than an arm’s length “amount”. In our view it is sensible to view the entire agreement rather than the price in isolation (and we understand this currently happens in practice).

However, the proposal again adopts the Australian approach which we believe would involve significant overreach. As with the “economic substance” proposal, this one is also based on section 815.130 of the Australian Income Tax Assessment Act 1997.

The full text of the section requires that one disregards the form of the arrangement to the extent that it is inconsistent with the substance and also provides (in subsections 3 and 4) as follows:

“ ... if:

1. independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations; and

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2. independent entities dealing wholly independently with one another in comparable circumstances would have entered into other commercial or financial relations; and
3. those other commercial or financial relations differ in substance from the actual commercial or financial relations;

the identification of the *arm's length conditions must be based on those other commercial or financial relations.

(4)

Despite subsection (1), if independent entities dealing wholly independently with one another in comparable circumstances would not have entered into commercial or financial relations, the identification of the *arm's length conditions is to be based on that absence of commercial or financial relations.”

As we have stated under “economic substance”, above, in most cases is likely that the arrangement would be different if it had been entered into by a third party; it is also likely that the parties would not have entered into the arrangement had it had not been with a related party. Businesses do not always negotiate the best deal every time. Sometimes they simply need to move forward.

As we have stated under “reconstruction”, above, we believe this this proposed threshold is uncommercial and therefore not appropriate. In our view the appropriate test is whether a taxpayer would be “more likely than not” to have agreed such an arrangement with a third party. This should be specified in legislation

Burden of proof

The document proposes the burden of proof be reversed for transfer pricing issues and be placed on the taxpayer. We understand this is also the position in Australia.

We appreciate the taxpayer has better information about their affairs than the Commissioner does. However, we understand that the reason for the burden of proof being on the Commissioner in transfer pricing cases is due to the nature of the issues involved. Transfer pricing issues are often matters of judgement. The Commissioner and taxpayers use benchmarks and comparables to show that the arrangement is “arm’s length”. The Commissioner has access to the tax records of every taxpayer in New Zealand, and has access to offshore information from overseas tax authorities, so can be in the best position to determine whether the arrangement is similar to one that has been entered into elsewhere.

We do not believe the burden of proof should simply be reversed. If the burden is to be shifted to that taxpayer then, at the least, the burden should be on the Commissioner in situations where she is using data that is not available to the taxpayer.

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Transfer pricing documentation

We understand most multinational enterprises over the proposed turnover threshold provide this information already and we do not have a problem with the requirements being formalised in legislation.

We agree compliance costs will be low because most or all affected taxpayers undertake this work currently. Compliance costs can often be an issue in transfer pricing requirements and we believe the proposal is smart and pragmatic.

Time bar

The Discussion Document proposes that the time bar for transfer pricing assessments be increased from four years to seven years, noting that this would be consistent with other jurisdictions.

The table on page 37 gives information on the time bars for ten other countries. Of these, Australia and Canada have the four year / seven year split; all others seem to have the same or a similar time bar for transfer pricing matters as for other tax matters. Given this, we do not believe that consistency with other jurisdictions is, in itself, a reason to make the change.

We understand Officials' concerns regarding the complexity of modern commercial arrangements but in our view these concerns should be addressed by increasing resource to investigate and deal with arrangements at the time they occur. We do not believe spreading the work over an additional three years to be a useful solution.

Increasing the time bar also seems inconsistent with the direction Inland Revenue is heading in its customer-centric approach. We understand one of the goals of the Business Transformation project is to provide more "real time" advice, information and assurance. A key aim is to encourage taxpayers to "get it right from the start".

In addition, Inland Revenue's compliance management approach for multinational enterprises has been to move to resolving any issues with commercial transactions in real time. It is doing this by providing more pre-filing reviews and risk reviews. In our view this is working well. The time bar has remained at four years but many taxpayers are now able to achieve practical certainty within one year.

The proposal to move the time bar for transfer pricing to seven years is out of step with and other Inland Revenue initiatives and, in our view, is a retrograde step.

If this move were to go ahead it would be imperative that the change were prospective only – i.e. would include only transactions and documentation from when the change were enacted and not documentation from six years ago.

Applying the transfer pricing rules to investors acting in concert

We understand Officials' wish to align the "associated persons" rules for thin capitalisation and transfer pricing.

However, we are concerned that, as a practical matter, many minor investors would not be involved in

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transfer pricing decisions and would not have access to transfer pricing documentation. They would rely on the decisions of the major investors. We believe the rule needs to be flexible to allow for this possibility.

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Chapter 6: Administrative measures

The new administrative measures proposed generally provide more incentives for taxpayers to comply with Inland Revenue requirements and more sanctions when they do not comply. We question whether the new administrative measures are needed when most multinational enterprises cooperate with Inland Revenue. However, if such measures are to be implemented, we agree that this should be done by way of legislation and not by reliance on administrative practice.

It is our view that any increase in administrative sanctions must be accompanied by corresponding measures to encourage and assist taxpayers to comply.

In practical terms, this means initiatives to give taxpayers certainty that they are doing the right thing, such as greater access to rulings; real time Commissioner's opinions; greater access to earlier signoffs via risk reviews; and assistance from Inland Revenue – from staff or a website – when required. As we have previously discussed, the Inland Revenue restructure provides an opportunity for the Commissioner to redeploy resources to areas where they will be most needed going forward.

In addition, in our experience, most multinational enterprises cooperate with Inland Revenue and so we question the need to introduce new administrative measures to encourage cooperation.

In terms of the specific proposals, we do not agree that Inland Revenue should have the power to unilaterally fine taxpayers for not providing information. Fines should be imposed only by an independent body such as a court. If the Government wishes Inland Revenue to have the power to impose fines we believe, at the least, that this power should exist only with the signoff from an independent party such as a TRA judge, the Solicitor-General or the Attorney-General.

We would be happy to discuss our submission with you and look forward to the opportunity to do so.

Yours sincerely

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BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
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21 April 2017

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Transfer pricing and permanent establishment avoidance

We support the consultative approach adopted by the Government in its adoption of measures associated with the G20/OECD-led Base Erosion and Profit Shifting (“BEPS”) project.

BEPS – Transfer pricing and permanent establishment avoidance forms part of an interconnected package, alongside *BEPS – Strengthening our interest limitation rules* and *New Zealand’s implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS*. The package is a powerful combination, which will put New Zealand at the forefront of worldwide approaches to BEPS implementation.

This submission should therefore be read alongside our submissions on the other elements of the package.

Permanent establishment avoidance and amendments to source rules

We agree that economic activities which should result in a permanent establishment (“PE”) in New Zealand should be subject to tax here. Nevertheless, the discussion document does not provide a compelling case for the adoption of measures in domestic legislation regarding PEs and source-based taxation.

In general, we support New Zealand’s implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.¹ As elaborated in Appendix A, the multilateral convention is the best opportunity for a coordinated international approach, with significant risks inherent in New Zealand departing from international norms through the introduction of standalone rules.

New Zealand’s position can be distinguished from that of Australia and the United Kingdom. Those countries’ early action has had the effect that their equivalent rules will be in place for a period of several years before the multilateral convention applies: the impact of their rules includes being a transitional bridge for an interim period. New Zealand’s later application means this argument has little force here.

¹ See our submission regarding *New Zealand’s implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS*.

Should New Zealand seek to introduce the PE and source rules proposed, it will be important that legislation be drafted with great clarity as to scope and application. Our experience in the United Kingdom and Australia shows that poorly drafted rules lead to disputes, with uncertain outcomes for taxpayers and deteriorating relationships between multinationals and tax administrations. Further, if the rules are adopted, there should be a substantial lead time before they take effect. Multinational groups often structure their supply chain consistently across all operating territories. Restructuring will be complex and will require time.

As set out in Appendix B, we have a particular concern that amendments to the source rule overreach: they could tax foreign sourced income of non-residents in contravention of New Zealand's international tax framework.

Transfer pricing

We support better alignment with Australian transfer pricing rules given the high level of trans-Tasman investment and degree of business integration - but only to the extent those rules remain consistent with the principles set down by the OECD and do not seek to tax a greater than arm's length proportion of profit.

That means we support aligning transfer pricing rules with economic substance and giving Inland Revenue the power to reconstruct transactions. Reconstruction should, however, only be an option in exceptional circumstances and this, or similar, wording should be included in legislation. The Commissioner must not treat unsuccessful commercial decisions as irrational and our support is conditional upon appropriate safeguards to protect taxpayers.

It is important for any changes to be prospective, both in law and practice. It is not appropriate for Inland Revenue to apply the 2016 revisions to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") to transactions that occurred before the publication of the revised Guidelines.

If the taxpayer is to bear the burden of proof in relation to transfer pricing, we consider that Inland Revenue should be more prescriptive around what is required by way of evidence. Documentation requirements should be set out in some formal way (rather than through webpages on the transfer pricing section of Inland Revenue's website).

We see little justification for an extension to time bar for transfer pricing enquiries. New Zealand's current four year time bar is by no means out of step with other countries, with any extension running contrary to the real time approach adopted as a part of Business Transformation.

With the expansion of Inland Revenue's powers under the proposed transfer pricing rules, it will become more important for specific guidance to be available to taxpayers and advisors. Guidance would be welcome regarding documentation requirements, comparable and benchmarking, and the circumstances in which particular transfer pricing methods are favoured by Inland Revenue. This should be provided by way of detailed rulings or interpretation statements rather than informal website changes.

We expand these points in Appendix C.

Administrative measures

Collection of information in transfer pricing audits is time consuming and draws heavily on both Inland Revenue and taxpayer resources. We are not convinced that granting the Commissioner extensive additional powers will resolve the difficulties. Instead many of the proposed administrative measures could better be resolved by additional resourcing of Inland Revenue's transfer pricing and investigations teams.

Our comments on the specific measures proposed are provided in Appendix D.

Future engagement

The consultation period following release of the discussion documents has been short. To that end, our submission is intended to flag issues which we consider require further analysis, and, where appropriate make recommendations on the approach. We look forward to continuing to engage in discussion on the proposals throughout the coming policy-making and legislative stages.

We understand that these submissions may be the subject of a request under the Official Information Act 1982, and consent to the submissions being made publicly available.

We would appreciate the opportunity to discuss our submissions in person. Please contact David Snell (david.snell@nz.ey.com, +64 21 845 361) in this regard.

Yours sincerely



Aaron Quintal
Partner – Tax Advisory Services
Ernst & Young Limited

Appendix A – Permanent Establishment Avoidance

Multilateral instrument should be implemented before considering further permanent establishment reforms

We agree that economic activities which should result in a permanent establishment in New Zealand should be subject to tax here and support a rule which does not widen the accepted international definition of a PE in substance (paragraph 3.2).

New Zealand's implementation of the *Multilateral convention to implement tax treaty related measures to prevent BEPS* has the potential to address most, if not all, of these concerns. On this basis, we suggest efforts should focus on its implementation and resultant impact before introducing potentially wide ranging domestic PE and source reforms, with uncertain application.

Should that approach not be adopted, it will be of critical importance that legislation be drafted with great clarity as to scope and application. We are concerned that where the wording adopted is in any way ambiguous or uncertain this would lead to significant taxpayer uncertainty around the validity of global operating models and a significant increase in the number of disputes between taxpayers, Inland Revenue and other tax authorities.

We have a further concern that the proposals will not be consistent with our existing double tax agreement ("DTA") commitments and will therefore fail to work in practice.

Our concerns are driven by the experience to date with comparable rules in Australia and the United Kingdom. Our understanding is that uncertainty in the wording of the corresponding legislation in these territories has led to:

- ▶ A significant rise in the number of cross-border tax disputes.
- ▶ Concern among taxpayers that the Australian Tax Office and Her Majesty's Revenue and Customs are "cherry picking" arguments, leading to greater incidence of the rule being invoked than stated at the time of introduction. This is in contrast to a principled approach taking into account the underlying commercial substance of a given arrangement.
- ▶ Apparent administrative difficulties within the Australian Tax Office, evidenced by delays in providing guidance around its diverted profits tax.
- ▶ An increase in compliance costs, with costly restructuring imposed on global supply chains for little benefit to revenue authorities or multinationals.
- ▶ The threat of the legislation being used to compel taxpayers into costly and impractical changes to their operating models, notwithstanding that there may be strong technical support for the tax position.
- ▶ Consequent damage to the relationship and mutual trust between taxpayers and tax authorities.

Application of the rule (paragraphs 3.20 to 3.26)

If the PE avoidance rule is adopted, there should be a transitional rule to enable taxpayers to structure out of arrangements that would give rise to a deemed PE.

Inland Revenue should provide guidance on the meaning of various new concepts which form part of the rule – notably “commercially dependent”, “in connection with”, “low tax jurisdiction”, “high paid employee” and “specialised services”.

Need for transitional rule (paragraph 3.20)

Paragraph 3.20 provides that the proposed rule will apply to income years beginning on or after the date of enactment. We submit there should be a transitional rule to enable taxpayers to structure out of arrangements that would give rise to a deemed PE. The rule should apply only with effect to income years beginning three years on or after the date of enactment, as reorganising global supply chains can be a complex business, with New Zealand unlikely to be central to many multinational enterprises’ structures.

There will be taxpayers subject to these rules with existing investment structures that have previously been reviewed by Inland Revenue, in some cases perhaps having obtained rulings, tax audit sign-offs or Advance Pricing Agreements (“APAs”). Formerly compliant taxpayers should be given time to comply with any new rules.

In particular, it is common for multinational groups to structure their supply chain or operating model on a consistent basis across all operating territories. Restructuring in accordance with the proposed New Zealand rule will often not be as simple as amending New Zealand aspects and will often require fundamental change to global operations. This, by definition, has flow on consequences (commercial and tax) in a large number of territories and it follows that this is not something that can (or should) be undertaken quickly. It is considered inappropriate to impose such a short time frame for realignment (with the threat of 100% penalty if that timing is not met) for many or most taxpayers.

A related point is considered below in the “consequences of application” section of this submission regarding the imposition of a 100% penalty for currently compliant structures in the absence of grandparenting.

We have particular concerns that Inland Revenue may seek to assess companies planning to restructure ahead of these changes. There is a possible case for an Operational Statement regarding implementation. Otherwise companies will be unwilling to change arrangements as this could be seen as an admission of tax avoidance.

New concepts will require explanation (paragraphs 3.21 and 3.24)

Any legislation needs to be sufficiently clear in what it is intended to do to ensure taxpayers are capable of complying with it at a reasonable outlay of time and cost. In particular the legislation needs to clarify:

- ▶ The rule will apply where there is a related entity that is either “associated” or “commercially dependant (sic)” (paragraph 3.21). The discussion document does not provide in-depth analysis as to the meaning of “commercially dependent” - although this appears to be quite broad. There will be many situations where an entity is arguably commercially dependent on a major customer, even though the agent is independent. For example, would an independent agent who received over 50% of revenue from a single foreign entity be “commercially dependent” on that entity? The “commercially dependent” terminology could also pick up relationships such as independent

distributors whose business is limited to one brand, which we assume is not the intent of the rules. A car dealership would be an example of a commercially dependent, but independent, agent, albeit one likely already to have a taxable presence in New Zealand. Alternatively, is “commercially dependent” intended to be consistent with the dependent agent clause in New Zealand’s DTAs? We note that New Zealand businesses, given its relatively small market size, could be particularly susceptible to triggering “commercial dependence” where this is sufficiently widely drafted to catch arm’s length dealings with major or sole offshore customers. Given New Zealand business’ unique bargaining position (or lack thereof) as a function of relative size, particular care should be taken to ensure this concept is not drafted so as to apply far more broadly than intended.

- ▶ The rule is to apply where a related entity carries out an activity in New Zealand “in connection” with a particular sale (paragraph 3.21). The discussion document does not address what constitutes “in connection”. This is a broad term and may need more clarification. At present, it is unclear whether there must be a direct causal connection that actually brings about the sale or whether an indirect connection (e.g., any activity which facilitates the sale) is sufficient. We note Australia and the United Kingdom have taken different approaches to this issue, with Australia requiring a direct connection. We would suggest that the Australian “direct” connection approach should be favoured to ensure nebulous connections to sales activity cannot be caught by virtue or “mere” or ancillary connection.
- ▶ Indicators of a PE include the involvement of a “low tax jurisdiction” (paragraph 3.24). It will be important to define this term. Does “low tax jurisdiction” mean lower than 28%, 20%, 15% or other? Many corporate tax rates have fallen in recent years, with the United Kingdom currently at 20% but scheduled to fall to 17% in 2020 one example. Is the tax base, as well as rate, a relevant factor? Proposals to introduce a border tax adjustment, combined with a reduced rate, could potentially bring the United States into any definition. There could also be issues regarding jurisdictions which have a low company tax rate but instead tax other bases (such as a resource rent tax or royalties), with state-level taxes, or with tax rate changes over time.
- ▶ PE indicators also include the existence of “a number of well paid employees”. Clarity regarding what is meant by a “well paid employee” would be welcome. It can also be argued that a combination of well paid employees and low profits is a transfer pricing, rather than PE, issue.
- ▶ Finally, the term “specialised services” is unclear. What are “specialised services” and why is that indicative of a PE? Turning again to the concept of ancillary services, these are often highly specialised and it is suggested that often a high degree of specialisation would support significant separation from sales activity.

Arrangements involving third party channel providers (paragraphs 3.27 to 3.31)

More guidance is needed in respect of what would constitute “sales promotion and services”

The concept of “sales promotion and services” is crucial to the application of the rule to arrangements involving third party channel providers and should therefore be explained. For example, if a related party organises a tradeshow for a number of different suppliers, would this constitute “sales promotion and services”?

Consequences of application (paragraphs 3.32 to 3.39)

More guidance is needed on Inland Revenue’s approach to profit attribution.

Applying a 100% abusive tax position appears harsh given the lack of grandparenting for existing structures which fully comply with current law.

Paragraph 3.35 notes that profits attributable to the deemed PE will be determined by normal profit attribution principles. We have no issue with this statement, but Inland Revenue guidance on normal profit attribution principles is limited. If Inland Revenue were to apply a method different to that of a trading partner, then double taxation and further pressure on the mutual agreement procedure (“MAP”) are likely outcomes.

That concern is reinforced by the statement in paragraph 3.36 that application of normal profit attribution principles will “result in a fairly significant amount of the sales income being attributable to the deemed PE” in most cases. It is not clear to us that this should be the outcome: if, as will often be the case, little value is added in New Zealand, then the attributed profit will be small. Expenses will also be attributed to New Zealand, rather than attribution being based on gross sales income alone.

As an obvious example, it would be expected that an unrelated New Zealand supplier, albeit one with a degree of “commercial dependence” or reliance on a dominant customer, would negotiate at arm’s length to arrive at a remuneration level fairly reflecting its value additive functionality. We would be concerned were the proposed deemed PE rule seek to re-examine or recharacterise commercial economics negotiated by arm’s length counterparties.

We also note that New Zealand would intend to impose withholding tax on any royalty paid by the non-resident in respect of supplies made through the deemed PE. Such a royalty may well relate in part to other supplies made by other jurisdictions. We anticipate that apportionment would be necessary, which would again be difficult to calculate. Detailed guidance as to an apportionment methodology would be necessary should this aspect be introduced.

Paragraph 3.38 states that the current 100% abusive tax position penalty will apply for the purposes of the deemed PE rule. This appears to be an unduly harsh penalty for arrangements which are in compliance with current law for which it is currently proposed that no grandparenting is available. We consider Inland Revenue is significantly underestimating the time it will take for a multinational enterprise to reorganise its global supply chain.

We note the comments in the discussion document around a significant “lead time” between now and the introduction of the law. Notwithstanding such lead time we emphasise that there is currently no draft legislation or certainty around the time gap between publishing such draft legislation and effective date of final law. It is unrealistic to assume or expect taxpayers to restructure global operating models on the basis of a discussion document given the inherent uncertainty of what the actual law will say and the significant global commercial implications such a restructure would have.

We recommend that the potential for grandparenting or non-application periods for particular taxpayers be revisited.

Interaction with New Zealand’s double tax agreements (paragraphs 3.40 to 3.45)

The proposed permanent establishment avoidance rules may be inconsistent with New Zealand’s DTA network, thereby creating uncertainty, deterring investment and undermining confidence in New Zealand’s DTAs.

We agree that taxpayers should not be able to rely on DTAs to protect tax avoidance relations. We are not convinced, however, that the proposed anti-avoidance rule will only capture arrangements which should be treated as avoidance arrangements for the purposes of our DTAs.

In fact, the breadth of the proposed unilateral approach is likely to reduce confidence in the integrity of New Zealand's double tax agreements and to create uncertainty for foreign investment into New Zealand. There is inherent inconsistency between the alignment with suggested OECD approaches to international taxation (including but not limited to the adoption of the multilateral convention, including an enhanced PE definition) and the introduction of New Zealand-specific deemed PE provisions such as that suggested.

In addition, the proposals are arguably inconsistent with the generally accepted OECD approach of separate entity taxation that applies in respect of associated enterprises and has been agreed to by New Zealand in all of its DTAs. It is unclear how the proposals will apply in relation to the interaction between deemed PEs and the operation of the arm's length principle in respect of existing related party transactions. The proposals could potentially apply to transactions to which no actual New Zealand taxpayer is party.

More specifically, the proposals would impose new tests that are inconsistent with New Zealand's obligations under various existing DTAs. Tax could potentially be payable where a multinational operates a business structure that complies with existing DTA concepts of PE, within integrity measures agreed in our treaties and which meets the legal substance requirements of both parties to the DTA.

Where this occurs, it is likely that double taxation will occur, with MAP invoked. It appears possible to us that competent authorities would rule in favour of treaty provisions and the proposal's purported domestic law override would be invalid.

This uncertainty would reduce the effectiveness of the proposals as a base maintenance measure, while worsening the impact of the measures on inbound investment. In substance, little revenue may be gained while substantial inbound investment using new or innovative business models may be deterred.

Appendix B – Amendments to source rules

Permanent establishment source rule has potential to overreach (paragraphs 4.18 to 4.22)

The permanent establishment source rule could tax foreign sourced income of non-residents, in contravention of New Zealand’s international tax framework.

Income attributable to a PE and royalties that New Zealand can tax under a DTA will automatically be deemed to have a New Zealand source under the new rule.

While we understand that the intention in respect of this aspect is to ensure that there is not a “gap” between PE attributed income under New Zealand tax treaties and that may be taxed under our domestic source rules. However, it appears possible to us that such a rule could be indeed be drafted so as to deem, for example, a New Zealand source for the foreign-sourced income of non-residents. Taxing such income would be inconsistent with New Zealand’s longstanding international tax framework and would go significantly beyond the stated purpose of the amendment. A DTA should not be used to create a tax liability where none would exist under domestic law.

The PE definitions contained in individual treaties will be used for the purposes of this rule (paragraph 4.19). Before final decisions are made on the design of the source rule, it would be helpful for Inland Revenue to analyse the definitions of PE across our treaty network, as we anticipate these will contain significant differences around, for example, building sites (6/12 months), natural resources, standing timber, or operating substantial equipment. Industry specific guidance may be helpful, as some sectors (such as film or technology) are particularly subject to disputes regarding PE status and income source.

Anti-avoidance source rule (paragraphs 4.23 to 4.28)

There is a risk that the anti-avoidance source rule will extend to situations beyond those targeted by the OECD BEPS Action Plan.

We have no objection to a targeted anti-fragmentation and contract-splitting rule, consistent with the OECD’s BEPS measures aimed at countering PE avoidance strategies.

The risk is that a rule treating the non-resident’s income as having a source in New Zealand if it would have had a source, considering the non-resident’s wholly owned group as a single entity will go beyond an anti-fragmentation rule. We consider that where a non-resident is earning income that has no domestic source there should be no tax. This is not a PE avoidance issue as in the absence of a New Zealand PE there is no need to even refer to the DTA. If drafted too broadly, it could seek to tax not only the New Zealand sourced income of the PE but also income derived by other group members with a New Zealand source where those other group members have no PE here (in effect, a “force of attraction” approach). We do not anticipate this is the intent but would welcome clarity on this point.

Life insurance source rule (paragraphs 4.29 to 4.35)

The life insurance source rules should be changed by way of renegotiating the relevant DTAs.

While we understand what this proposed change is seeking to achieve, we consider this would be better achieved by a change to the relevant DTAs rather than via domestic law creating another boundary for life insurers to navigate.

Appendix C - Transfer Pricing

Broad support for direction of reform

We broadly supports better alignment of New Zealand transfer pricing rules with Article 9 of New Zealand's DTAs and the OECD Guidelines, which are an aid to interpret Article 9: Associated enterprises). Better alignment with Australian transfer pricing rules makes sense given the significant investment by Australian companies and to mitigate the potential for double taxation – but only to the extent those rules remain consistent with the principles set down by the OECD and do not seek to tax a greater than arm's length proportion of profit.

Transfer pricing definition (Paragraphs 5.7 to 5.9)

At paragraph 5.7, the document states that transfer pricing is a strategy used by multinationals to “shift profits out of New Zealand and reduce their worldwide tax bills”. We are concerned this interpretation indicates a mind-set that multinationals generally target New Zealand taxable income through their transfer pricing strategy, which overstates the significance of New Zealand in global terms and understates the rigour imposed by the arm's length principle.

Transfer prices rules are defined in the 2016 revisions to the OECD Guidelines² as being concerned with determining the conditions, including the price, for transaction within an MNE group resulting in the allocation of profits to group companies in different countries. Transfer pricing might therefore be more neutrally defined as the setting of those prices (whether or not that results in the shifting of profits or a reduction in worldwide tax bills). Multinational enterprises cannot help but engage in transfer pricing, the concept itself is not tax driven and should not be used in derogative terms.

The in-market distributor structure (paragraph 5.16 and Appendix)

The in-market distributor structure given in example 4 is overly simplistic. It leads to an interpretation that the Government considers all distributors with low profits to be problematic, where they happen to be performing distribution activities for a procurement hub in a jurisdiction with a lower corporate tax rate.

Inland Revenue should clarify that using a limited-risk distributor (“LRD”) has commercial justification. Use of the example without additional necessary factual information (e.g., regarding the risks actually borne by the respective parties) otherwise creates uncertainty.

Paragraph 5.16 of the discussion document refers to example 4 in the appendix, which relates to the use of an in-market LRD in New Zealand.

The LRD model is one commonly used throughout the world, including in New Zealand. It is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development (“R&D”) happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken in New Zealand happens at the end of the supply chain and is often relatively low in terms of the value-adding functions contributing to the system profits of the enterprise.

² Executive summary, *Aligning transfer pricing outcomes with value creation*: OECD Final report on Actions 8-10.

OECD Guidelines (Chapter IX) recognise the LRD model and that companies may convert from full risk to limited risk models. Of course, consideration needs to be given to risk allocation and the revisions proscribe more emphasis on the economic substance of the structure. The structure should not be viewed as lacking “commercial reality”³ simply because it is not a structure commonly seen between independent parties - yet the trade-off of risk and return is a fundamental commercial principle.

At paragraph 5.31, the discussion document quotes the revised OECD Guidelines as endorsing a substance-over-form approach to the allocation of risk. Viewed in isolation, this paragraph might suggest that contractual assumption of risk is not relevant to a transfer pricing analysis. However, the OECD Guidelines confirms that the contractual terms are the starting point in “delineating” a transaction, but not the only consideration.⁴

We endorse OECD’s initiatives to ensure that transfer pricing outcomes are consistent with the location of value creation. We also support that under BEPS Actions 8-10 revisions, structures will need to be tested to ensure the pricing aligns with the economic substance of the transaction. However, the discussion document’s commentary on the LRD structure is broad and is concerning in its wholesale designation of the LRD model as a form of profit-shifting (paragraph 5.16).

The implication seems to be that, in most cases, LRDs structures lack commercial reality and most risks are controlled by the New Zealand entity. Our experience is that invariably a substantial proportion of market risk is assumed and indeed controlled by the foreign principal (or other affiliates offshore). More often, marketing strategy is conducted offshore and tight control maintained over marketing spend, inventory levels and major business decisions of the LRD. The New Zealand subsidiary will often undertake market activation activity rather than development.

State of the law and reference to the OECD guidelines (Paragraphs 5.19 to 5.23)

We support adding a reference to the OECD Guidelines into New Zealand’s transfer pricing legislation but dispute this reference will “simply clarify our existing practice”: it is not clear that Parliament intended the OECD Guidelines to be used as an interpretative aid to existing rules.

Any law change to incorporate the OECD Guidelines should be prospective - both in law and in practice. It is not appropriate for Inland Revenue to apply the 2016 revisions to the OECD Guidelines to transactions that occurred before the publication of the revised Guidelines.

At paragraph 5.23, the discussion document states the OECD Guidelines are “generally consistent with our existing law” and that “Adding a reference to the OECD guidelines into New Zealand’s transfer pricing legislation will simply clarify our existing practice of using the latest guidelines”. We have previously argued in disputes with Inland Revenue that the current transfer pricing rules are not aligned with Article 9 and therefore some aspects of the OECD Guidelines do not sit well with the current New Zealand transfer pricing rules (similar to Australia following the decision in the *SNF*⁵ case). While much of the OECD Guidelines are useful in assisting to interpret the arm’s length principle under New Zealand transfer pricing law, there have been some areas of controversy caused by the non-alignment, notably around the extent to which arm’s length prices should be subject to interpolated arm’s length conditions. We do not agree that the OECD Guidelines can simply be referenced as an authority under current law. Inland Revenue practice of using the OECD Guidelines will not be

³ Appendix, Example 4, page 51.

⁴ See paragraph 1.78 of the revisions to section D.1.2.1.2 of the OECD Guidelines.

⁵ Commissioner of Taxation v SNF (Australia) Pty Ltd [2011] FCAFC 74.

consistent with the existing transfer pricing law in all circumstances. It should be clear that any law change to incorporate the OECD Guidelines is prospective - both in law and in practice.

We have concerns that some of the 2016 revisions to OECD Guidelines brought about through Actions 8-10 are already being referenced by Inland Revenue for years prior to 2016. Concerns centre on the focus on economic substance, despite the discussion document confirming that existing transfer pricing legislation is focused on the legal form of arrangements (paragraph 5.15). We are not comfortable with Inland Revenue's current practice of applying all the 2016 revisions to the OECD Guidelines to preceding years. Such practice is applying changes retrospectively.

This is of further concern given we do not consider OECD Guidelines fully align with existing transfer pricing law, as noted above. The BEPS initiatives in Actions 8-10 are a substantial revamp of the OECD Guidelines and the revisions made in 2016 to the OECD Guidelines should not be applied retrospectively. A taxpayer cannot be expected to forecast substantive changes to OECD Guidelines when determining tax positions prior to 2016. Taxpayers take tax positions based on the information available to them, and it is unreasonable for Inland Revenue to challenge these tax positions armed with hindsight and a set of guidelines that never existed at the relevant time.

In support of our concerns regarding Inland Revenue's approach towards incorporating the OECD Guidelines, we refer to legislative history. The current transfer pricing rules were substantially enacted by the Income Tax Act 1994 Amendment Act (No. 3) 1995, and came into effect at the beginning of the 1996/1997 income year.⁶ The rules effectively legislated the arm's length principle which had long since been a feature of Article 9 of New Zealand's double tax agreements ("DTAs"). In turn, the DTAs are largely modelled on the OECD Model Tax Convention.

Our domestic legislation in fact makes no reference to the OECD Guidelines. Parliament's original intention⁷ was for the five available methods set out in section GC 13 to be consistent with the then OECD Guidelines (first released in 1995). Parliament did not, however, choose to make explicit reference to the OECD guidelines. Without explicit reference in the legislation, it is not clear how the 2016 OECD Guidelines are relevant for the purposes of the New Zealand transfer pricing rules.

We note that the position of the OECD Guidelines is unique in that they are not binding on member states of the OECD, and have not been ratified in domestic New Zealand law. The extent to which Inland Revenue uses them as an extrinsic aid to the legislation, assisting in the interpretation of section GC 13, is questionable. It is not supported by the legislation itself which provides no indication of how the five available methods are to be interpreted.

Since the passing of the legislation, the OECD Guidelines have expanded and changed considerably, most recently through the implementation of Actions 8-10 and 13 of the OECD's BEPS project. The drafters of section GC 13 could not have foreseen the changes that have since taken place.

As shown by the legislative history of section DB 34 regarding research and development,⁸ it seems unlikely that Parliament would have contemplated the Income Tax Act 2007 be interpreted in light of

⁶ Tax Information Bulletin [1210-110] *Arm's Length Principle*, 1 October 2000.

⁷ Set out in the commentary on the Taxation (International Tax) Bill, August 1995.

⁸ Section DB 34 which allows a deduction for expenditure incurred on research or development where that expense has been recognised for financial reporting purposes. Section DB 34 not only refers explicitly to the relevant reporting standard but has been consistently updated to reflect changes in generally accepted accounting practice and in the specific reporting standards. Notably, changes have been made in the Taxation (Business Taxation and Remedial Matters) Act 2007 and the Taxation (Consequential Rate and Remedial Matters) Act 2009. The failure of Parliament to consider incorporating specific reference to the OECD Guidelines materially weakens any Government arguments that the Guidelines should be seen as a strong aid to interpretation of section GC 13.

whatever guidance OECD produce on a prospective basis. Parliament did not delegate responsibility for New Zealand's transfer pricing rules to OECD officials; rather, it took note those in place at the date of enactment in the design of New Zealand's rules.

Aligning the rules with economic substance (paragraphs 5.24 to 5.33), requirement for arm's length conditions (paragraphs 5.41 and 5.42)

We agree with the proposed changes to align the rules with economic substance. This reflects a step-change in the law and drafting of the legislation should set out unambiguously what is required of taxpayers, in order to demonstrate that all conditions of their transfer pricing arrangements are arm's length.

We have no issues with aligning the rules to economic substance in principle. In most respects the rules are already aligned to economic substance; present transfer pricing analyses necessarily involve preparation of a functional analysis.

However, reference to "arm's length conditions" would considerably broaden the scope of section GC 13. Inserting a rule to specify that taxpayers are required to take into account the relevant conditions that a notional third party would be willing to accept is likely to have a subjective and uncertain impact on many arrangements. While the Commissioner is entitled to make enquiries in assessing arm's length terms and conditions, a commercial negotiation will take into account many factors. Given that the burden of proof will fall on taxpayers to show that the conditions of their arrangements are arm's length, it is important that Inland Revenue is clear about what is required of taxpayers.

Reconstruction of transactions (paragraphs 5.34 to 5.40)

We submit that the test under which the Commissioner should be able to reconstruct transfer pricing arrangements must have a high threshold, consistent with the OECD Guidelines. New Zealand's legislation should refer to "exceptional circumstances" or provide similar wording that ensures it is only used where the arrangement is aggressive and/or commercially irrational.

Adjustments which propose to reconstruct transactions should have a high level of sign-off internally within Inland Revenue, in the same way as our domestic avoidance laws.

In conducting investigations, Inland Revenue looks at such arrangements retrospectively. It is important that the merits of any commercial decisions taken prospectively are not labelled irrational by the Commissioner who has the benefit of hindsight simply because they turn out to be unsuccessful.

Inland Revenue should release robust guidelines to assist taxpayers on factors it will take into account in considering reconstruction; along with useful examples.

The discussion document proposes to grant Inland Revenue a wider mandate to reconstruct arrangements than that contemplated by OECD, similar to that adopted in Australia. According to paragraph 5.39, the proposed reconstruction rules would not be explicitly limited to "exceptional circumstances". Dropping the "exceptional circumstances" condition (which exists in the OECD Guidelines⁹) suggests that Inland Revenue would seek to reconstruct a transaction if a taxpayer cannot "benchmark" those particular dealings against those seen in the market between independent parties. We have concerns that taxpayers will be required to demonstrate that such dealings occur between

⁹ D.2.1.121-125.

unrelated parties and the transaction is “commercially rational”. Non-recognition or reconstruction will inevitably result in more international disputes and need for international dispute resolution.

The revised OECD Guidelines emphasise the problems inherent in reconstruction. Specifically, paragraph 1.123 of the revised part D.2 of the OECD Guidelines states:

“Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should be noted again that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm’s length arrangement.”

Given the serious risk of double taxation, we consider that reference should be made in the reconstruction rules to be explicitly limited to exceptional circumstances. New Zealand’s reputation as a good place for doing business depends in part on fair and certain regulation.

Wording along the lines of the Australian rules, i.e., that “independent entities dealing wholly independently with another in comparable circumstances would not have entered into the actual commercial or financial relations” will create considerable uncertainty for taxpayers. This is because this wording does not take account of the fact that associated enterprises do commonly enter into actual commercial or financial relations which would differ from those entered into by independent parties. It is only where the circumstances of such an arrangement are commercially irrational that the rule should be invoked. Section 1.123 of the revised OECD Guidelines states that the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties *under comparable economic circumstances, not whether the same transaction can be observed between independent parties.*

Paragraph 5.40 of the discussion document acknowledges that the rule will reduce certainty for taxpayers, but should only be the case where the arrangement is aggressive and commercially irrational. If that is the case, then we consider that the legislation should say so. If the concept of an “exceptional circumstance” is subjective, then perhaps some other word or phrase conveying the relevant meaning could be used.

Paragraph 5.35 of the discussion documents states that “if the commercially rational alternative is that an independent business would not enter into a similar arrangement, it may make sense to disregard (rather than reconstruct) the arrangement for tax purposes.” This could present worrying outcomes. In most cases, Inland Revenue will be investigating retrospectively and would need to exercise caution that its conclusions as to whether an arrangement is commercially rational is not prejudiced by the benefit of hindsight, which a taxpayer entering into the arrangement would not have.

There is risk Inland Revenue will assert that an arrangement cannot be commercially rational simply because it is not seen in practice between unrelated parties. Inland Revenue needs to be cognisant of the important principle emphasised in OECD that cautions tax authorities to take into account that multinationals often enter into transactions that are rarely encountered between by independent parties.

Further, we note that disregarding an arrangement entirely should be rare. If an arrangement giving rise to a deduction is considered to be commercially irrational, the relevant counterfactual might not be the lack of any deduction at all. It might be that, but for the arrangement, the taxpayer would have entered into an alternative, commercially rational arrangement, which might have yielded a lesser deduction. Disregarding the arrangement entirely would therefore be unjust. We defer to the revised

OECD Guidelines which provide additional guidance as to when arrangements should be disregarded, and note that these examples are limited in scope (see for example, those at section D.2.).

Advance Pricing Agreements

APAs should remain unaffected by any law change until such time as the APA is required to be renewed.

While the proposed law changes will be prospective in effect, this could well impact APAs that have been negotiated and signed under the current law, yet will be subject to any law change.

Given that APAs, by their nature, are approached in good faith by a taxpayer to get certainty for a period of time, all APAs should remain unaffected by any law change until such time as the APA is required to be renewed.

Burden of proof (paragraphs 5.43 to 5.48)

If the taxpayer is to bear the burden of proof in relation to transfer pricing, we consider that Inland Revenue should be more prescriptive around what is required by way of evidence.

Documentation requirements should be set out in some formal way (rather than through webpages on the transfer pricing section of Inland Revenue's website).

The risk of arrangements being reconstructed or disregarded (and deductions being denied) is serious for taxpayers who, under the proposals, bear the burden of proof in relation to showing that the conditions of their associated party transactions are arm's length. We submit that Inland Revenue will need to provide some guidance about what evidence should be provided. The proposed rules will necessarily increase compliance costs, with more robust transfer pricing documentation required.

The discussion document notes at paragraph 5.48 that the additional compliance costs imposed by a shift of the burden of proof would not be substantial. That may be so if the burden of proof was the only change. However, coupled with the need for taxpayers to show that all conditions of their cross-border associated party transactions are arm's length, the risk that Inland Revenue could reconstruct their cross-border arrangements and other measures such as the extended statutory time bar, the compliance costs for taxpayers will be substantial. We envisage that these proposals will add considerable expense for multinational companies and will likely increase the occurrence of disputes with Inland Revenue.

The additional expense might be mitigated if Inland Revenue set out more clearly what is required from taxpayers and what is not. Documentation supporting *all* conditions of a transfer pricing arrangement could encompass an almost unlimited amount of analysis. Inland Revenue would need to consider which conditions it deems to present more material risk, and what taxpayers must do to demonstrate that any given condition is appropriate.

One specific area on which guidance from Inland Revenue would be helpful is that of the use of the profit split method.

The OECD's Revised Guidance on Profit Splits¹⁰ states at section C.3 that *"the application of a transactional profit split of actual profits reflects a relationship where the parties either share the same economically significant risks associated with the business opportunity or separately assume closely related risks associated with the business opportunity and consequently should share in the resulting profits or losses"*. In particular, profit splits are deemed to be more appropriate where multiple parties make unique and valuable contributions such as unique and valuable intangibles.¹¹

We are concerned that the increasing transparency over a taxpaying group's entire supply chain in transfer pricing matters and information-gathering powers given to the Commissioner in the proposals will lead to Inland Revenue increasingly seeking to use the profit split method for New Zealand taxpayers in circumstances beyond those envisaged by the OECD.

We are finding in practice that, in obtaining more information about the group's supply chain, Inland Revenue is proposing using the profit split method where we would not have considered it appropriate. We are concerned that, using additional powers to force taxpayers to pay tax early, Inland Revenue could devise profit splits using somewhat arbitrary calculations based on visibility of the group's global supply chain (and where the role of the New Zealand entity in that supply chain is neither particularly unique nor valuable). Not only is Inland Revenue's use of the profit split method sometimes problematic, the resulting calculations regarding attributable profit can often be unsustainable. For example, a technology company is unlikely to have been able to allocate losses to New Zealand in its development phase, so application of the profit split method as soon as profits eventuate can lead to inequitable outcomes. Further guidance is needed from Inland Revenue on its use of the profit split and other methods; in practice we consider that its use can often be contrary to the relevant OECD guidance.

General requirement to document transfer pricing practices (paragraphs 5.60 to 5.63)

We submit Inland Revenue should provide guidance to taxpayers on when transfer pricing documentation needs to be prepared, and what the documentation ought to contain.

One approach would be to provide some de minimis rules to allow taxpayers to prepare simplified documentation, along the lines of the simplified record keeping requirements in Australia. Taxpayers with a small amount of related party transactions should be able to take a cost/risk approach to documentation without concern of a potential shortfall penalty.

Multinationals often ask us whether transfer pricing documentation is required by New Zealand legislation, whether there are monetary thresholds for preparing transfer pricing documentation, and what the penalties are for non-compliance. These questions are driven by taxpayers' experience in other jurisdictions, where the legislation clearly sets out these matters. In New Zealand the answer is less clear, because:

- ▶ Transfer pricing documentation is not explicitly required by legislation, but rather in practice required by Inland Revenue as evidence that taxpayers have exercised reasonable care;
- ▶ Monetary thresholds for which documentation is required are not explicitly stated; rather Inland Revenue considers that transfer pricing documentation should reflect the level of risk (without stating what level of risk is material)¹²;

¹⁰ Issued 5 September 2016.

¹¹ See section C.3.2.

¹² See paragraphs 317ff of the New Zealand transfer pricing guidelines.

- ▶ Penalties are calculable with respect to any tax shortfall (not whether transfer pricing documentation has been prepared at all), for example where the taxpayer has not taken reasonable care.

New Zealand's self-assessment regime therefore places a larger burden on taxpayers to determine for themselves whether their cross-border associated party transactions are material, and the level of documentation that is appropriate. Some multinationals are not well-equipped to determine what the New Zealand Government would deem to be material. What is material for one revenue authority can be insignificant for another.

Further, multinationals often determine their transfer pricing obligations centrally. They must enquire into the transfer pricing rules of a large number of jurisdictions, and require straightforward answers as to what level of documentation is required in each. If the requirements are vague and complex, as they arguably are in New Zealand, on a cost/risk basis the multinational may decide only to prepare transfer pricing documentation for those countries whose law explicitly requires it.

At paragraph 5.61, the discussion document is critical of the varying quality of documentation prepared by taxpayers. In our experience, multinationals generally prepare their transfer pricing documentation consistent with the OECD Guidelines. Inland Revenue has not specifically stated what it would like to see included in transfer pricing documentation. It did produce its own transfer pricing guidelines (the "IRD Guidelines").¹³ However, it has now stated its intention not to further update the IRD Guidelines and instead follow the 2010 OECD Guidelines.¹⁴ This begs the question: what would Inland Revenue like to see in the documentation (other than what the OECD Guidelines prescribe)?

In summary, the present transfer pricing rules do not adequately describe to taxpayers:

- ▶ How the arm's length standard is to be interpreted and how the five available methods should be applied (i.e., whether the OECD Guidelines are authoritative, and if so, which version);
- ▶ When taxpayers are required to prepare transfer pricing documentation to comply with the law;
- ▶ What documentation should contain so as to satisfy the Commissioner that the taxpayer has taken reasonable care in determining its transfer prices.

Inland Revenue is not proposing any compulsory filing of transfer pricing documentation. It will expect transfer pricing documentation, such as a master file and local file, to be provided on request or audit. Experience in Australia under its new transfer pricing laws is that the level of document compliance has increased. Given alignment of the transfer pricing rules with those of Australia, and the concerns we express above, the Government should consider providing some de minimis rules to allow taxpayers to prepare simplified documentation, along the lines of the simplified record keeping requirements in Australia. Taxpayers with a small amount of related party transactions should be able to take a cost/risk approach to documentation without concern of a potential shortfall penalty.

¹³ An appendix to *TIB* Volume 12, No 10 (October 2000).

¹⁴ See for example: <http://www.ird.govt.nz/transfer-pricing/transfer-pricing-guidelines.html>.

Time bar extension (paragraphs 5.67 to 5.72)

We oppose the extension of the time bar for transfer pricing matters. The fact-specific nature of a transfer pricing dispute is neither unique to transfer pricing nor justification for the extension.

The discussion paper suggests that an extended time bar would bring New Zealand in line with other jurisdictions. The paper points to Australia and Canada which have time bars that are three years longer than their four year time bars for other tax matters. We note from the table given at paragraph 5.70 that there are several other jurisdictions which have the same time bar for transfer pricing as they do other tax matters; so New Zealand is by no means out of step with the world.

The discussion document seeks to draw a distinction in relation to transfer pricing assessments which are more dependent on the facts and circumstances of each case than other tax matters. Other tax matters also are dependent on facts and circumstances; the avoidance regime would be one example where factual inquiries are more necessary and yet the time bar remains the same.

It should also be noted that a longer time bar creates the same difficulties for a taxpayer trying to defend its tax position as it does for the Commissioner. This is particularly pronounced where, for example, the taxpayer has since restructured or closed their New Zealand operations and there are no longer staff in New Zealand with institutional knowledge of the taxpayer's operations.

Further, the extension of the time bar would be inconsistent with Inland Revenue's other moves towards real-time tax compliance. It is contrary to the scheme and purpose of Inland Revenue's Business Transformation programme. We also note that participation in the Inland Revenue's APA programme has been strong in recent years, reflecting a willingness on the part of both the Commissioner and taxpayers to settle transfer pricing matters contemporaneously, rather than engage in costly and lengthy disputes.

Many other changes are proposed in the discussion document which assist the Commissioner in assessing multinationals on their international tax obligations. We consider that implementation of the statutory time bar could be deferred until the full effect of the other proposals is seen.

If the proposed extension of the time bar does go ahead, it should not unfairly reopen any previously closed periods. For example, tax positions assessed in the year ended 31 March 2013 will now be time barred, but could be reopened for a further three years unless any change is prospective.

Inland Revenue should provide more substantive rulings and guidelines to assist taxpayers

Inland Revenue should provide some specific guidance to complement OECD Guidelines in the New Zealand context. This guidance should be in the form of detailed rulings or interpretation statements rather than informal website updates.

Guidance would be particularly important regarding suitable comparables for benchmarking, and the circumstances in which Inland Revenue views particular methods such as profit split as the most reliable transfer pricing method.

Although not specifically covered in the discussion document, with more complexity and uncertainty in Action 8-10 revisions, we urge Inland Revenue to prepare detailed rulings, interpretation statements or similar guidance in consultation with transfer pricing practitioners. The Australian Tax Office typically assists taxpayers by preparing rulings and other interpretation statements for their transfer pricing

rules (for example TR2014/6 relating to section 815-130). These rulings tend to provide explicit justification for departures from OECD Guidelines and follow a transparent consultative process with an opportunity for taxpayers and advisors to submit their views.

Inland Revenue released final transfer pricing guidelines in October 2000¹⁵ but has ceased updating them. It has more recently relied on website updates, which contains relatively scant detail, have unclear authoritative value, are not widely publicised and may be removed from the website at any time. To ensure better compliance and less controversy, with these changes in law, we recommend Inland Revenue provide some specific guidance to complement OECD Guidelines in the New Zealand context.

Fundamental to the OECD Guidelines is comparability. Difficulties in benchmarking comparables for New Zealand companies typically requires taxpayers to seek comparables in geographies outside New Zealand. Inland Revenue has previously suggested (via EY Global transfer pricing surveys) a hierarchy of geographies in terms of reliability of comparables (e.g., Australian companies have traditionally been considered the best geography to search for comparables and Asian countries the least). More recently we have noticed in practice Inland Revenue has been presenting benchmarking based on a wide geographical spread of comparables contrary to previously stated guidance. Further written guidance would be useful to minimise risk of dispute.

The administrative measures proposed in chapter 6 of the discussion document will give Inland Revenue more power to seek information held offshore about a multinational group's affairs and to apply sanctions for non-cooperation. We acknowledge the need for Inland Revenue to be able to collect sufficient information in a timely manner to audit transfer pricing matters, but do have concerns about how the information is used. In particular, and as referred to above, visibility of a multinational group's global supply chain is not in itself adequate justification for the use of the profit split method. The additional administrative measures therefore confer a responsibility on Inland Revenue to provide some robust guidance on transfer pricing matters, including use of the profit split, so that taxpayers can ensure that they are meeting Inland Revenue's expectations of transfer pricing analysis and documentation.

¹⁵ Tax Information Bulletin, Vol 12, No 10, October 2000, appendix

Appendix D - Administrative measures

Cooperation and resourcing (paragraphs 6.1 to 6.18)

We submit that many of the proposed administrative measures could better be resolved by additional resourcing of Inland Revenue's transfer pricing and investigations teams. The administrative measures proposed would give the Commissioner substantial powers to issue an assessment and avoid many formalities of the existing disputes process. We consider that these powers overreach in light of the other proposals advanced, such as the shifting of the burden of proof to taxpayers.

We acknowledge that collection of information in transfer pricing audits is time consuming and draws heavily on both Inland Revenue and taxpayer resources. In practice, most multinationals are cooperative with Inland Revenue: it is in their interest to resolve disputes quickly and with certainty. In our experience, Inland Revenue as well as the taxpayer will cause delay. Delays are caused by lengthy periods waiting for Inland Revenue to respond and information requested proving not to be of much assistance to Inland Revenue, thereby requiring alternative information to be requested. We suggest some protocols and guidelines be put in place, agreed with transfer pricing practitioners, around transfer pricing audits so taxpayers can also be assured that matters will be dealt with expediently and Inland Revenue positions reached within a reasonable period of time, with reasonable clarity and with least possible disruption to the taxpayer group.

The majority of problems noted above could be resolved through resourcing. Powers to gather more information will worsen transfer pricing administration unless Inland Revenue is able to deal with that information on a timely basis.

We are concerned that resourcing issues will be exacerbated by the implementation of other proposals in the BEPS package. In particular, we consider that interaction of the interest rate cap and transfer pricing rule changes will lead to a larger number of cross-border disputes, double taxation and MAPs. We are concerned that Inland Revenue will not have sufficient resources to devote to these requests and procedures. It would be concerning if the Commissioner uses her new administrative powers to push seemingly "uncooperative" taxpayers further into the disputes process due to a lack of available resources at the investigation end.

Assessments (paragraphs 6.19 to 6.20)

Should the proposal for Inland Revenue to issue a NOPA or assessment based on information available at the time proceed, a taxpayer should be able to challenge that assessment.

At paragraph 6.19, the discussion document proposes that Inland Revenue be able to issue an assessment based on the information available to Inland Revenue at the time. As a drafting matter, it seems likely that this would need to be added as an exception to section 89C of the Tax Administration Act 1994, which provides the circumstances in which the Commissioner may make an assessment without first issuing a notice of proposed adjustment ("NOPA").

Further, we note that, all other things being equal, section 138E(1)(e)(iv) would operate to ensure that there would be no right of challenge against a decision of the Commissioner. This is concerning given the potential gravity of a taxpayer being caught by the rule and having an assessment made against them. The proposal could be seen as draconian given that the Commissioner's decision would not be reviewable. Other than that it would need to be signed off by a senior member within Inland Revenue,

there seem to be few safeguards to stop Inland Revenue issuing an assessment based on relatively subjective criteria.

Payment of tax in dispute (paragraphs 6.21 to 6.26)

We submit that this measure should not proceed:

- ▶ Large multinational enterprises are unlikely to default on tax due
- ▶ At current rates, use of money interest will not compensate taxpayers should Inland Revenue's position not be confirmed

Should our main submission be declined, purchases of tax from a tax pooling service should be accepted as payment of tax.

It is important to consider the position of a taxpayer against whom an assessment is issued under the new rules. In such a case, the taxpayer would have to challenge the assessment in Court. Even if it succeeds, it would then only receive the Commissioner's paying rate of interest on the tax recovered. Given that the Commissioner initiated the dispute the current rate of 1.02% per annum¹⁶ this effectively penalises the taxpayer through no fault of its own.

The purpose of the use of money interest regime is stated in section 120A of the Tax Administration Act and includes compensating taxpayers for the loss of use of money through their paying too much tax. Further, interest payable under the regime is not a penalty.

The proposals only affect large multinationals with revenue of over EUR750 million. Generally these taxpayers do not default on tax payments. Yet, under the current disputes regime, the Commissioner can recover interest at the taxpayer's paying rate which reflects a higher credit risk than these types of taxpayers actually represent to Inland Revenue. It is unclear why upfront payment of tax would really be necessary for these taxpayers when the use of money interest regime already adequately compensates the Commissioner.

Further, no reason has been advanced for why purchases from a tax pooling services should not be accepted as payment of the relevant tax. Denying pooling as an option seems to support that the use of money interest regime is in fact being used to impose a penalty rather than incentivise the correct payment of tax. We submit that purchases of tax from a tax pooling service should be acceptable.

Collection of information (paragraphs 6.29 to 6.37)

We submit that section 21 should have an exception for information which is subject to legal privilege.

Drafters of the legislation will need to take particular care in relation to the expansion of section 21 of the Tax Administration Act, as described at paragraph 6.37 of the discussion document. One concern is the position of tax advice which is subject to legal privilege. In some circumstances, the Commissioner will request information from a taxpayer in a section 21 request and the taxpayer might have legally privileged advice which arguably falls within the ambit of the request. In such a case, the taxpayer should not be required to disclose the document, but not doing so might affect its ability to later waive privilege should it wish to use the documents as admissible evidence in court.

¹⁶ From 7 May 2017



Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
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sent via email: policy.webmaster@ird.govt.nz

1 May 2017

BEPS – Transfer pricing and permanent establishment avoidance

Dear Deputy Commissioner

Thank you for the opportunity to comment on the Discussion Document (DD). We appreciate that targeting base erosion profit shifting to ensure multinationals are paying an appropriate level of tax in New Zealand is a key focus for the Government.

We have a number of comments that we would like Officials to consider as part of the design of the proposals. A summary of our submission points is as follows (all of which we discussed with Officials in our recent meetings), with more detail provided in the Appendix:

- the application date for any new policy changes should be the income year commencing after 31 March 2019 (or equivalent non-standard tax years) at the earliest;
- the proposed rule around permanent establishment avoidance (New PE Rule) should adopt the wording used in Article 13 of the Multilateral Instrument;
- if the New PE Rule is to override tax treaties, this needs to be clear in the legislation;
- there needs to be clarity in the concepts and drafting around where the line is drawn between marketing services etc that are not intended to be captured by the New PE Rule and sales activity that is intended to be captured;
- there needs to be more clarity around the other elements of the New PE Rule;
- urgent guidance is needed from Inland Revenue in relation to attribution of profits to the deemed PE;
- the biggest risk of the New PE Rule is that multinationals may decide to exit NZ if the uncertainty and tax risks are too high;
- there should be a post-implementation review within 3 years of enactment;
- 100% penalty for abusive tax position should not automatically apply if the New PE Rule applies;
- royalties deemed to have a NZ source may be subject to double withholding tax;
- Inland Revenue resourcing for transfer pricing matters needs to be increased;

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- more guidance is needed from Inland Revenue in a number of areas related to transfer pricing;
- the time bar for transfer pricing should not be extended to 7 years;
- new administrative measures should not apply from enactment to disputes already in progress;
- “non-cooperation” needs to be clearly defined and have a higher threshold than the bullet point summary in the DD suggests;
- imposing an obligation on a NZ subsidiary to pay a multinational’s tax is too harsh;
- tax pooling should be available to multinationals in relation to any new payment rules;
- it may be difficult for a NZ subsidiary to demonstrate adequately it has discharged its obligation to provide information requested of its parent; and
- section 21 of the Tax Administration Act 1994 needs to be rewritten to more closely accord with the current Inland Revenue practice and intention.

As discussed with Officials, we would appreciate the opportunity to review and comment on draft legislation before it is released as part of a Bill, if possible, in particular wording around the scope of the New PE Rule and the definition of a non-cooperative taxpayer.

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely



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Appendix: Detailed Submissions

1. Application dates

Application date should be no earlier than 1 April 2019

We understand that targeting BEPS is a key focus for the Government and an early enactment date may be its preference. In our view, the proposed application date should be no earlier than the first income year after 31 March 2019 (or the equivalent non-standard tax years). The proposed changes will affect a significant number of taxpayers, and not just those who may be viewed as having adopted unacceptable tax practices. It is reasonable to allow taxpayers time to consider how best to deal with these issues, and to rearrange their affairs if they decide it is necessary. It will be in the interest of continued investment from overseas to allow properly for this.

2. PE avoidance proposal

The New PE Rule should adopt the wording used in Article 13 of the MLI

We understand Officials' concern is that multinationals are currently able to structure their tax affairs so that they are subject to no or very little tax in NZ despite carrying on significant economic activity here. From discussions with Officials, we understand that the scope of the New PE Rule is not intended to be wider in scope than the changes to NZ's double tax agreements (DTAs) to be implemented by Article 13 of the Multilateral Instrument. This policy intention is also stated in paragraph 3.2 of the DD, where Officials say that "the proposed rule is not trying to widen the accepted international definition of a PE in substance".

The best way to ensure that this scope is matched in a domestic context, is to adopt word for word the OECD standard for dependent agent permanent establishments (PEs) used in Article 12(1) of the MLI. That wording has already been through a rigorous process of negotiation between jurisdictions and an extensive submissions process on a global basis, and has been refined to ensure that the language is not wider than the OECD considers it should be. The MLI will also provide the new global standard for when a source country will have taxing rights in relation to a non-resident, and taxpayers will have a greater amount of certainty as to the scope of the New PE Rule if the global standard wording is used. Whilst we understand that Officials have some concerns about how some aspects of the MLI wording will be interpreted, the benefit of global consistency and clarity around how the rule will operate should outweigh these concerns. Furthermore, existing anti-avoidance rules can be used to address any residual concerns.

If the New PE Rule is to override tax treaties, this needs to be clear in the legislation

Regardless of the drafting approach preferred, it should be made clear in the legislation that the New PE Rule is not wider in scope than the widened PE definition under the MLI – in other words, it should be clear that a non-resident in a jurisdiction which has a treaty amended by the MLI will not have a permanent establishment (PE) under NZ domestic law if it does not have one under the relevant treaty (as amended by the MLI). This approach is consistent with paragraph 3.2 of the DD. We do not think that the concerns raised in paragraph 3.45 arise in a situation where the relevant treaty partner has adopted the widened definition of PE under the MLI.

In cases where a treaty is not amended by the MLI, a non-resident will have a PE under NZ domestic law, but absent specific provision in the NZ legislation, the treaty will override this result so the non-resident will not have a PE. If the intention (per paragraph 3.45 of the DD) is that the New PE Rule will override the treaty, this must be specifically provided for in NZ's domestic legislation to be effective.

There needs to be clarity around where the New PE Rule line is drawn between sales and marketing activity

In principle it sounds simple to refer to sales activity being within the New PE Rule but marketing/support activity being outside. However, in reality there is a spectrum of customer relationship activity and it may be far from clear where the line will be drawn as to whether particular activities will result in the new rule applying, or whether identified activity leads to a particular sale or not. At its broadest, any activity carried on by a subsidiary in NZ could be argued as intended to lead to sales of the multinational's product or service in NZ. Furthermore, there may be a number of activities carried on both inside and outside NZ that lead to a particular sale. Is it the activity which is most influential in leading to a particular sale, or is it any activity in NZ which can be connected to a particular sale, that matters? What if the NZ account manager is generally responsible for a customer's account, but it is not clear whether the activity of the account manager is what leads to a sale of a particular product?

For example, will the following multinationals have a deemed PE in NZ under the New PE Rule?

- a multinational that has a NZ subsidiary, whose staff are contracted to visit existing and potential customers and explain contractual terms, but refer customers to the multinational's website for orders of goods on standard terms;
- the multinational's NZ subsidiary has initial and ongoing contact with customers, but at a certain stage of negotiations for a particular sale refers customers to multinational's foreign sales force and legal team, which discuss in detail the customer's needs and negotiate the sales contract;
- a multinational who has technical support staff in NZ, who occasionally refer a customer directly to the multinational for a sale of a particular product; or
- a multinational who deals in high value goods where heads of terms for sales contracts are negotiated locally but detailed terms of contracts are entered into directly by a group member in another jurisdiction.

Inland Revenue should provide detailed guidance and examples around when the new rule is intended to apply. The OECD guidance in this area is not particularly helpful and we understand Officials acknowledge this issue too. We see this issue as a key area of uncertainty.

There needs to be more clarity around the other requirements of the New PE Rule

Further explanation is required around a number of the other elements of the New PE Rule. For example:

- What does "commercially dependent" mean? Guidance should be provided here as to what Officials have in mind.

- It does not make sense for qualification criteria to refer to some or all of the profits not being attributed to a NZ PE – if the non-resident already has a PE, it is not necessary for the new rule to deem a PE to exist – rather, any issue should be around profit allocation.
- What is the “purpose of the DTA’s PE provisions”, and how will this criteria apply when a non-resident is not resident in a treaty country? It would be preferable for any language here to follow language in existing anti-avoidance provisions, such as section BG 1 of the Income Tax Act 2007. Introducing a new standard for a concept that relates to avoidance will create unnecessary uncertainty and complexity for taxpayers and Inland Revenue, and it may take many years before its meaning is conclusively established.
- What is the distinction between an “unrelated independent agent” referred to in paragraph 3.22 and not caught by the New PE Rule, and an “independent third party” referred to in paragraph 3.27 who is caught by the rule? Is the meaning of “independent party” the same in both cases, with the scope of the rule determined by the activities of a non-resident or a related entity, or do the independent parties have different features in each case (e.g. is an independent party within paragraph 3.27 nonetheless managed or controlled by the non-resident)?
- How does a third party within paragraph 3.27 differ from a commercially dependent entity referred to in paragraph 3.21?
- It may be difficult to distinguish in practice between independent agents, commercially dependent entities, and third party channel partners – it would be helpful for the distinguishing features of each arrangement to be set out in more detail.
- Should it be clear that publicly traded third parties are independent agents/third parties in all cases?
- If the third party referred to in paragraph 3.27 carries out sales activity with respect to a particular sale to a consumer, does this mean the New PE Rule would not apply? Further guidance should be provided as to what particular services a related entity might provide that would be relevant – for example, services that include locating a customer, promoting products to that customer, discussing the customer’s needs, tailoring a product to a customer, and indicating pricing, delivery dates and other key terms to the customer.
- It would be helpful to establish the scope of the new rule if the legislation contained features of arrangements that Officials consider to be indicators of PE avoidance.

Urgent guidance is needed in relation to attribution of profits to the deemed PE

Our understanding is that Officials view the intended outcome of the New PE Rule as being to match tax paid in NZ by multinational groups with the economic value created by the activity carried on in NZ. This outcome can be achieved if a group enters into a buy/sell model whereby a NZ subsidiary buys products from an offshore group member and on-sells to NZ customers. If the NZ subsidiary pays a royalty to an offshore group member, this is recognised for NZ tax purposes, subject to the application of usual transfer pricing principles, with the result that the taxable profit in the NZ subsidiary properly reflects the value created by that subsidiary’s activities (which are in many cases in NZ limited to routine sales functions).

However, it is uncertain how the intended outcome can be achieved in the context of profit attribution to a PE given that NZ does not endorse the Authorised OECD Approach to profit attribution. The main benefit of the Authorised OECD Approach is that it is possible for profit attribution to properly match economic value by treating the non-resident and its PE as separate entities, and therefore allowing internal arrangements, to be recognised (such as an appropriate royalty to be allocated to the branch from the head office from internally generated intellectual property). In contrast, NZ's current approach permits only actual costs incurred by the non-resident to be attributed to a NZ PE. The amount of profit subject to NZ tax can therefore be disproportionate to the activity of the PE because value attributed to intellectual property generated offshore may be taxed in NZ. This is the wrong outcome and is not in accordance with our understanding of the desired policy basis for the New PE Rule. Furthermore, this outcome does not align with the proposed changes to the transfer pricing rules, which are intended to base NZ's tax rules on economic substance rather than legal form.

We acknowledge that this issue already exists. However, there are currently relatively few PEs recognised in NZ in this scenario so the issue is limited in practice. It will become much more relevant if the New PE Rule is enacted. It is therefore essential that Inland Revenue assists taxpayers by releasing more detailed guidance in this area.

This guidance will be particularly important in the case of:

- “large” multinationals who may be at risk of being seen as uncooperative under the administrative measures proposed by the DD if they do not provide sufficient information to determine the profit attributable to a PE; or
- “large” multinationals and their wholly owned NZ subsidiaries, who may be required to pay disputed tax early under the DD proposals related to payment and collection of tax in dispute, even if the multinational cooperates with Inland Revenue.

A big risk of the New PE Rule to NZ is that multinationals may exit NZ

Uncertainties around the scope of the deemed PE rule and profit attribution are likely to lead multinationals to restructure their affairs so the new rule does not apply (as has been the experience in Australia following the enactment of their Multinational Anti Avoidance Rule). There are fundamentally 2 ways in which a restructure can occur:

- (a) the non-resident and its NZ subsidiary could enter into a buy/sell model, where the NZ subsidiary buys product from the non-resident on arm's length terms and sells to NZ customers; or
- (b) The non-resident could wind up its NZ subsidiary and either (i) not sell product in NZ, or (ii) sell product in NZ directly from overseas with no group employees in NZ.

This outcome is consistent with the policy outcome identified in paragraph 3.39 of the discussion document. However, in light of the relative size of the NZ market compared to global operations of the multinationals this rule is likely to affect, and time and cost involved in restructuring, (b) is the more likely scenario. The risk is that the multinational will exit from NZ altogether – we have had preliminary discussions with some multinationals who have indicated that this is likely to be their solution if the New PE Rule is enacted. Officials need to consider whether it is an acceptable risk that foreign investment into NZ will be reduced.

100% penalty for abusive tax position should not automatically apply

Simply having a deemed PE under the new rule should not be enough to trigger a penalty for taking an abusive tax position. If the multinational's view is that the group has already returned taxable income in NZ equivalent to the economic value of activities conducted in NZ, it is not appropriate for such a penalty to be imposed.

There should be a post-implementation review within 3 years of enactment

We would recommend a post-implementation review within 3 years of enactment. Given the OECD work programme and similar domestic law changes being made in other countries, any new law should be measured against necessity and inconsistencies with other jurisdictions, and whether it has resulted in unintended consequences for business and Inland Revenue, such as multinationals exiting their investment into NZ.

Amendments to the source rules

Royalties deemed to have a NZ source may be subject to double withholding tax

A royalty paid by a non-resident to another non-resident may be subject to foreign withholding tax. If all or part of a royalty is deemed to have a NZ source, and is therefore subject to NZ withholding tax, the royalty will be subject to withholding tax twice. Relief would not be available under a DTA. Officials should reconsider whether this is acceptable tax policy.

Strengthening the transfer pricing rules

Inland Revenue resourcing for transfer pricing matters should be increased

In our experience, Inland Revenue's transfer pricing team is significantly under-resourced. This leads to frustration for taxpayers because risk reviews, audits and advance pricing agreements (APAs) take a long time and are very expensive for taxpayers, and a lack of regular correspondence with Inland Revenue while matters are ongoing typically exacerbates the issue of uncertainty. We currently have several unilateral APA applications held up with Inland Revenue that were submitted more than 24 months ago. This is in stark contrast to Inland Revenue's 6 month timeframes for APAs.

These frustrations will only increase under the strengthened transfer pricing rules, particularly if the time bar is extended. A better solution, and one more in line with Inland Revenue's business transformation project, would be to ensure that Inland Revenue is properly resourced (with adequately trained transfer pricing specialists) to provide guidance as to expected timeframes, and to consistently respond within these timeframes.

If the transfer pricing rules are strengthened as proposed (particularly with respect of the timebar extension and change in the onus of proof), it will become critical to ensure that Inland Revenue is able to provide certainty through the APA process in a timely and efficient manner. Accordingly, we recommend the introduction of strict timeframes for Inland Revenue to respond to APA applications to ensure taxpayers can obtain certainty as to process and cost, as well as certainty as to tax treatment of transactions in addition to substantial increases in transfer pricing specialised resources within Inland Revenue.

More guidance is needed from Inland Revenue in a number of areas related to transfer pricing

Inland Revenue needs to provide guidance in the following areas to help taxpayers comply with their obligations and manage their risk:

- What information does a taxpayer need to obtain to be able to discharge the onus of proof? For example, what exact level of documentation will be required? Many taxpayers may form a reasonable view on the arm's length nature of their dealings without formally preparing documentation – will this be possible going forward? Or will it only be possible through the preparation of full transfer pricing documentation in line with the OECD's recommended Masterfile/Localfile approach?
- This issue will be particularly important in the case of large multinationals, who may be at risk of being seen as uncooperative under the administrative measures proposed by the DD if they do not provide sufficient information to determine the arm's length amount of a related party transaction.
- Will there be simplification measures to ensure the compliance burden does not outweigh the tax at risk in relation to smaller taxpayers or those with low-risk structures? For example, will standard practice or more de minimis safe harbours be introduced? We strongly recommend these types of measures be considered.
- What are expected timeframes for risk reviews, audits and APA negotiations?
- Will there be a period of transitional measures or relaxed enforcement following enactment of the new rules especially in circumstances where taxpayers have existing APAs under existing structures that may be impacted by the changed in the transfer pricing rules.
- Will the Inland Revenue be providing clear detailed guidance as to the limited circumstances where the Commissioner can reconstruct a related-party transaction. We strongly recommend it is made clear that this power will only be exercised by the Commissioner in extremely limited circumstances (and guidance as to what type of circumstances could be impacted). This power is essentially giving the Commissioner the ability to tell a taxpayer how to conduct its business commercially which clearly will not be appropriate in almost all cases.

The time bar for transfer pricing should not be extended to 7 years

The transfer pricing time bar should not be extended for the following reasons:

- If Inland Revenue's transfer pricing team was properly resourced, it would be possible to deal with disputes and other matters within the 4 year time bar already provided for in NZ's legislation. NZ is a small market, and it should be possible to deal with all matters within the 4 year time bar. A survey performed by the OECD's Forum on Tax Administration revealed that the average resolution for transfer pricing cases (amongst 43 OECD and non-OECD countries) was 540 days. The proposed time limit of seven years is more than four times this average, which seems unjustifiable in the NZ context. Whilst Australia and Canada allow for 7 years, most other countries have a shorter period.
- As Officials recognise, extending the time bar will decrease certainty for taxpayers, and will not promote efficiency in transfer pricing disputes. It will also prolong transfer pricing disputes, and

the costs of disputes will increase. These effects are not in the interests of either Inland Revenue or taxpayers.

- The extension of the time bar in combination with the administrative measure requiring large multinationals to pay tax within 12 months of a NOPA being issued or 90 days of an assessment means that Inland Revenue has little incentive to resolve the dispute in a timely way. The multinational (or potentially a wholly owned subsidiary in NZ) may be out of pocket for a significant period of time if the dispute is resolved in a way which means the multinational is entitled to a refund. Retaining the time bar at 4 years will give the parties a better incentive to resolve the dispute more quickly.
- Taxpayers will be required to obtain all information necessary to support their positions on an annual basis through the tax return process. We are not aware of any compelling justification as to why Inland Revenue needs a longer period than the 4 years already provided for to consider transfer pricing matters.
- Whilst we acknowledge that it is possible to seek certainty through APAs, in practice APAs are very expensive and take a long time to obtain, generally due to delays with Inland Revenue due to resourcing constraints (as per our example set out above).
- If a transfer pricing dispute is resolved in favour of Inland Revenue, the group will be at risk of double tax in jurisdictions where the time bar has already passed. This is because the group will not be able to claim a corresponding adjustment in the other jurisdiction. This outcome makes NZ appear less attractive for a non-resident considering whether to continue investment in NZ.
- There will be also commercial consequences to the extension. For example, a vendor selling a NZ company generally gives a tax indemnity to the buyer lasting around 5 years. If the time bar is extended, the buyer will no doubt seek to obtain a tax indemnity of around 8 years. This will significantly extend the time period for tax risk faced by the vendor. Furthermore, if the vendor seeks to mitigate its risk through indemnity insurance, it will need to obtain insurance cover for the extra time period, which will result in an increase in premium costs.

If the time bar is extended:

- as mentioned above, the detrimental effect on taxpayers must be negated by improvements in the APA process for obtaining certainty; and
- exemptions for small and medium sized entities and for NZ entities investing overseas should be considered.

Administrative measures

New measures should not apply from enactment to disputes already in progress

In fairness to taxpayers, the new administrative measures should not apply to disputes in progress, or there should be transitional rules.

Non-co-operation needs to be clearly defined and of a high threshold

The concept of significant and persistent non-cooperation needs to be of a sufficiently high threshold to justify the consequences. Our view is that instances of non-cooperation should be specifically

connected to failures to meet legal obligations imposed in the tax legislation – a taxpayer should not be treated as non-cooperative if it does not respond to a non-binding informal information request, or a request that is outside the ambit of the specific provisions. Furthermore, behaviour should be able to be objectively assessed, and based on clear guidelines provided by Inland Revenue.

Some of the circumstances listed in paragraph 6.16 of the DD do not seem appropriate to trigger non-cooperativeness. For example:

- a taxpayer may not be legally obliged to respond to Inland Revenue correspondence in some situations – if so, non-response should not be non-cooperative behaviour;
- failure to provide sufficient information to determine an arm's length amount or profit attribution to a PE will require a subjective assessment by Inland Revenue – it seems unreasonable for non-cooperation to arise in such a case.

Consequences which follow from transfer pricing and profit attribution issues highlight the need as mentioned above for clear and urgent guidance from Inland Revenue to ensure taxpayers are aware of the standards required for compliance.

Imposing an obligation on a NZ subsidiary to pay a multinational's tax is too harsh

It is not clear in the DD whether the proposal applies to all tax payable by a large multinational, or just tax arising in relation to disputes listed in paragraph 6.24. In either case, imposing what could potentially be a large tax liability on a NZ subsidiary that may have limited assets or resources seems disproportionate. Furthermore, imposing such a liability on a subsidiary may have other adverse effects on the subsidiary such as breaching loan covenants, breaching thin capitalisation requirements, and, if a subsidiary is sold, increased risk for a vendor under a tax covenant.

If this obligation is introduced, it should only arise in circumstances where the multinational is non-cooperative and has not met its payment obligations under law. Furthermore, the subsidiary should not have an obligation to pay its parent's disputed tax early as proposed in paragraph 6.22.

It will also be necessary to consider how the obligation on a NZ subsidiary to meet its parent's tax liabilities interacts with directors' duties under sections 131 to 137 of the Companies Act 1993. We are aware of at least one instance where Inland Revenue has sought to recover unpaid tax liabilities from the directors of a company that could not meet its liabilities on the basis that directors had breached their duties.

Tax pooling should be available

There is no explanation in paragraph 6.24 regarding why tax pooling would not be available to a multinational with payment obligations under the proposals, and this does not seem justifiable when considering the purpose of tax pooling. Officials should give this issue further consideration.

It may be difficult for a NZ subsidiary to adequately demonstrate it has discharged its obligation to provide information requested of its parent

We understand from Officials that it is not intended that employees of a NZ subsidiary can be convicted of an offence of failing to provide information about an offshore group member. This should be clear in the legislation.

In many cases, it may be difficult for a NZ subsidiary to obtain the information required from its parent. Furthermore, it may be difficult for a NZ subsidiary to demonstrate that the overseas entity does or does not have the information.

Section 21 of the Tax Administration Act 1994 needs to be rewritten

If section 21 is to be extended as proposed, it needs to be rewritten as a whole to be more balanced and reasonable to taxpayers.

The consequences of section 21 applying are severe. Section 21 excludes a taxpayer's right to access the courts (through the exclusion of challenge rights) and also excludes a taxpayer's rights to use relevant evidence in challenge proceedings. This effectively means that, where this provision is invoked, an assessment can be treated as final, without the ability to challenge the assessment for its correctness. This is a significant limitation of taxpayer rights and should only occur in the most serious cases.

As section 21 is currently drafted, the mere failure to respond adequately to an information request may be sufficient to trigger the severe consequences set out above. There is no requirement for a taxpayer's failure to be significant or persistent, which means that this provision is inconsistent with the other provisions proposed in the DD.

In our view, section 21 should be rewritten to ensure that the severity of the consequences are appropriately matched by the significance and persistence of a taxpayer's non-co-operation and failure to provide information. As the consequences are more severe than the other measures proposed in the DD, the legislative threshold for its application should be higher.



26 April 2017

BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir/Madam

Submission on Discussion Document: BEPS – Transfer pricing and permanent establishment avoidance

The following submission has been prepared by AMP Capital Investors (New Zealand) Limited (AMP Capital New Zealand) on the Discussion Document: BEPS – Transfer pricing and permanent establishment avoidance. AMP Capital New Zealand is a specialist investment manager that manages a number of funds that are Portfolio Investment Entities (PIEs), as well as private equity investments.

Our submission focuses on the potential affect of the transfer pricing proposals contained in the discussion document on some of the investments that we manage on behalf of investors. We are not commenting on the permanent establishment proposals. However, this does not mean that we necessarily endorse the comments and outcomes reached by the Commissioner in the discussion document on permanent establishment.

Background

New Zealand has a broad base, low rate tax system with limited exceptions. We understand what you are trying to achieve which is ensuring that if economic activity occurs here that New Zealand collects tax. Thus where non-residents are carrying on business in New Zealand they should bear their share of tax. However, some of the proposals seem to go too far and will affect the majority of multinationals that you state operate in New Zealand and are tax compliant¹. Our comments on the specific transfer pricing proposals set out in the discussion document are detailed below.

Economic substance

The proposal for transfer pricing practices to align with economic substance² moves New Zealand to a “would have test”. Under the economic substance test taxpayers may have issues with obtaining relevant external facts that match for comparison to their circumstances. This is applicable to specific industries and distinctive fact taxpayers. This issue needs to be considered and workable solution found.

There also needs to be consideration on how Inland Revenue Officials will use and apply the economic substance test in the future. Views may shift over time which could result in detrimental effects on taxpayers. This could result in Inland Revenue with the benefit of hindsight assessing taxpayers based on better level of information than what was available at the original time. Safeguards need to be built into any rules that introduce the economic substance test, to ensure that views or interpretation do not shift over time.

¹ Page 2, point 1.8, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

² Pages 29-30, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

Reconstruction of transactions

The proposed transfer pricing reconstruction rules³ comments that these rules will reduce certainty for taxpayers but this should only be in the case where the arrangement is aggressive and commercially irrational. There is no explanation on what would or could be considered arrangements that are aggressive and commercially irrational for the proposed reconstruction rules to apply. Further there are no details on what measures or how one measures aggressive and commercially irrational arrangements.

We are concerned that test for an arrangement being aggressive and commercially irrational appears subjective and dependant on Inland Revenue Officials. Further, we note the issue of Inland Revenue Officials understanding, awareness and comprehensive of commercial environments, specific industries and the structures in which different businesses operate. For example a lack of familiarity with the commercial and legal implications of managed funds. There need to be safety measures in any rules introduced to ensure that a lack of commercial comprehensive and familiarity does not trigger the application of the reconstruction rules to a taxpayer. Applying an exceptional circumstances test like Australia has to the application of the reconstruction rules, may assist with this.

If any reconstruction rules are introduced there needs to be clear legislation and guidance for both taxpayers and Inland Revenue Officials on:

- what is meant by arrangements that are aggressive and commercially irrational,
- what is measured and how it is tested, and
- Inland Revenue sign-off i.e. Deputy Commissioner to apply the reconstruction rules to a taxpayer.

Arms length conditions

It is proposed that the transfer pricing rules are changed to refer to arms length conditions. This would require taxpayers to take into account the relevant conditions that a third party would be willing to accept when determining an arm's length price⁴. The proposals do not consider the situations of there being no equivalent third party comparisons or data for a taxpayer to use and very limited publically available data. Further there are situations where associated cross-border entities may accept a lessor commercial deal in order to give a better overall outcome for the group e.g. keep a client. How would the types of situations outlined be considered by Inland Revenue? In particular, would Inland Revenue consider each scenario for group member in isolation or can or will the bigger commercial picture of the outcome for a group of entities be taken into consideration?

Burden of proof

It is proposed that the burden of proof for transfer pricing should be shifted to taxpayers, due to taxpayers being far more likely to hold the relevant information to support its pricing than the Inland Revenue or other parties⁵. If this proposal is adopted, then Inland Revenue Officials will need to:

- factor in their own preconceptions, biases and assumptions when taxpayers provide their facts, and
- be prepared to obtain from taxpayers an awareness and familiarity of commercial environments, industries and specialised taxpayer circumstances, and
- be aware of constraints that apply to taxpayer's and the implications of these restrictions. For example trustees or supervisors roles in managed funds.

There should be some sort of protection included into the updated transfer pricing rules that preserves presented or stated taxpayer's facts unless exceptional circumstances apply such as the application of the reconstruction rules.

Time bar

We question the need to extend the time bar on transfer pricing matters from the current four years to seven years given the Inland Revenue will have real time data from its international questionnaires and

³ Pages 30-31, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

⁴ Pages 31-32, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

⁵ Pages 32-33, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

transformation project. If there are issues resolving transfer pricing reviews surely it is more appropriate for Inland Revenue to buy in or hire more resources just like commercial operators are required to do, rather than changing the rules. Further obtaining resources with commercial and specific industry experiences could assist Inland Revenue. For completeness, we have experienced significant delays (over a year) in obtaining transfer pricing responses from Inland Revenue Officials. Thus not all delays in this area are taxpayer based and therefore any timing requirements should apply to both Inland Revenue and taxpayers.

There is no transition period mentioned in the extension of time bar proposals, the result of this means that periods that are currently statute barring will be reopened for transfer pricing purposes on application of this rule. This will create uncertainty for businesses as they have already assumed that particular years are statute barred. Further this would allow Inland Revenue the benefit of hindsight through applying the amended transfer pricing rules rather than using current transfer pricing rules for a further additional three years.

Master and local files

It is stated that master and local file transfer pricing documents are to be provided upon a request or audit⁶. There is no commentary about the reasoning's behind a request and the form a request should take. To ensure that there is no change in view from Inland Revenue in the future, it would be appropriate to codify the circumstances in which such a request for master and local files can be made and the form of that request.

Investors acting in concert

There are limited details on how investors will be determined to be "acting in concert" for transfer pricing purposes and in what way this proposal may work. There are no comments on whether other jurisdictions will be applying similar rules; is New Zealand out of step with the rest of the world? New Zealand is a capital importing country thus we need offshore investors for large capital intensive projects and private investments. There will be additional costs for non-resident investors under this proposal through the acquired New Zealand entities being subject to transfer pricing rules and possibly themselves. This is yet another barrier to get non-residents across before they will invest in New Zealand entities or projects.

Prima facie it appears that private equity managers may be pushed into assisting non-resident investors and New Zealand acquired entity's with their transfer pricing obligations in these circumstances. This is not a usual role for a private equity manager. The level of fees charged by private equity managers would need to reflect the time and effort spent on transfer pricing matters.

Non-cooperation

If the proposed rules are introduced about when a taxpayer is being regarded as non-cooperative, they need to clearly define non-cooperation, what is measured and how this is tested. In particular, around any materially misleading information as this appears a subjective test and dependant on points of views which can be different between Inland Revenue and a taxpayer. There needs to be clear guidance, transparent procedures and processes to ensure the application of this type of rule is fair to taxpayers and not subject to preconceptions, biases and assumptions.

Any rules introduced need to contain appropriate timeframes that apply to both the multinationals and the Inland Revenue. The Inland Revenues standard of four weeks to six weeks for businesses replying to their requests for information needs to be extended, to account for peaks in work flow.

Payment of tax in dispute

The proposal for tax to be paid earlier in a dispute by multinationals is justified by the statement that collection of tax can be delayed for several years and this provides an incentive for multinationals to prolong disputes. However, as previously noted Inland Revenue has delayed responding to taxpayers and in these circumstances this would unfairly penalise taxpayers. There is a cost to having funds tied up. If Inland Revenue are holding on to large amounts of disputed tax they should pay the market rate for the opportunity cost of taxpayers having to fund these amounts. Further, checks and balances would need to be put in place to ensure that any assessment of whichever disputed tax issued to a taxpayer has a solid basis behind it.

⁶ Page 34, point 5.58, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

No reasoning's have been provided to back up the statement that purchases from a tax pooling service would not be acceptable as the payment of tax⁷. What is the justification for why this type of payment should be excluded?

Collection of Information

The fact that the Inland Revenue is having issues with obtaining information about offshore multinational group members of taxpayers from other tax authorities should not be a reason for changing the powers of the Commissioner in this area. Instead Inland Revenue Officials should put effort into their working relationships with other tax authorities to ensure that they obtain the information or assistance they want. Further, this proposal would push information collection onto New Zealand taxpayers of multinational groups as "information would first be passed on to the relevant New Zealand taxpayer who would then supply this information to Inland Revenue"⁸. There is a cost impact for taxpayers under this proposal.

Inland Revenue seems to be propositioning taking on an international policing role under this proposal, is this appropriate?

Please feel free to contact the writer on 9(2)(a) if you would like to discuss any of the points outlined above.

Yours sincerely



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⁷ Page 43, point 6.24, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

⁸ Page 44, point 6.33, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

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27 April 2017

BEPS – Transfer pricing and permanent establishment avoidance
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON

Dear Cath

BEPS – TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE

We are writing to submit on the Government Discussion Document, *BEPS – Transfer pricing and permanent establishment avoidance*, (the “discussion document”). In particular, our submission relates to the proposed changes to the life insurance source rules (the “proposed changes”).

We appreciate the opportunity to submit on the discussion document and would be happy to meet with Officials to discuss any of the matters raised in this submission further.

Summary

We submit that:

- The proposed changes place an onerous and unfair burden on New Zealand life insurers to have completeness of information regarding a non-resident reinsurer’s place of tax residence and/or whether the non-resident reinsurer has a New Zealand permanent establishment. This seems a disproportionate response to what we would regard as a remote risk.
- Double tax agreements (“DTAs”) operate to, among other things, protect a company from the risk of double taxation. A unilateral change to domestic legislation can deny a company the ability to rely on a DTA for protection from double taxation. The proposed change to deny deductions to a New Zealand life insurance company, represents an unfair and unilateral reconstruction of the tax treatment of life reinsurance and gives rise to what is in effect a double taxation, with no ability to rely on the relevant DTAs or the protection mechanisms within those DTAs. The appropriate response to this risk would be to amend the relevant DTAs.

- The proposed changes could have significant adverse economic implications to the tax treatment of existing life reinsurance contracts (where the reinsurer is resident in Singapore, Canada and Russia, and does not have a New Zealand permanent establishment) and unfairly penalises New Zealand reinsured life insurance companies. Life insurance reinsurance agreements are typically long term agreements. New Zealand life insurance companies will typically not be in a position to renegotiate such agreements part way through the term of the agreements. Therefore, should the proposed changes proceed, they should be restricted to life reinsurance contracts entered into after the enactment of the changes with reinsurers who are resident in Singapore, Canada and Russia and who do not have a permanent establishment in New Zealand. The rules should not apply for existing contracts or for contracts where the reinsurer, subsequent to entry into the reinsurance contracts, changes its tax status by losing its permanent establishment in New Zealand and/or becomes resident in Singapore, Canada or Russia.

Life insurance source rules

Article 7 of New Zealand's DTAs provide relief to non-residents such that, broadly, New Zealand is prevented from taxing business profits earned by a non-resident unless they are attributable to a permanent establishment in New Zealand. However, New Zealand DTAs (with the exception of New Zealand's DTAs with Canada, Russia and Singapore) specifically exclude income from insurance with non-resident insurers from this Article.

Therefore, in most cases, New Zealand has a taxing right on any life insurance contract which is entered into or offered in New Zealand by a non-resident life insurer. However, New Zealand's DTAs with Canada, Russia and Singapore do not exclude income from insurance so a non-resident life insurer in those jurisdictions (with no permanent establishment in New Zealand) will not be subject to New Zealand taxation on life insurance contracts entered into or offered in New Zealand.

Proposed changes to life insurance source rules

Officials concern seems to be that there may be tax relief for New Zealand sourced insurance income if the reinsurer is resident in Singapore, Canada or Russia, and does not have a permanent establishment in New Zealand. In response to this concern, the discussion document proposes the following amendments to the Income Tax Act 2007:

- *Section DR 3*
The section is to be amended to specifically provide that no deduction is available for the reinsurance of policies if the premium income on that policy is not taxable in New Zealand (including under a DTA).
- *Section EX 28*
The definition of a FIF included in the section is to be amended to specifically provide that New Zealand residents are subject to the FIF rules in respect of policies that are not subject to New Zealand tax under the life insurance rules or any applicable DTA.

Essentially, the proposed changes seek to deny deductions for the reinsured party in circumstances where the reinsurance premium income is not taxable in New Zealand (due to DTA relief provided to reinsurers under New Zealand DTAs with Canada, Russia and Singapore).

Adverse impact of the proposed changes

New Zealand life insurers cannot be expected to have completeness of information regarding a reinsurer's place of tax residence or whether the offshore insurer has a New Zealand permanent establishment. The proposed drafting places an unfair burden on the New Zealand life insurers to confirm the tax residence of the reinsurer. If the reinsurer is resident in Canada, Russia and Singapore, the New Zealand life insurer may not be in a position to renegotiate their reinsurance contracts. Furthermore, a reinsurer's tax status can change during a contract. It is unfair to penalise an insured part way through a contract by denying deductions for premiums.

Proposed changes are contrary to international tax principles

In general, double tax agreements ("DTAs") operate to allocate taxing rights between contracting states. One of the objectives of DTAs is to protect a company from the risk of double taxation. Double taxation occurs when two jurisdictions seek to tax the same source of income. Where this occurs a company can often rely on a DTA to protect them from tax in one of the jurisdictions. DTAs also provide mechanisms, such as the mutual agreement procedure ('MAP'), for countries to determine which country has the right to tax income.

Despite DTAs, a unilateral change to domestic legislation can deny a company the ability to rely on a DTA for protection from double taxation. In particular, if a country denies a tax deduction for a particular expense, where that amount is taxable abroad effectively gives rise to double taxation.

We would submit the proposed change to deny deductions to a New Zealand life insurance company, represents an unfair and unilateral reconstruction of the tax treatment of life reinsurance and gives rise to what is in effect a double taxation. The result of this change also leaves a NZ life insurance company, subject to these changes, with no ability to rely on the relevant DTAs or the protection mechanisms within those DTAs. We would also submit that the appropriate response to this risk would be to amend the relevant DTAs.

Grandparenting

The current tax treatments of reinsurance contracts have no doubt informed decisions taken when entering into existing insurance contracts. While uncertainty and risk is of course inherent in any long term agreement, particularly over an extended horizon like that used for life reinsurance contracts, we consider that it is a legitimate expectation of life insurer that they should be able to continue under reinsurance arrangements for the remainder of their terms without being subject to significant changes in tax policy.

Therefore, we submit that it is important that grandparenting treatment is adopted such that reissuance arrangements that existed before the enactment of the proposed changes are not subject to them. Furthermore, effective grandfathering treatment should apply if the tax status of the reinsurer changes during the contract.

For any queries in relation to this submission, please contact Teresa Farac (+64 9 303 0845 or tfarac@deloitte.co.nz).

Yours sincerely



Teresa Farac
Partner
for Deloitte Limited (*as trustee for the Deloitte Trading Trust*)

27 April 2017

By email

BEPS - Transfer pricing and PE avoidance
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SUBMISSION: BEPS - TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE - A GOVERNMENT DISCUSSION DOCUMENT

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document "BEPS – Transfer pricing and permanent establishment avoidance" (March 2017) ("**Discussion Document**"). We would be happy to discuss any aspect of the submissions.

1.2 We use the following references:

- (a) "**DTA**" means a double tax agreement that New Zealand has entered into;
- (b) "**Income Tax Act**" means the Income Tax Act 2007;
- (c) "**Multilateral Instrument**" means the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*;
- (d) "**PE**" means a permanent establishment; and
- (e) "**TAA**" means the Tax Administration Act 1994.

2. PERMANENT ESTABLISHMENT AVOIDANCE (CHAPTER THREE)

Summary of proposal and its rationale

2.1 Chapter 3 of the Discussion Document proposes a new anti-avoidance rule that would apply to certain arrangements entered into by multinational groups having annual turnover exceeding EUR750 million which defeat "the purpose of [a] DTA's PE provisions" (Discussion Document at paragraph 3.21). A similar rule is proposed in respect of third party channel providers. Again, the rule would apply only if (among other criteria) the arrangement "defeats the purpose of the PE provisions" (Discussion Document at paragraph 3.27).

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- 2.2 The Discussion Document refers to the Multilateral Instrument which contains a widened PE definition to counter the avoidance of PE status. Paragraph 3.15 of the Discussion Document explains why the Government is concerned that the OECD's response will not be sufficient to prevent arrangements being entered into to avoid a multinational having a PE in New Zealand:

This widened definition should be effective in addressing some of the PE avoidance we see in New Zealand. **However an issue with the widened definition is that it will only be included in a DTA if both parties so elect. Several of New Zealand's trading partners are not expected to elect to include the widened PE definition**, including some countries from which significant investment into New Zealand is made. **Therefore, the Government expects that the OECD's PE amendments will not be sufficient to address the issue of PE avoidance in New Zealand.**

[Emphasis added]

- 2.3 The Discussion Document therefore proposes (see paragraphs 3.40 to 3.45) that the new PE avoidance rule should override New Zealand's DTAs. This aspect of the proposed PE avoidance rule is said to be justified on the basis that "the proposed rule is an anti-avoidance provision [and] will only apply to an arrangement which defeats the purpose of the DTA's PE provisions".

Submission: PE avoidance rule should not override DTAs

- 2.4 The definition of PE is an important provision in delineating the source country's taxing rights. It appears (given the variations to the definition seen in New Zealand's DTAs) that the PE definition in any given DTA reflects a negotiated position. In those circumstances, New Zealand should not enact a rule that could in effect unilaterally vary the agreed definition. For New Zealand to do so could do significant harm to the confidence that foreign investors have in the stability of New Zealand's tax policy settings and ability to rely on what New Zealand has agreed in its DTAs.

- 2.5 For these reasons, we submit that:

- (a) the PE avoidance rule should be drafted so it is clear that it applies only to arrangements that defeat the purpose of the PE definition in the particular DTA; and
- (b) the PE avoidance rule should not override DTAs. Given the comments at paragraphs 3.40 to 3.44 of the Discussion Document, and the fact that the PE avoidance rule would apply only to arrangements defeating the purpose of the PE definition, there is no justification for the avoidance rule to override a DTA. Rather, the rule should be read alongside the relevant DTA, and in light of the recognition in the OECD Commentary (referred to at paragraph 3.42 of the Discussion Document) that there will generally be no conflict between such anti-avoidance provisions and the DTA.

3. AMENDMENTS TO THE SOURCE RULES (CHAPTER FOUR)

Summary of proposals and rationale

- 3.1 A new source rule is proposed to confirm that income will have a source in New Zealand if it is attributable to a PE in New Zealand ("**proposed PE source rule**"). A domestic law definition of PE is proposed, so that this rule applies even if the non-resident with the PE is resident in a country with which New Zealand does not have a DTA. It is also proposed that a non-resident's income be deemed to have a source in New Zealand if it would have a New Zealand source under a particular source rule, treating the non-resident's wholly owned group as a single entity ("**anti-avoidance source rule**").

Submission: anti-avoidance source rule should not proceed

- 3.2 The stated rationale for the anti-avoidance source rule is to prevent non-residents from avoiding having New Zealand sourced income by dividing their activities between group members (paragraph 4.23 of the Discussion Document). This issue will, however, be addressed by the broadening of the PE definition in DTAs as a result of the Multilateral Instrument, the PE avoidance rule, which will apply to all PE definitions, and the new PE source rule and domestic law PE definition.
- 3.3 The only examples the Discussion Document provides of situations in which the anti-avoidance source rule is necessary are of contract-splitting and fragmentation of activities arrangements. Again, these arrangements would be addressed by the changes to the PE definition in the Multilateral Instrument and/or by the proposed PE source rule and PE avoidance rule. Possibly for this reason, the Discussion Document does not refer to (and we are not aware of) any international precedent for a wide-ranging anti-avoidance source rule such as is proposed.
- 3.4 In summary, we therefore submit that the proposed anti-avoidance source rule should not proceed. It would introduce unnecessary complexity in light of the proposed PE source rule, other source rules and the broadening of the PE definition in a number of DTAs as a result of the Multilateral Instrument. In addition, it runs the risk of conflicting with DTAs and appears not to be consistent with international practice.

4. STRENGTHENING THE TRANSFER PRICING RULES (CHAPTER FIVE)

Reconstruction power in domestic law is unnecessary

- 4.1 It is proposed that New Zealand's transfer pricing legislation include an explicit reference to the latest OECD Transfer pricing guidelines. If our domestic law is amended to incorporate the guidelines, we submit that there is no need for an additional reconstruction power in domestic legislation, as such a power is already contained in the guidelines in appropriate cases (see paragraphs 1.64 to 1.69 of the guidelines).

Burden of proof should not be shifted to the taxpayer or, alternatively, procedural protections are necessary

- 4.2 It is proposed that the burden of proof be placed on the taxpayer rather than the Inland Revenue. The stated reason for the proposed change is that multinational structures and transactions have become more complex since the transfer pricing rules were introduced, and that the taxpayer has better information than Inland Revenue does.
- 4.3 Under current law, the taxpayer determines the arm's length amount in the first instance, but Inland Revenue may determine the amount where Inland Revenue can demonstrate that another amount is a more reliable measure, or where the taxpayer has not co-operated with Inland Revenue (section GC 13(4) of the Income Tax Act). Therefore, while the underlying transactions may be complex, and while the taxpayer should have access to information supporting its determination of the arm's length amount, the taxpayer must nonetheless justify to Inland Revenue the arm's length rate it has determined and persuade Inland Revenue that another amount (proposed by Inland Revenue) is not a more reliable measure of the arm's length amount.
- 4.4 The current law recognises that there will usually be a range of arm's length prices rather than one precise arm's length amount. In the context of a self-assessment system, it should be sufficient for the amount determined by the taxpayer to be within the range of arm's length amounts. Section GC 13(4) achieves this, whereas placing the onus on a taxpayer to disprove Inland Revenue's asserted arm's length rate would not.
- 4.5 In the alternative, if the proposed change to the onus of proof does proceed, Inland Revenue should only be able to rely on publicly available information as the basis for whatever arm's length rate it asserts. This needs to be an express requirement in the legislation. If the taxpayer has the onus of proof in respect of a transfer pricing dispute, they need to have full access to the same information that the Inland Revenue is using. Inland Revenue should not be permitted to rely on tax secrecy to decline to disclose details underlying data that Inland Revenue may be relying on.

The time bar should not be extended

- 4.6 It is proposed that the time bar for transfer pricing matters be increased to seven years. The policy underlying the time bar and the significant role that it plays in the tax system is well known. In the government 2003 discussion document entitled *Resolving tax disputes: a legislative review* it was stated (at paragraph 6.2) that:

Time frames provide certainty and finality in respect of a person's tax position. The finality provided by the four-year statutory time bar is emphasised by the courts as central to tax administration so that after the stipulated period of time taxpayers and Inland Revenue may close their books and dispose of their papers.

- 4.7 The stated rationale for lengthening the time bar in respect of transfer pricing disputes is that such disputes are very dependent on the facts and circumstances of the specific case. This rationale is difficult to sustain. Tax disputes generally are often very dependent on the facts and circumstances. A number of examples are readily available, for example capital/revenue disputes (such as the *Trustpower* case) and tax residency disputes.
- 4.8 To extend the time bar in transfer pricing matters would provide the wrong incentives for all parties. A particular difficulty in transfer pricing matters is that there will usually be no single "right" answer but instead a range of prices or rates that should be consistent with the arm's length standard. A further difficulty is that the search for comparables could (potentially) be endless if there is not a time limit on the parties to bring the issues to a head.
- 4.9 In our experience, these factors can result in transfer pricing investigations and disputes (already) taking longer than they should. Time limits are especially important in such cases, to encourage the parties to compromise if they can, and if they cannot compromise, setting a time limit within which an assessment must be made so the case can be considered by the court.
- 4.10 Finally, we submit that the table at paragraph 5.70 of the Discussion Document comparing the standard time bar and time bar for transfer pricing issues in a number of jurisdictions is not compelling evidence that New Zealand should change its approach. While Australia and Canada have adopted the approach that the Discussion Document proposes, many other jurisdictions, such as the US and the UK, have not done so.
- 4.11 Accordingly, we submit that the time bar should not be extended.

5. ADMINISTRATIVE MEASURES (CHAPTER SIX)

Any determination that a large multinational is non-cooperative (see paragraphs 6.13 to 6.20 of the Discussion Document) should be subject to additional procedural safeguards

Criteria and process for determining that a taxpayer is non-cooperative need to be clear, transparent and principled

- 5.1 A determination that a taxpayer is non-cooperative will not only have adverse consequences for the taxpayer under the proposed rules, but could also have significant reputational consequences for the taxpayer. As such, we submit that the definition of non-cooperative should be set out in legislation and further procedural safeguards should be provided for the taxpayer.

Statutory definition

- 5.2 Any statutory definition should make it clear that a taxpayer is not non-cooperative merely because the taxpayer exercises its right to dispute Inland Revenue's position or to contest any steps that Inland Revenue may take in an investigation. We are concerned that any definition that provides

otherwise would be inconsistent with section 27(3) of the New Zealand Bill of Rights Act 1990. Relevantly, section 27(3) provides that:

Every person has the right to bring civil proceedings against, and to defend civil proceedings brought by, the Crown, and to have those proceedings heard, according to the law, in the same way as civil proceedings between individuals.

- 5.3 The White Paper on the Bill of Rights was in the same terms as the current Act. The White Paper commentary noted that the purpose of what is now section 27(3) was:

to give constitutional status to the core principle recognised in Crown Proceedings Act 1950: that the individual should be able to bring legal proceedings against the Government, and more generally to engage in civil litigation with it, without the Government enjoying any procedural or jurisdictional privileges. This is central to the rule of law.

- 5.4 The Courts have interpreted the right consistently with the White Paper.¹ If Inland Revenue could deem a taxpayer to be non-cooperative merely because the taxpayer is questioning or resisting (using proper process) some action Inland Revenue is taking in connection with a dispute, this would provide a procedural advantage to Inland Revenue that is not enjoyed by a lay litigant. This would be contrary to the right enshrined in section 27(3).

Further procedural safeguards

- 5.5 In addition to the statutory definition, Inland Revenue should issue guidance regarding the process to be followed in determining whether a taxpayer is non-cooperative. Such guidance should be in the form of a Standard Practice Statement.
- 5.6 We agree with the Discussion Document (at paragraph 6.16) that the power to make any such determination should be confined to a relatively small number of officials within Inland Revenue. This should help achieve a consistency of approach. Furthermore, we submit that the senior official making such a determination should be independent from the personnel auditing/investigating or otherwise engaged with the taxpayer.
- 5.7 We also agree that Inland Revenue should warn the taxpayer before any determination is made. We submit that this should take the form of a written notice specifying the acts or omissions that Inland Revenue considers make the taxpayer non-cooperative. The taxpayer should then have the opportunity to respond to the warning and/or to remedy the acts or omissions that Inland Revenue has specified.
- 5.8 It is important for a taxpayer to have a right to challenge (before a court) any decision of Inland Revenue to deem it to be non-cooperative. As noted above, any decision to deem a taxpayer to be non-cooperative may have consequences going beyond the proposals in the Discussion Document.

¹ See for example *Vinelight Nominees Limited v Commissioner of Inland Revenue* (2005) 22 NZTC 19,298 at [52]–[55].

The proposal to bring forward the date for payment for tax in dispute (paragraphs 6.21 to 6.26 of the Discussion Document) is arbitrary and should not proceed

Primary submission: proposed amendment is unnecessary and should not proceed

- 5.9 The Discussion Document proposes that the payment of tax in dispute for large multinationals in a dispute with Inland Revenue in relation to certain disputes be brought forward. We submit that this proposal is unjustified for the following reasons:
- (a) The proposed rule is arbitrary. The Discussion Document proposes that the rule apply where the dispute relates to transfer pricing, the amount of income with a New Zealand source or the amount of tax payable under a DTA. We submit that there is nothing special about these matters to warrant the payment of tax in advance.
 - (b) The general rule that disputed tax be payable only following final determination of any dispute should remain. In cases where Inland Revenue considers there to be a significant risk that the tax in dispute will not be paid should the disputant's challenge be unsuccessful, the Inland Revenue can require the taxpayer to pay the tax early (see section 138I(2B) of the TAA).
 - (c) Contrary to the suggestion in the Discussion Document (at paragraph 6.21) large multinationals are not currently incentivised to delay the resolution of a dispute. The rate of use of money interest is materially higher than commercial rates for large multinationals. While the ability of a taxpayer to access funds in a tax pooling account can mitigate to some extent the use of money interest regime, it does not eliminate it since the use of tax pooling involves its own costs.
 - (d) The Discussion Document provides no evidence of large multinationals not paying disputed tax found to be owing at the conclusion of the dispute. If there is a risk of non-payment in a particular case, Inland Revenue has the power (in section 138I(2B) of the TAA) to require advance payment, as noted above.
- 5.10 Further, there is no justification for the Discussion Document proposal to restrict the use of tax pooling in disputes relating to transfer pricing, the amount of income with a New Zealand source or the amount of tax payable under a DTA. The tax pooling rules were introduced in order to allow taxpayer to "[reduce] use-of-money interest exposure".² The Discussion Document offers no justification as to why that rationale does not apply (and tax pooling should not be available) in the three categories of dispute identified.

² Inland Revenue Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* (November 2002) at 3.

Alternative submission: If the proposal does proceed, payment should be required within 90 days of Inland Revenue issuing an assessment and there should be further procedural safeguards

- 5.11 If the proposal does proceed, we submit that the first of the alternative options should be implemented (ie, that payment should be required within 90 days of Inland Revenue issuing an assessment for the tax in dispute). We consider that this would strike a more appropriate balance than the requirement to pay within 12 months of Inland Revenue issuing a notice of proposed adjustment.

The power to collect tax from a wholly owned subsidiary of a large multinational in New Zealand (paragraphs 6.27 and 6.28 of the Discussion Document) is unnecessary and inappropriate

Primary submission: proposed amendment is unnecessary and should not proceed

- 5.12 The Discussion Document proposes that any tax payable by a member of a large multinational would be collectible from "any wholly owned subsidiary of the multinational in New Zealand" and from "the related New Zealand entity in a case where the income is attributed to a deemed PE of the non-resident under the proposed PE avoidance rule" (discussed above).
- 5.13 The proposed rule will have the effect of making all wholly owned group members of a large multinational group jointly and severally liable for the tax obligations of the other members of the group. This overrides the fundamental principle of separate legal personality for companies and limited liability for obligations of a company.
- 5.14 We are unaware of any existing difficulty resulting from members of a large multinational group not paying tax which is due and payable which would justify this proposed new rule. The Discussion Document does not provide (or even suggest that there is) any evidence of such difficulties arising.
- 5.15 Under the *Convention on Mutual Administrative Assistance in Tax Matters*, Inland Revenue has the power (see Articles 11 to 16) to request assistance from other jurisdictions in the collection of tax owing. New Zealand should maintain its commitment to international cooperation in BEPS matters by using that convention, rather than seeking to impose unilateral measures which cut across fundamental principles of corporate law.

Alternative submission: If the proposal does proceed, further taxpayer protections should be implemented

- 5.16 If the proposal does proceed, we submit that Inland Revenue should be required to obtain a court order to collect tax from an entity other than the entity against which the tax was assessed. As noted above, the proposed rule is a significant departure from the norms of corporate law and any exercise of such a power should be subject to judicial supervision.

Collection of information from offshore group members (paragraphs 6.29 to 6.37 of the Discussion Document)

Overview

- 5.17 The Discussion Document proposes to make a New Zealand entity responsible for providing information that Inland Revenue believes is held by another member of the large multinational group. The proposal would go further than the current powers in section 17 of the TAA which requires a person to provide information held by foreign entities which that person controls.
- 5.18 The Discussion Document at paragraph 6.35 proposes a "consequential change" to section 143(2) of the TAA to allow a person to be convicted of an offence if the person does not provide information alleged to be held by a non-resident associated person. The proposal means that a New Zealand group member could be convicted of an offence in respect of acts or omissions by one or more non-resident associates even though the New Zealand group member may have no control or influence over that associate.

The proposed rule has been rejected previously

- 5.19 An amendment to section 17 of the TAA that would have required a New Zealand person to furnish information held by non-resident associated persons was proposed in the *Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill* as introduced.³ Following submissions to the Select Committee, it was accepted that the application of the rule should be restricted.⁴ This narrowed rule (applying only to information held by foreign entities controlled by the New Zealand person, not to all non-resident associates of the New Zealand person) was subsequently enacted.

Reference to Australian and Canadian provisions

- 5.20 Paragraph 6.34 of the Discussion Document states that the proposed change:

... would align New Zealand's offshore information powers with other countries' such as Australia and Canada which have specific provisions that enable their tax authorities to directly request information or documents from offshore

[Footnotes omitted]

For the reasons given below, the Australian and Canadian provisions are materially different from what is proposed in the Discussion Document.

³ Clause 75.

⁴ Inland Revenue *Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* ((November 2002) at 110.

Australia

- 5.21 The Discussion Document refers to section 264A of the Income Tax Assessment Act 1936 (Cth). Unlike the general power to request information in section 17 of the TAA, section 264A of the Income Tax Assessment Act 1936 (Cth) is directed at the particular risk to the Australian Commissioner of offshore information not being provided during an investigation and subsequently being used in proceedings to dispute an assessment.⁵
- 5.22 Failure to comply with an information request is not an offence.⁶ The only sanction for failure to comply with a notice under section 264A is evidentiary (ie, the information that the taxpayer failed to provide under the notice cannot be used in subsequent proceedings to dispute an assessment).⁷ In addition, there is greater scope to challenge the Australian Commissioner's decision to issue a notice given the more circumscribed nature of the power.⁸

Canada

- 5.23 The Canadian provision in section 231.6 of the Income Tax Act RSC 1985 c 1 also provides more scope for a taxpayer to challenge a decision to request information. Section 231.6(5) sets out the powers of a Judge when reviewing the decision to issue a request for foreign-based information or documentation. A Judge, on application of the taxpayer, may:
- (a) confirm the requirement;
 - (b) vary the requirement as the judge considers appropriate in the circumstances; or
 - (c) set aside the requirement if the judge is satisfied that the requirement is unreasonable.
- 5.24 Case law has clarified that a notice must be reasonable in all circumstances. That the information is held by a non-resident who is not controlled by a taxpayer will not make the request unreasonable,⁹ however, the fact that the information is held by a non-resident who is controlled by the taxpayer will not make it reasonable.¹⁰ A balancing exercise must be undertaken by the Judge in each case.
- 5.25 The consequence of failing to comply with a notice is similar to the Australian provision. Section 231.6(8) provides that:

If a person fails to comply substantially with a notice served under this subsection 231.6(2) and if the notice is not set aside by a judge pursuant to section 231.6(5), any court having

⁵ *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia* [1994] FCA 1492; (1994) 54 FCR 75 at [30].

⁶ Income Tax Assessment Act 1936 (Cth), section 264A(22)

⁷ Michael Chow (ed) *Australian Master Tax Guide* (56th ed, CCH Australia Limited, Sydney, 2015) at [21-220].

⁸ *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia*, above n 5, at [34].

⁹ Income Tax Act RS C 1985 c 1, s 231.6(6).

¹⁰ See *Fidelity Investment Canada Ltd v Canada (Revenue Agency)* 2006 FC 551 at [32]; and *Soft-Moc Inc v Canada (National Revenue)* 2013 FC 291 at [32].

jurisdiction in a civil proceeding relating to the administration or enforcement of this Act shall, on motion of the Minister, prohibit the introduction by that person of any foreign-based information or document covered by that notice.

- 5.26 In addition, a penalty can be imposed under section 238(1) but only by the court. On summary conviction, a taxpayer is liable to a fine of no more than CAN\$25,000 and/or up to 12 months imprisonment.

Discussion Document's justification for the proposal

- 5.27 The Discussion Document notes that Inland Revenue can and does request information from foreign tax authorities using its exchange of information rights. The Discussion Document suggests however, that these powers are inadequate for two reasons:

Recent improvements to the exchange of information between tax authorities are making it easier for Inland Revenue to request and exchange information that is held by offshore tax authorities. However, relying on an ability to request information indirectly from other tax authorities is not always adequate. In some cases, the relevant information is not held by the offshore tax authority and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.

- 5.28 The first reason given is that the relevant information is in some cases "not held by the offshore tax authority". But this is not a compelling argument, since foreign tax authorities can and do exercise their own information gathering powers to obtain information that Inland Revenue requests under the DTA, just as Inland Revenue does when it receives requests for information from foreign revenue authorities.
- 5.29 It is difficult to evaluate the second aspect of the justification (that the foreign tax authority may be slow or unhelpful in responding) without knowing how common this is. It is to be hoped that this is not often the case given that the DTA or Tax Information Exchange Agreement ("**TIEA**") (as applicable) imposes an obligation on the foreign Government to comply with a valid request, and that New Zealand (presumably) complies with its obligations under the DTA or TIEA.
- 5.30 But to the extent Inland Revenue might sometimes encounter difficulties or delays in obtaining information from a foreign revenue authority, we note that the New Zealand resident companies may be in no better position to compel a non-resident group member to supply information. This has been recognised by the courts in the discovery context. In that context, the courts are unlikely to order discovery when the information is held by an entity which the relevant party has no control over.¹¹ For the New Zealand company, it is not simply a matter of requesting the information from (or forwarding on Inland Revenue's information request to) the relevant foreign affiliates and expecting that the

¹¹ See for example *Howard Trading Auckland Limited and Anor v Nissan New Zealand Limited* HC Auckland CIV-2009-404-003111 at [32].

information will be provided. There are more obvious practical difficulties which, we submit, makes this proposal unworkable:

- (a) Multinational groups may be comprised of a large number of companies in many countries. It may be impossible for personnel working for the New Zealand entity to know which company holds what information.
- (b) Inland Revenue information requests are often very broadly worded, and may call for the production of large numbers (not infrequently thousands) of emails and other documents, which in turn could necessitate the review of an even greater number of documents to determine which are within the scope of the request. For such requests to apply not only to the New Zealand group but also to foreign associated persons could make the requests so costly and burdensome to comply with that compliance is for all practical purposes impossible.
- (c) The New Zealand company will usually have no legal right to require a foreign associate to provide information to it. And even if the foreign associate is willing (in the interests of the group) to devote the time and resources necessary to assist the New Zealand company in locating and providing relevant documents, the foreign associate will need to consider whether it is appropriate to do so. For example, some of the information may be legally privileged. And local privacy and confidentiality laws will need to be considered.¹²

Alternative submission: if the proposal does proceed a court order should be required

- 5.31 If the proposal does proceed, Inland Revenue should be required to obtain a court order to require the New Zealand entity to provide information not held by it or by an entity it controls. This would provide judicial oversight in respect of the breadth of the request and feasibility of complying with it, and as to whether the need for such an onerous power to be exercised is justified in the circumstances and its exercise would be reasonable.
- 5.32 We further submit that Inland Revenue should not have the power to impose a penalty for non-compliance with the offshore information request. New Zealand should follow the Australian and Canadian approach. Failure to comply with the information request should only result in evidentiary consequences unless a court imposes a penalty.

¹² These considerations were behind the need for FATCA to be implemented through Intergovernmental Agreements, such as that concluded between New Zealand and the United States. Had New Zealand financial institutions agreed to provide information directly to the United States (pursuant to an agreement with the United States Government under section 1471 of the Internal Revenue Code) they may have been in breach of their implied contractual obligation of confidentiality and/or their obligations under the Privacy Act 1993. For them to disclose the information to another Government to avoid a financial detriment (FATCA withholding) may not have been recognised as falling within the disclosure under compulsion of law exceptions to their confidentiality and Privacy Act obligations.

Penalties for not providing information requested by Inland Revenue

Penalty for non-compliance should be required to be imposed by the court

- 5.33 The Discussion Document proposes that a civil penalty of \$100,000 can be imposed by Inland Revenue if a large multinational fails to comply with an information request under section 17 or section 21. We submit that any power to impose such a penalty should rest with the Courts and not with Inland Revenue.

Alternative submission: if the proposed rule is introduced, taxpayers should have the right to apply to the court for relief

- 5.34 We submit that if the proposed rule is introduced, taxpayers should have the right to apply to the Court to have the penalty reduced or set aside. This is a necessary minimum requirement to comply with section 27 of the New Zealand Bill of Rights Act 1990 and should be explicit in the legislation.

General comments on section 21 of the TAA

- 5.35 Section 21 of the TAA should be rewritten or repealed. Inland Revenue has comprehensive information gathering powers under section 17 of the TAA. Section 21 is arbitrary in its application (being triggered by the non-response to an information request after 90 days, without regard to whether that time-frame is reasonable in the circumstances) and draconian in its consequences (denying a taxpayer access to the courts to challenge an assessment).
- 5.36 We do not consider there to be any reason why section 17 and section 21 should vary in their application. Denying a taxpayer access to the courts is, as discussed above, on the face of it a breach of section 27(3) of the New Zealand Bill of Rights Act. Section 21 therefore requires (at a minimum) to be reviewed, and unless on review it can be established that section 21 fulfils a purpose that is not met by section 17 then section 21 should be repealed.

Yours faithfully
RUSSELL McVEAGH



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26 July 2017

BEPS – Transfer pricing and PE avoidance C/-
Deputy Commissioner, Policy and Strategy Inland
Revenue Department PO Box 2198 Wellington 6140

Via email: policy.webmaster@ird.govt.nz

Submission re: BEPS - Transfer Pricing and Permanent Establishment Avoidance Discussion Document

Dear Deputy Commissioner, Policy and Strategy:

On behalf of the National Foreign Trade Council (the “NFTC”), we appreciate this opportunity to submit comments with respect to the “BEPS -Transfer pricing and permanent establishment avoidance” discussion document (the discussion document).

The NFTC, organized in 1914, is an association of approximately 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial and service activities and the NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. The NFTC’s emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment and through direct investment in facilities abroad. Foreign trade is fundamental to the economic growth of U.S. companies

The NFTC appreciates the willingness of the New Zealand Department of Inland Revenue (Inland Revenue) to request and consider comments regarding the discussion document. Contrary to the assertion made in paragraph 1.4 that “[t]hey are not intended to make any fundamental changes to the current international tax framework”, the NFTC believes the discussion document diverts from international norms and the OECD Base Erosion & Profit Shifting (BEPS) Action Plan in which New Zealand agreed and actively participated. The NFTC agrees with the statement in paragraph 1.5 that “It is important to enforce the

integrity and efficiency of the tax system in designing tax policy so that there is a level playing field.” However, while seemingly justifying the proposals in the discussion document by reference to Australian and UK efforts, enactment of the unilateral actions in the discussion document will make New Zealand an outlier, increase tax uncertainty, negatively affect foreign direct investment into New Zealand, and may lead to other countries enacting unilateral actions that erode progress made in the BEPS Action Plan.

A summary of the NFTC’s major points and recommendations are as follows:

Source and permanent establishment avoidance

- 1 The NFTC believes the proposed PE Anti-Avoidance Rule “deeming” a non-resident entity to have a permanent establishment in New Zealand if a related entity carries out sales activity in New Zealand will apply to non-abusive common regional sales structures with New Zealand sales and support entities that are appropriately compensated. This subjective proposal ignores legal entities, is outside of the OECD BEPS Action Plan, will apply to common non-abusive regional sales structures, and creates significant uncertainty and unnecessary disputes with taxpayers and between New Zealand and its trading partners.
- 2 If Inland Revenue believes these local sales support activities are not appropriately compensated, the NFTC believes the analysis should be considered under the transfer pricing guidelines rather than subjectively “deeming” a permanent establishment which may or may not have any additional profit attributable to the PE.
- 3 The reference in paragraph 3.24 regarding “[w]hether the arrangement has any of the indicators of PE avoidance, such as the involvement of a low tax jurisdiction, specialized services, or a related entity which is allocated a low amount of profit on the basis it is carrying out low value activities while having a number of well paid employees”, illustrates that any concerns should be considered using a transfer pricing analysis rather than creating a ‘deemed’ PE. Contrary to the statement made in paragraph 3.26 that “[i]t is not intended to deem a PE to exist where one does not in substance”, the discussion document does just that.
- 4 The helpful examples in the Appendix actually support the case that any New Zealand concerns should be addressed via a transfer pricing analysis rather than “deeming” a PE.
- 5 In example 1, a direct sale by a non-resident from offshore does not create New Zealand source income or a deemed New Zealand permanent establishment. As mentioned, “[f]rom a policy perspective this outcome is entirely in accordance with the current norms of international taxation which New Zealand – as well as other countries – follow.” The NFTC agrees.
- 6 However, in Example 3, a direct sale from offshore with in-market sales activities would, as a result of the discussion document “ensure that the New Zealand subsidiary’s sales activity created a PE for the non-resident; deem the non-resident to supply its goods or services through the PE; ensure the non-resident’s sales income had New Zealand

source; and allow New Zealand to apply NRWT to the royalty paid by the non-resident to the related entity resident in the no tax jurisdiction under any applicable DTA.” The discussion document notes: “[u]nder the in-market support structure, the New Zealand subsidiary is paid a fee for its services, but this fee generally only exceeds its costs by a small margin.” The NFTC submits that this is a transfer pricing issue rather than a permanent establishment issue. As a matter of policy, ignoring legal structures and “deeming” a PE for customary and non-abusive in-market sales activity, will create substantial uncertainty and may result in the non-resident eliminating local sales support functions to minimize PE risk to the detriment of the New Zealand economy and consumers

- 7 In addition, the NFTC believes that applying the subjective rule in the discussion document to “deem” a permanent establishment “under an arrangement in which those goods or services are to be on-sold to customers in New Zealand by a third party (whether related or not)”, will create additional uncertainty and PE risk that may negatively affect a non-resident’s decision to participate in the New Zealand market. The NFTC is concerned about the unpredictability and uncertainty caused by enacting domestic legislation which overrides the OECD PE standard. In this regard, the statement in 3.45 that the “PE avoidance rule would apply notwithstanding anything in the DTA” seems contradictory to the statement in 3.2 that “the proposed rule is not intended to widen the accepted international definition of PE in substance”. There is also an explanation in Section 3.15 that the domestic rule is being considered to address situations where a DTA does not exist or where the “broadened” language is not accepted in the DTA. The PE standard being considered for adoption is admittedly broader than the OECD definition.
- 8 The term “third party” buyer in the factors listed in 3.27 should be defined consistently with the description in 3.31 which carves out of the rule entities which purchase goods from a non-resident and independently sell them to third parties. In 3.27, the third bullet should clarify that “carrying out an activity related to the sale” does not apply when the buyer is independently selling to third parties. Otherwise the language in 3.27 is ambiguous. The definition of an independent third party should exclude third parties who are not managed or controlled by the offshore seller or are publically traded.. In these instances, it is not possible to offer sales of supplies on other than arms-length terms.
- 9 In the bullet point 3.24 where the application of the rule is discussed, the specific bullet addressing the nature of the services carried out should indicate that the rule would potentially apply only where the services include locating customers, promoting products to those customers, discussing the customer’s needs and tailoring the product to be sold for the customer, and indicating pricing and delivery dates and other key terms to the customer”, to be consistent with the example in 3.26.
- 10 Regarding the interaction with New Zealand’s double tax agreements, paragraph 3.45 provides “ [w]e propose providing that our PE avoidance rule would apply notwithstanding anything in a DTA.” The NFTC believes such unilateral action will

further erode the tax treaty network, erode international tax norms, and result in more tax disputes between New Zealand, taxpayers, and New Zealand's international trading partners.

Chapter 5: Strengthening the transfer pricing rules

- 11 Paragraph 5.69 notes that “[I]t can be difficult for tax authorities to adequately identify the risk, apply the arm’s length principle and amend the relevant tax return within four years.” Citing Australia and Canada as precedent for a seven-year time bar for transfer pricing, the discussion document proposes increasing New Zealand’s time bar for transfer pricing matters to seven years.
- 12 The NFTC believes the difficulties identified in the discussion document should be adequately addressed by the Government’s proposal to shift the burden of proof from the Commissioner to the taxpayer in transfer pricing matters. Extending the time bar to seven years in transfer pricing cases will increase uncertainty, delay timely resolution, and add to the inventory, time, and administrative costs for New Zealand and its treaty partners. A reasonable time bar benefits both taxpayers and tax administrators by not overly prolonging a transfer pricing determination. As such, the extension of the time bar should not proceed.
- 13 If the time bar extension does proceed, consideration needs to be given to the interaction of the extended time bar for transfer pricing matters, the impact on competent authority cases, and the time bar applicable for other purposes. An adjustment for transfer pricing could also have an impact on withholding tax and income tax. The NFTC is concerned that extending the time bar for transfer pricing matters may result in unintended consequences including a de facto extension of the time bar for other tax types, an inability for taxpayers to claim offsetting adjustments when transfer pricing matters are reassessed, and a growing inventory of expensive and prolonged competent authority cases for New Zealand and other governments.

Chapter 6: Administrative measures

Non-cooperation

- 14 Chapter 6 proposes to introduce new administrative measures that would apply to large multinationals as a result of non-cooperation. The proposed measures include the ability for Inland Revenue to issue an assessment based on information held at the time; and impose penalties for failure to comply with information requests.
- 15 The discussion document states in paragraph 6.17 that the proposed rules are not intended to impose unreasonable demands on multinationals. However, some of the factors put forward in the proposal in paragraph 6.16 are sufficiently vague and subjective including:

- Failure by the taxpayer to provide information within the possession or control of the taxpayer *or its associated parties* [emphasis added] within a statutory timeframe;
- Failure to respond to IR correspondence; the provision of misleading information (including where the information is misleading by omission);
- Failure to provide sufficient information to determine the arm's length amount of a related party transaction, or to determine the amount of profit which should be attributable to a PE;

16 The NFTC believes the threshold at which a large multinational is treated as “non-cooperative” should be carefully considered by Inland Revenue which should consider the following when determining that a taxpayer is “non-cooperative”:

- Information requests by Inland Revenue can be onerous and sourcing the level of material can often be difficult to obtain from within large organisations within timeframes set by Inland Revenue. The NFTC notes that delays in obtaining relevant information are generally not driven by unwillingness of taxpayers to provide information, but are a product of practical difficulties of sourcing relevant information from within large organisations. Practical difficulties faced by large multinationals are similar (and probably more significant in comparison) to difficulties experienced by large New Zealand corporations. NFTC does not consider it appropriate or necessary to require a different standard of co-operation for large multinationals in comparison to large New Zealand corporate taxpayers.
- Taxpayers that are required to provide a significant amount of information often treat the process of obtaining and providing information to Revenue Authorities as if it was part of the process of legal discovery to avoid costs involved in repeating the process if the matter progresses to litigation. This inevitably involves a more thorough process of data capture, compilation and review, with associated additional time and cost involved.

Payment of tax in dispute

17 The NFTC is concerned that payment of tax in disputes in advance of resolution may lead to inappropriate assessments, inappropriate incentives for Inland Revenue officials, and a substantial increase in tax risk and uncertainty which could chill foreign direct investment into New Zealand. Contrary to the assertion in paragraph 6.26 that the rule to impose early payment is intended to remove any incentive to prolong a dispute with Inland Revenue, the NFTC asserts that taxpayers favor early resolution of disputes. In any event, imposing interest on a final assessment, if any, fully compensates the government for the time before a final assessment is ascertained.

Collection of information

- 18 Paragraph 6.33 of the discussion document proposes that the Commissioner be provided with a direct power to request information or documents that are held by or accessible to a group member that is located outside New Zealand. The discussion document recognises that there have been recent improvements to the exchange of information between Revenue Authorities, making it easier for IR to obtain information. However, the discussion document states that in some cases the relevant information is not held by the offshore tax authorities and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.
- 19 The NFTC notes that in addition to automatic exchange of information with other Revenue Authorities, the ability of Revenue Authorities to collect information from large multinationals has also increased as a result of the OECD country-by-country reporting initiative.
- 20 The NFTC believes that the proposal to introduce specific provisions to enable Inland Revenue to directly request information or documents from a group member that is located outside of New Zealand is unlikely to result in Inland Revenue receiving information in a timelier manner than it would if it were to request the same information from the New Zealand taxpayer under New Zealand's existing rules. Delays in responding to appropriate and relevant information requests from Inland Revenue are attributable to practical difficulties of sourcing appropriate and relevant information within large organisations, rather than because of unwillingness by large multinationals to provide relevant information.

Penalties for not providing information

- 21 Paragraph 6.35 of the discussion document proposes that a person may be convicted of an offence for failing to provide information held by an associated offshore group member.
- 22 The NFTC believes it would be inappropriate for New Zealand to expect officers and/or directors of the relevant New Zealand subsidiary to have access to offshore information, the ability to require offshore parent companies to provide information, or the ability to influence the production of non-New Zealand information appropriately or inappropriately requested by Inland Revenue. Exposing local officers and or directors to substantial penalties for failure to produce documents outside of their control is inappropriate and would materially impact the willingness of individuals to act as officers of New Zealand subsidiaries of multinational groups. The NFTC believes that it would not be reasonable or appropriate to impose penalties on New Zealand officers and/or directors for failing to provide information held by an associated offshore group member outside of their control.

The NFTC appreciates Inland Revenue's willingness to consider our comments and concerns. If you have any questions or comments regarding our submission, please feel free to contact me at 202 – 887-0278.

Sincerely,

A rectangular box containing a handwritten signature in black ink. The signature is written in a cursive style and reads "Catherine G. Schultz".

Catherine G. Schultz

Vice President for Tax Policy

28 April 2017

**Interest limitation #023
TP +PE #012**

BEPS – Transfer pricing, PE avoidance & Interest limitation rules

C/- Deputy Commissioner, Policy and Strategy

Inland Revenue Department

PO Box 2198

Wellington 6140

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Transfer pricing, PE avoidance and proposed interest limitation rules

The American Chamber of Commerce in New Zealand Inc appreciates the opportunity to comment on New Zealand's proposals for international tax reform released on 3 March 2017.

The American Chamber of Commerce in New Zealand Inc – better known as AmCham – has been New Zealand's number one business organisation for the promotion of trade and investment between the United States and New Zealand and the Asia Pacific region for over 50 years. We are "The Voice of American Business in New Zealand". Our members represent turnover in excess of NZ\$50 billion and over 100,000 employees.

Our submission covers two Government discussion documents – BEPS – Transfer pricing and permanent establishment avoidance and BEPS – Strengthening our interest limitation rules.

We provide comments on the overall approach which we recommend should be adopted by the Government, supplemented by our recommendations for changes to the specific proposals regarding permanent establishments ("PEs"), interest limitation rules and transfer pricing.

1. Executive Summary

Inbound investment from the United States is important to New Zealand – both in absolute dollars (at least 8% of total foreign direct investment ["FDI"]) and through wider contributions to the economy and society. Tax policy should recognise the importance of inbound FDI while ensuring that inbound investors, including our members, pay their "fair share".

Fairness and certainty considerations lead us to supporting implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem.

However, there is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

IN NEW ZEALAND

With regards to the proposals concerning PE avoidance:

- *We support enforcement of the accepted international definition of a PE. This is best done by way of implementing the Multilateral convention to implement tax treaty related measures to prevent BEPS rather than a unilateral PE anti-avoidance rule.*

- *Should New Zealand proceed with the PE anti-avoidance rule, clarity of scope and application is essential, there should be a transitional rule to allow our members the time to restructure and guidance from Inland Revenue regarding profit attribution would be welcome.*

We agree with aspects of the proposed reforms to interest limitation rules but wonder if the Government has lost sight of the strength of New Zealand's existing thin capitalisation rules. Members have major concerns regarding the proposed limit on interest rates on related party loans, as it will lead to double taxation in many cases and is incompatible with the arm's length principle.

We agree in principle with the change to require total assets to be calculated net of non-debt liabilities, but our members should be given time to adjust their existing arrangements. Other conditions for our support include that the ability to use net current asset values is retained, deferred tax liabilities are excluded from the definition of non-debt liabilities and existing financing arrangements are grandparented for an extended period.

With respect to transfer pricing, we support aligning New Zealand's transfer pricing rules to OECD Guidelines. Better alignment with the Australian transfer pricing rules is also appropriate, but only to the extent that those rules remain consistent with the principles set down by the OECD and do not seek to target a greater than arm's length proportion of profit.

Members do have concerns regarding the references to limited risk distribution ("LRD") structures. LRD structures commonly reflect commercial substance and are frequently embedded within a global group's worldwide framework. The LRD structure is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken is often relatively low in terms of value-add.

Members also see a number of the administrative measures proposed as inappropriate. We have concerns regarding penalties for not providing information, the factors leading to a finding that a taxpayer is non-cooperative, Inland Revenue's additional information gathering powers and the enforced early payment of tax in dispute.

We expand on these issues below.

2. Importance of New Zealand/United States relationship

The United States is New Zealand's second largest source of foreign direct investment, representing at least 8% of total FDI.

Many American inbound investors create substantial value through their business activity here, over and above the tax paid, in ways not visible through financial statements alone.

Tax policy should take account of these hard to measure spillover effects while ensuring that inbound investors continue to pay their fair share.

As the world has become more interconnected FDI has increasingly become a hot topic. For New Zealand how we connect with the world is a major issue since we import most of our technology and have a relatively shallow domestic capital base.

New Zealand–United States trade and investment has a considerable impact on the New Zealand economy. The Government has acknowledged our tax settings must “be consistent with maintaining New Zealand’s position as an attractive location to base a business.” There is a broad consensus that taxation is a significant factor in location decisions regarding inbound investment.

United States companies operating in New Zealand account for investment totalling in excess of NZD 12.6 billion and thousands of jobs. Direct investment in New Zealand is mostly in the finance/insurance and manufacturing sectors, with many investments having some degree of mobility. The United States accounts for at least 8.0% of foreign direct investment into New Zealand. This figure is likely to be materially understated as it excludes investment ultimately sourced from the United States but routed via third countries such as Australia and Singapore. Inland Revenue’s own statistics show that, of the 314 foreign owned groups completing its international tax questionnaire, some 59 (or 19%) have ultimate American ownership.

The United States has become New Zealand’s third largest trading partner, with trade totalling in excess of NZD 11 billion. In particular, New Zealand’s largest imports of tangible goods from the United States include aircraft, jets, motor vehicles, medical instruments, food and appliances.

Our members’ businesses have a positive impact on New Zealand society in many ways. Technology companies among our membership are commonly singled out during tax debates due to their digital nature. Yet these members belong to a sector having a transformative effect on the New Zealand economy, with the benefits from their presence extending well beyond New Zealand’s receipt of corporate income tax.

Traditional economic and accounting indicators can underplay this effect and lead to the importance of inbound investment being underplayed. The digital economy in particular has the potential to drive future economic growth and productivity when it is adopted by businesses and consumed by users, whereas a large portion of the value of the digital economy goes unmeasured in today’s economic indicators. For example:

- *In terms of economic development, the digital economy can help alleviate the “double tyranny” of New Zealand’s relative size and distance that affects businesses;*
- *Consumer benefits of digital communication are seen in increased convenience, better access to information, well informed decisions and more time saved in our daily lives; and*
- *With respect to transport, better mapping technology enables improved navigation and helps people find local businesses and tourist destinations.*

AmCham consider that it is legitimate for the Government to take into account the wider spillover effects of our members’ inbound investment when setting tax policy. We emphasise that we are not seeking any form of tax break or incentive: it is important that taxes are fair and seen to be fair. Our members are happy to pay their “fair share” in accordance with legislation.

3. Overall comments on the approach taken in the discussion documents

AmCham supports implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem.

Our members do not accept that aggressive tax practices are commonplace in New Zealand.

There is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

Today’s business structures have evolved within a dated tax system and everyone will benefit from a simpler, more transparent, tax system.

The members of AmCham support the work of the Organisation for Economic Co-operation and Development (“OECD”) and the G20 towards coordinated tax reform to ensure that global tax rules keep pace with business evolution. We recognise that consistent and fair taxation of multinationals has become more difficult in recent years. We also note the Government’s consistent support for, and major policy contribution to, the OECD’s work.

AmCham therefore agrees a proportionate implementation of the OECD recommendations is the right tax policy for New Zealand.

Keeping the Government’s response proportionate to the size of the problem, while not deterring inbound investment, will be crucial. To this end, we agree with the Government that the majority of multinational companies operating in New Zealand comply with their tax obligations and with the

Minister of Revenue that “most foreign-owned firms operating here have relatively conservative debt positions and pay significant amounts of tax.” We note further recent research conducted by EY which supports the conclusion that the majority of multinationals are not loading their New Zealand subsidiaries with excessive interest-bearing debt and that the majority have an effective tax rate close to, or equal to, the New Zealand corporate tax rate. While the evidence is not fully conclusive, AmCham does not accept that aggressive tax practices are prevalent in New Zealand.

We are further concerned that measures enacted unilaterally in New Zealand will over time have a similar impact on our New Zealand members operating in overseas jurisdictions. Should all countries implement the full package of measures proposed in New Zealand, such as the interest rate cap or anti-avoidance source rule, double taxation appears inevitable.

AmCham therefore considers it essential for New Zealand to take a measured approach and to stay within international norms. Governments should harmonise tax rules so that businesses can continue to create value. Fragmentation along country lines puts this value at risk. Unilateral action by New Zealand in addressing perceived base erosion and profit shifting (“BEPS”) will be harmful if it also creates double taxation. A coordinated approach to BEPS will lead to more certainty for businesses, more efficient economic outcomes and growth, fewer cross-border tax disputes between revenue authorities and a higher global tax-take.

AmCham also endorses New Zealand’s international tax framework. We consider the Government needs to confirm that it is open for business, consistent with New Zealand’s taxation framework for inbound investment. Foreign businesses will respond favourably to certain and predictable tax laws in New Zealand. The benefits of foreign direct investment are endorsed in the discussion documents.

We note that the package is a powerful combination. It has gained international attention, and will put New Zealand at the forefront of BEPS implementation worldwide.

Given the substantial impact that some components of the package will have, we suggest that the Government consider whether any measures can be targeted at highly geared companies which have sought aggressively to minimise their New Zealand tax liability.

Finally, we support the consultative process adopted by the New Zealand Government.

4. Permanent establishment avoidance

Support for rule which enforces the accepted international definition of a permanent establishment

We agree that economic activities which should result in a PE in New Zealand should be subject to tax here. We therefore support a rule which enforces but does not widen the accepted international definition of a PE in substance.

We further agree that there is no need for a separate diverted profits tax. That said, the proposed PE anti-avoidance rule does replicate elements of the United Kingdom diverted profits tax, notably sharing many features with Australia's multinational anti-avoidance law.

We highlight, however, that New Zealand's implementation of the Multilateral convention to implement tax treaty related measures to prevent BEPS has the potential to address most, if not all, of the attempts to flout PE rules. That approach, being the coordinated international response, is the appropriate mechanism by which to enforce New Zealand's PE rules.

The introduction of more robust transfer pricing rules as proposed in the discussion document will also counteract the need for a specific PE avoidance rule. In particular, the discussion document indicates that the existence of a "number of well paid employees" would be an indicator of the existence of a PE. This could be addressed through the transfer pricing regime, and strengthened transfer pricing rules will assist Inland Revenue in relation to enforcement.

We are concerned that implementation of a unilateral response such as the new PE avoidance rule will impede the coordinated global response to BEPS. We therefore do not support its introduction at this time.

Uncertainty will not lead to good tax administration

There is a risk that vague and uncertain wording within the legislation could lead to disputes about the nature of activities being performed by taxpayers in New Zealand. In particular, a number of phrases and concepts central to the operation of the rule ought to be defined, including "commercially dependent", "in connection with", "low tax jurisdiction", "high paid employee" and "specialised services".

As an example of uncertainty, consider the proposal that an "arrangement involving third party channel providers" should necessarily result in a PE. Any such investigation would be a fact-specific enquiry and would depend on the activities provided by related party and third party channel providers. It will not always be clear whether the related party is performing "sales promotion and services", and there will inevitably be cases where the activities in New Zealand are in reality something less than this, or where the non-resident and the third party are in fact not working together to sell the goods or services to the end customer. The legislation, or guidance supporting the legislation, should be clear as to what kinds of specific arrangements give rise to a deemed PE.

If PE anti-avoidance rules are uncertain or difficult to apply, then the corresponding compliance costs could potentially outweigh the gains to the Government from more tax being paid here. Uncertainty in the rules could dissuade investment into New Zealand. Further, we highlight Inland Revenue's expectations regarding initiatives to tackle complex technical issues (such as PE anti-avoidance). The Commissioner of Inland Revenue is required to collect over time the highest net revenue practicable within the law having regard to the compliance costs incurred by taxpayers. Inland Revenue's

unaudited target return on income for additional funding voted by the Government in 2015/16 was \$13.00 per dollar spent, on the basis of the economic inefficiencies involved in chasing down the last dollar of revenue. There is risk that attempted enforcement of the PE anti-avoidance rule will fall short of Inland Revenue's targets.

An ambiguous rule, combined with the proposed 100% penalty, could dissuade investment in a legitimate PE structure, within New Zealand's double tax agreements, on the mere potential that New Zealand would take unilateral action. This would not benefit tax enforcement, the New Zealand economy or our members.

We submit that taxpayers should be able to obtain confirmation from Inland Revenue that the PE avoidance rule would not apply in respect of a particular business structure. The process should operate similarly to an Advance Pricing Agreement ("APA") for transfer pricing purposes, and would add clarity for business with unique circumstances that risk breaching the proposed rule.

Changes to group structure will take time

Reorganising a global supply chain can be a complex business taking a substantial amount of time. New Zealand will often be a small component of a much larger supply chain. The effect of reorganising a global supply chain in a short period of time would be exacerbated for our multinational members operating in a larger number of countries.

We are also concerned that the proposed PE anti-avoidance rule could apply to members whose existing investment structures have previously been reviewed by Inland Revenue by way of a ruling, tax audit sign-off or an APA.

Further, the proposed 100% penalty applicable would present a punitive outcome for such taxpayers with a history of complying with New Zealand tax law if it is not possible for a multinational to reorganise its supply chain before the PE avoidance rule is implemented.

Additional guidance required on profit attribution

We anticipate that multinationals will engage more frequently in disputes with revenue authorities regarding the attribution of profits across jurisdictions.

It is important that the New Zealand Government consider the risk of double taxation where its preferred method of profit attribution differs from that applied in the jurisdiction of the foreign entity.

In light of these substantial proposed changes to the rules around PEs, it would be timely for Inland Revenue to provide additional guidance around the attribution of profit to a New Zealand PE.

5. Interest limitation rules

No case for interest rate cap

Limiting interest deductions based on credit rating within wider group is uncommercial, a departure from the arm's length principle and is likely to lead to cross-border disputes and double tax.

Our members find that there are many circumstances in which a foreign investor might want to invest in New Zealand through debt funding which should appropriately be priced at an interest rate higher than its group cost of funds. The New Zealand entity might be a high credit risk, for example a start-up or different industry. New Zealand is also a small, isolated, market and presents more risk to a (say) United States investor for which the next best alternative would be to expand its existing operations in the United States.

In such circumstances, a third party bank would conceivably lend to the New Zealand subsidiary at an interest rate much higher than the parent company's cost of funds. It will therefore often be more cost-effective for the parent company to provide funding directly to New Zealand. We anticipate that for our members providing finance into New Zealand, double taxation is a likely outcome. The lender will be required by its home tax authority to charge interest at arm's length rates, whereas New Zealand would apply its interest rate cap. In such a case, more disputes between tax authorities would result, most likely leading to additional mutual agreement procedures. Additional compliance costs would be inevitable, and it is not clear that the New Zealand Government would prevail.

An alternative approach would be for the US parent to provide a guarantee to the New Zealand subsidiary to reduce the cost of borrowing. In such circumstances, OECD guidance suggests that a guarantee fee should be paid to the parent company. The fact that OECD endorses the payment (and therefore deduction) of a guarantee fee reflects the fact that an interest rate anchored to the parent's cost of funds is not arm's length.

Agreement in principle to change in treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities for consistency with the test employed in other jurisdictions, but we note that this would result in a material increase in gearing levels for some members, particularly those with large provisions, trade creditors or deferred tax liabilities.

The ability to use net current assets should be retained.

The Government is correct to highlight that current thin capitalisation rules work well given their aim of ensuring that excessive interest deductions are not used to shelter New Zealand sourced profits.

Most multinationals operating in New Zealand have relatively modest debt levels. EY's recent research (cited above) supports that conclusion. Members have seen no evidence to suggest that the

majority of multinationals are sheltering New Zealand sourced profits using excessive levels of related-party debt.

Members do however note that the changes to the treatment of non-debt liabilities will significantly increase calculated gearing levels, particularly for members with large provisions, trade creditors or deferred tax liabilities. That makes it more important for calculations to give fair value to assets and for the definition of non-debt liabilities to be well designed.

The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.

The non-debt liabilities definition is based on the Australian definition, and – as in Australia - deferred tax should be excluded.

For some of our members, deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS. Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

Compliance costs will increase

The ability for taxpayers to carry out a thin capitalisation calculation once each year should be retained.

We note that the changes to the thin capitalisation test will increase the burden of compliance for multinational taxpayers. An example is the proposal that only quarterly or daily calculations should be acceptable for the purposes of the measurement date of the thin capitalisation test. Absent any evidence that multinationals are abusing the annual method, we see no reason to change the rules. To do so would add a compliance burden to the majority in order to address a problem which has not been seen by our members and must be very rare in practice.

Existing financing arrangements should be grandfathered

We are concerned that companies will not have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time. This logic applies equally to all multinationals.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return. It would not be reasonable to expect borrowers to refinance based on a proposal in a discussion document which may be subject to significant amendment prior to enactment.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature.

6. Transfer pricing

Support for alignment with OECD Guidelines and appropriate Australian rules

We agree that New Zealand's transfer pricing regime should be aligned to international best practice. Consistency with the regimes applied in other jurisdictions will also help avoid the incidence of double taxation.

In our members' experience, since reform in 2012, the Australian transfer pricing rules have led to additional disputes between multinationals, the Australian Tax Office and overseas tax administrations. We expect that the proposals to reform the transfer pricing regime in New Zealand will result in a similar increase in the number of disputes, and we note the compliance costs associated with this.

Limited risk distributors commonly reflect commercial substance

The LRD model is one commonly used throughout the world. It is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken in New Zealand happens at the end of the supply chain and is often relatively low in terms of the value-adding functions contributing to the system profits of the enterprise.

The implication of the discussion document seems to be that, in most cases, LRDs structures lack commercial reality and most risks are controlled by the New Zealand entity. More often, for these businesses the global marketing strategy is conducted offshore and tight control maintained over marketing spend, inventory levels and major business decisions of the LRD. The New Zealand subsidiary will have substantially smaller resources at its disposal and will often undertake market activation activity rather than development.

This point has previously been accepted by Inland Revenue. In one recent example, John Nash, Manager (International Revenue Strategy) was commented:

"In terms of the way we tax, is you tax the value-add. I wish it wasn't like this. But you can only tax what gets added in New Zealand and we're right at the end of the value chain. Unfortunately, that's the state of the industry in New Zealand; it's not necessarily a reflection of profit-shifting."

Applying the arm's length standard

We note that, in assessing the transfer prices employed by taxpayers and determining whether adjustment is appropriate, the Commissioner has the advantage of hindsight which our members will not have when entering into the transaction. Shifting the burden of proof onto our members in relation to transfer pricing matters could be problematic, if we are later required to show that the arrangement was arm's length based on an outcome we could not have predicted. The Commissioner should take care not to impose unrealistic requirements on members in relation to genuine, but underperforming, business ventures.

Opposition to time bar extension

Tax positions assessed in the year ended 31 March 2013 are now time barred, but under the proposals could be reopened for a further three years. Members consider that this is inappropriate; any changes should be prospective in their application only.

Some members have invested considerable time and money in negotiating APAs with Inland Revenue. It is possible that legislative changes could override the effect of these APAs, effectively penalising taxpayers whose intention it was to be proactive in managing transfer pricing risk in a constructive way with Inland Revenue. The agreements should be honoured given their lower risk to the New Zealand revenue base and the inequity that would be created should taxpayers need to renegotiate such agreements.

We consider that any need for the extension of the time bar is limited should the proposal to shift the burden of proof to the taxpayer be adopted. This is because, should the taxpayer have the burden of proof, the Commissioner's concerns in relation to accessing relevant information are mitigated by an ability to more readily adjust transfer pricing outcomes where the taxpayer is non-compliant.

In addition, the Government will already have access to improved information flows through country-by-country reporting and automatic exchanges of information between Revenue Authorities.

Further, although the proposed extension of the time bar is limited to transfer pricing matters, there are complications associated with an adjustment for the interactions between transfer pricing and other matters, including income tax and withholding tax. If an extension of the transfer pricing time

bar is pursued, it should be clear what delimits a “transfer pricing matter” from another, to avoid the Commissioner pursuing something as a transfer pricing matter to “get around” a more restrictive time bar for another regime.

Evidence and documentation requirements

Given that the revised transfer pricing rules would place a burden of proof on our members to show that their transfer pricing is arm’s length, it is important that it is clear to members what is required. In other jurisdictions around the world, the legislation is notably more prescriptive and sets out clearly what is required in documentation.

In New Zealand, Inland Revenue does not habitually set out its requirements in a formal way which creates difficulty for multinationals attempting to assess their documentation requirements (in many cases, by centralised tax functions overseas). Inland Revenue should set out unambiguously what is required of taxpayers. Mere endorsement of the OECD Guidelines does not assist taxpayers with little understanding of the particular risks to the New Zealand revenue base to which Inland Revenue’s concerns more specifically relate.

7. Administrative measures

Penalties for not providing information

Penalties for failure to provide transfer pricing information should not be imposed on New Zealand business officers and/or directors.

It is proposed that changes be made to allow a person to be convicted of an offence if they fail to provide information held by an associated offshore group member. The New Zealand subsidiary of a multinational tends to be small in the context of the group’s global operations. Our members note that officers and/or directors of New Zealand subsidiaries will often have little or no ability to compel offshore parents to provide information. We submit that it is not appropriate to impose penalties on New Zealand officers and/or directors for this reason.

Non-cooperation

Obtaining information can be difficult for a small subsidiary of a multinational.

We note that some of the factors proposed in the discussion document that lead to a finding that a taxpayer is “non-cooperative” are wide in scope (e.g. failure to respond to Inland Revenue correspondence). We submit that there should be some acknowledgement that on occasion delays in

obtaining information are not driven by an unwillingness to provide information, but rather by the difficulties in obtaining information from within large organisations generally.

Collection of information

Additional information gathering powers are unlikely to be effective and should not proceed.

We submit that Inland Revenue is likely to have sufficient ability to collect information from large multinationals under existing rules by virtue of country-by-country reporting and automatic exchange of information.

As noted previously, the introduction of specific provisions that enable Inland Revenue to directly request information or documents offshore may be unlikely to result in Inland Revenue receiving information in a timelier manner, on the basis that delays in obtaining information tend to be attributable to the internal workings of large organisations rather than deliberate non-cooperation. This is particularly so in light of the size of New Zealand relative to other jurisdictions that multinationals operate in, rather than a result of unwillingness by large multinationals to provide information. Country-by-country reporting and automatic exchange of information arguably provides Inland Revenue with a better method of collecting information than the specific provisions proposed in the discussion documents.

Early payment of disputed tax

Payment of tax in dispute at an earlier stage of the disputes process is not appropriate. Large multinationals are unlikely to default on the tax due, with use of money interest being an inadequate form of recompense for taxpayers.

Taxpayers generally do not enter into a dispute with Inland Revenue to delay the payment of tax. Rather, there is a genuine dispute over the tax position taken and amount of tax payable. In this respect, large multinationals in dispute with Inland Revenue should not be treated differently from any other New Zealand taxpayer.

The use of money interest and late payment penalties regime should be a strong enough disincentive not to prolong a dispute. The power of use of money interest is further evidenced by taxpayers using tax pooling services to mitigate its effects.

8. Conclusion

AmCham believes that New Zealand's tax laws are currently among the best in the world. New Zealand has a strong tax treaty network, a proven and effective thin capitalisation regime and a well-established transfer pricing regime.

AmCham supports a coordinated global response to BEPS, and endorses the work of the G20 and OECD. To the extent that the New Zealand Government proposes implementing the OECD's recommendations, our members broadly support the Government's intentions. However, where the proposals extend beyond implementing OECD recommendations, we do not see the Government has sufficient justification to take unilateral action.

A coordinated global approach will lead to better outcomes for tax authorities and for taxpayers.

We understand these submissions may be the subject of a request under the Official Information Act 1982 and consent to their release.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mike Hearn', followed by a horizontal line extending to the right.

Mike Hearn

Executive Director

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BELL GULLY

April 27, 2017

BEPS - Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington, New Zealand 6140

policy.webmaster@ird.govt.nz

Comments on BEPS - Transfer pricing and permanent establishment avoidance

Dear Deputy Commissioner, Policy and Strategy:

We represent the Digital Economy Group (the “DEG”), an informal coalition of leading U.S. and non-U.S. software, information / content, social networking, and e-commerce companies that provide goods or services through digital and non-digital means. A number of the members of the DEG have business activities in New Zealand. We are writing to provide the comments of the DEG on the proposal to deem a New Zealand PE of a nonresident enterprise if a related entity carries out sales-related activities for the nonresident in New Zealand (the “PE Anti-Avoidance Rule”), as set forth in the discussion document entitled, “BEPS - Transfer pricing and permanent establishment avoidance” (the “Discussion Document”). Although our comments principally address the PE Anti-Avoidance Rule, we also provide some brief comments on the Discussion Document’s transfer pricing and administrative proposals.

We thank the New Zealand Inland Revenue (the “Inland Revenue”) for the opportunity to provide comments on the Discussion Document. We applaud the Inland Revenue for following a transparent approach of soliciting and considering comments on the PE Anti-Avoidance Rule. This approach is particularly welcome in cases such as this, where the proposed changes to domestic legislation deviate from international norms. We also applaud the Inland Revenue for including in the Discussion Document detailed examples that allow interested parties such as the DEG to identify and address the exact causes of the Inland Revenue’s concern with certain business structures.

Historically, New Zealand has been a firm advocate that the fundamental concepts of international tax law, such as nexus, source, character, and the application of the arm’s length principle, should be developed and agreed on a consensus basis, and implemented consistently among trading partners. Even before the BEPS consensus is implemented, we are seeing a small number of jurisdictions choose the path of unilateral actions, creating a significant risk of serious fragmentation of the consensus-based international

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tax framework, if other jurisdictions follow that path. Despite these recent examples, we respectfully suggest that New Zealand should maintain its historic position as an advocate for consensus-based rules and uniform implementation.

Accordingly, for the reasons we discuss in this submission, we respectfully recommend that the Inland Revenue either withdraw the PE Anti-Avoidance Rule or, in the alternative, defer consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the BEPS Project recommendations on the common commercial structures that fall within the PE Anti-Avoidance Rule's scope. We respectfully request a meeting with representatives of the Inland Revenue and the New Zealand Treasury (and/or relevant Ministerial officials) to discuss further the points we raise in this submission.

Executive Summary

1. As requested in the Discussion Document, we provide a brief summary of our major points and recommendations in the order in which they appear in this submission.
 - i. As proposed, the PE Anti-Avoidance Rule captures common commercial arrangements involving affiliated New Zealand entities that are not abusive. Transfer pricing adjustments, and not deemed PEs, are the appropriate response to any perceived undercompensation of the New Zealand sales support entity.
 - ii. The PE Anti-Avoidance Rule creates almost a *per se* PE rule for many multinational groups that sell into New Zealand using a nonresident principal. Imposing direct tax on a nonresident on the grounds that a local affiliate performs *any* sales related activities would be a radical departure from the established norms for imposing direct tax on a nonresident and thus would constitute a “fundamental change[] to the current international tax framework.”
 - iii. We are not aware of any other jurisdiction, including Australia or the UK, that has adopted a rule similar in scope to the PE Anti-Avoidance Rule. The PE Anti-Avoidance Rule therefore represents the most extreme unilateral PE measure in the world.
 - iv. The PE Anti-Avoidance Rule is inconsistent with the consensus approach of the OECD/G20 BEPS Project, which already has developed a consensus based recommendation for changes to the treaty law PE standard to address the in-market support structures on which the PE Anti-Avoidance Rule focuses. As the BEPS Project recommendations already are addressing the concerns the Discussion Document identifies, we believe that the more

appropriate course of action is to defer the consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the BEPS Project recommendations on the structures that are within the PE Anti-Avoidance Rule's scope.

- v. We endorse the proposal to adopt the revised OECD Transfer Pricing Guidelines ("TPG") and conform the New Zealand transfer pricing rules to the rules in the TPG. We respectfully recommend that New Zealand not adopt New Zealand-specific transfer pricing rules that deviate from the consensus interpretation of the TPG.
- vi. If New Zealand shifts the burden of proof in transfer pricing cases from the Inland Revenue to the taxpayer, we respectfully recommend that the taxpayer only be required to prove that a result is within the range of reasonable results. We also respectfully recommend that the existing four-year statute of limitations for transfer pricing assessments be retained.
- vii. We respectfully recommend that multinationals only be considered "noncooperative" from a tax administration standpoint where there is a willful, reckless, or negligent disregard of the requirement to timely produce truthful information in response to an Inland Revenue information request. We also respectfully recommend that New Zealand preserve the existing payment rule for amounts in controversy, and require taxpayers to pay the disputed tax only once the dispute is resolved. In addition, given the new country-by-country reporting and automatic exchange of information requirements, we believe that there is no need to expand the Inland Revenue's information-gathering powers in the manner described in the Discussion Document.

Centralized Sales Structures

- 2. We applaud the inclusion of examples in the Appendix to explain the Inland Revenue's concerns with centralized sales structures. As proposed, however, the PE Anti-Avoidance Rule will include in its scope common commercial structures that are not abusive.
- 3. In Example 1, a multinational group sells remotely into New Zealand without establishing any actual business presence in New Zealand. The PE Anti-Avoidance Rule does not apply in this case. In Example 4, the PE Anti-Avoidance Rule also does not apply where a multinational group sells into New Zealand using an affiliated New Zealand reseller. In an important comment, the Discussion Document notes that the proposed changes to New Zealand's transfer

pricing rules will allow New Zealand to “appropriately tax” this structure.

4. In contrast, Example 3 states that the PE Anti-Avoidance Rule applies to a multinational group that sells remotely to New Zealand customers because a New Zealand affiliate performs sales support activities. The inference from these examples is that combining the centralized sales model with some degree of local presence is abusive.
5. We respectfully submit that the basic fact patterns in both Examples 3 and 4 reflect extremely common business models that companies in a wide range of business sectors employ for sound commercial reasons. Some of the business reasons for choosing the centralized sales model include: (i) efficient cash management due to a single legal entity receiving all customer payments; (ii) simplified intercompany invoicing; (iii) simplified foreign exchange hedging at the principal company level for all receivables; (iv) consistent enforcement of group legal and financial business policies through centralized customer contract approvals; (v) application of single contract terms and choice of law in customer and supplier contracts; (vi) single legal entity identified as responsible party to pursue or defend IP enforcement claims; (vii) centralized compliance responsibility for regulatory requirements at a single entity; (viii) cost efficiencies arising from hiring personnel who can perform regional roles in a central location; and (ix) avoided costs of implementing financial accounting system support for multiple revenue points and intercompany sales transactions.
6. From a policy standpoint, it is difficult to justify treating the fact pattern in Example 3 as inherently more prone to abuse than the fact pattern in Example 1. If remote sales into New Zealand with no local presence are not abusive, adding local activities that are appropriately compensated for their role in creating value under the revised OECD TPG, as incorporated into New Zealand law, should not change that conclusion.
7. We suspect that the real concern about this structure is expressed in Example 3 itself as an assumed fact: that “the New Zealand subsidiary is a paid a fee for its services . . . [that] generally only exceeds its costs by a small margin.” If that indeed is the actual concern, then the proper response is a transfer pricing adjustment, not a deemed PE of the nonresident. We see no reason why the revised TPG, with the recent enhancements expressly written to assure that transfer pricing outcomes are in line with value creation in exactly these cases, would not provide the Inland Revenue with the appropriate tools to “appropriately tax” this structure, just as the revised TPG provide such tools to “appropriately tax” the structure in Example 4.
8. The discussion in Example 3 notes the concern that a proper transfer pricing review of the value created by the local subsidiary would not be possible “as a practical matter (largely due to a lack of visibility over the value added through

the entire supply chain).”¹ We believe that these concerns based on lack of transparency will be directly addressed through country-by-country reporting and the enhanced transfer pricing reporting requirements imposed by Action 13.

9. We note that the Discussion Document in Example 4 expressly states that one of the problematic features of structures involving a New Zealand reseller is that principal companies in regional hub structures “typically carr[y] on limited actual activities in relation to” New Zealand sales.² As a broad generalization, this assumption is incorrect. In most cases, a company centralizes important functions in regional hubs to maximize both the commercial efficiencies of the centralized sales model described above and the company’s ability to achieve market penetration across the region. Of relevance to the proposed PE Anti-Avoidance Rule, however, Example 4 shows that even under the assumption that the principal company carries on “limited actual activities” related to New Zealand sales, a proper application of the TPG will address any cases of undercompensation of the New Zealand in-market distributor. There is no more (or less) reason to assume that the business activities of a centralized sales entity which acts as principal for an in-market support structure conducts “limited actual activities” related to New Zealand sales. Accordingly, it is difficult to see how the tax policy responses to the cases of Examples 3 and 4 can be different.
10. We also believe that the TPG give the Inland Revenue the necessary tools to address third party channel provider arrangements, as set forth in paragraphs 3.27 - 3.28 of the Discussion Document. If transfer pricing adjustments are the appropriate response to perceived abuses in connection with sales into New Zealand through an affiliated New Zealand reseller, as Example 4 clearly states, transfer pricing adjustments, and not deemed PEs, also are the appropriate response to undercompensated New Zealand support affiliates in channel provider arrangements.

New PE Standard Under the PE Anti-Avoidance Rule

11. The Discussion Document states that the proposed rule “is not trying to widen the accepted international definition of a PE in substance.”³ With respect, the proposal does exactly that, as it creates almost a *per se* rule that applies to business structures that cannot be regarded as abusive, and proposes a PE threshold based on less economically significant activities than anything in current tax treaties or in the BEPS-recommended changes to Article 5.
12. Specifically, the rule applies if an arrangement satisfies the four criteria set forth in paragraph 3.21 of the Discussion Document. Of these four criteria, in practice

¹ Discussion Document, Example 3, p. 49.

² Discussion Document, Example 4, p. 50.

³ Discussion Document ¶ 3.2.

only two will be operative terms, as the first and the third criteria are neutral facts - i.e., whether a nonresident supplies goods or services to a person in New Zealand and whether some or all of the sales income is not attributed to a New Zealand PE of the nonresident - which facts by themselves cannot indicate whether a structure is abusive, since they will exist in every case where goods or services are supplied into New Zealand without the involvement of an affiliate acting as a reseller of the goods or services. Therefore, the second and fourth criteria are the relevant subjects for discussion, as those two criteria represent the elements of the proposed standard which are meant to define an abusive structure.

13. Under the second criterion, the PE Anti-Avoidance rule may apply if a related entity “carries out an activity in New Zealand in connection with [a] particular sale for the purpose of bringing it about.” This is a far lower threshold of economic activity for creating tax nexus of a nonresident than even the “principal role” standard that BEPS Action 7 recommends. The BEPS standard requires a local affiliate to play “the principal role” leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, a much more substantive activity than “an activity ... for the purpose of bringing” about the sale. Under the proposed criterion, a New Zealand affiliate could give rise to tax nexus of a nonresident enterprise if it plays *any* role leading to the conclusion of a sales contract by the nonresident. Further, the requirement in the Action 7 recommendation that the contracts be concluded without material modification by the enterprise was intended to describe cases where there is no material business judgment exercised by the nonresident enterprise at the moment of contract conclusion. That point is absent from the proposed rule, so that a PE could arise even if personnel of the nonresident were heavily involved in contract negotiation and acceptance. Although the Discussion Document expressly excepts auxiliary or preparatory activities (such as advertising and marketing) from the list of tainted activities,⁴ a wide range of activities that have never been considered to give rise to a deemed dependent agent PE, such as collaborative product design, routine sales promotion, solicitation, tech support, warranty repairs, etc., could conceivably fall within the scope of this criterion and trigger the application of the rule.
14. We believe that it is difficult as a policy matter to justify imposing tax nexus on a nonresident enterprise based on such limited local activities performed by an affiliate which is appropriately compensated under the arm’s length principle. The objective of the PE standard is to assess when a nonresident enterprise itself conducts sufficient business activity through its actual presence in a state to warrant direct taxation of the nonresident. In considering whether a nonresident should be subject to local tax by virtue of attribution theories based on a dependent agent or similar activity, that policy choice should take into account

⁴ Discussion Document ¶ 3.22.

the fact that the local affiliate is fully taxable in that state.

15. Thus, a nonresident without premises at its disposal in a state should be subject to direct tax in that state only if the nonresident itself could be said to be in fact conducting its business in that state - i.e., concluding contracts - on a regular basis through a local person operating in that state. The “principal role” standard lowers the threshold for tax nexus but still is faithful to the premise that the dependent person must be performing those activities in the state which lead immediately to contract conclusion, without material involvement at that moment by the nonresident, before the nonresident may be subject to direct taxation in that state by virtue of the attributed activities.
16. Imposing direct tax on a nonresident on the grounds that a local affiliate performs *any* sales related activities would therefore be a radical departure from the established norms for imposing direct tax on a nonresident. It is difficult to reconcile this feature of the PE Anti-Avoidance Rule with the statement in the Discussion Draft that the proposed measures “are not intended to make any fundamental changes to the current international tax framework.”⁵
17. Under the fourth criterion, the PE Anti-Avoidance Rule applies where an “arrangement defeats the purpose of [the relevant tax treaty’s] PE provisions.” Nothing in the hypothetical case of a nonresident enterprise selling remotely into New Zealand with the assistance of a local sales support affiliate defeats the “purpose” of the PE standard, which is to define when the actual commercial facts indicate that the nonresident seller itself has sufficient actual presence in a state to justify the state’s imposition of direct tax on the nonresident. Thus, unless a particular arrangement has some unique hallmarks of treaty abuse, nothing in what is otherwise a common commercial arrangement in itself should be considered to defeat the “purpose” of the treaty.
18. The Discussion Document states that the objective of the fourth criterion is to assess whether supplies are made “through a PE in substance.”⁶ The Discussion Document then proposes five factors to use in determining whether this test is met. The first three factors (the commercial and economic reality of the arrangement, the relationship between the nonresident and the related entity in New Zealand, and the nature of the services carried out by the related entity) are exceedingly vague, and provide no particular guidance as to whether the nonresident has the requisite degree of physical or other business presence in New Zealand.
19. The fifth factor seems to be the key to the proposal, as that factor purports to list indicators of PE avoidance, which indeed is the policy focus of the proposal. It is

⁵ Discussion Document ¶ 1.4.

⁶ Discussion Document ¶ 3.24.

hard to see, however, that the proposed indicators (i.e., whether the arrangement involves a low tax jurisdiction, specialized services, or a related entity which is allocated a low amount of profit on the basis it is carrying out low value activities while having a number of well paid employees) actually point towards abusive structures.⁷ Whether a principal company has a tax rate that is lower than the New Zealand rate has no relationship to whether activities actually conducted in New Zealand directly by or on behalf of a nonresident rise to a level that could justify imposing direct tax on the nonresident. This element of the proposal suggests that New Zealand intends to apply different PE standards to different trading partners based on whether a partner has a tax rate that is acceptably high from a New Zealand perspective. Whether the New Zealand affiliate performs “specialised” services and the amount of profit allocated to the New Zealand affiliate based on that entity’s functions, assets and risks also are not relevant to whether the nonresident itself has the requisite degree of actual business presence in New Zealand to warrant direct taxation. Rather, these issues relate to whether the pricing of the relevant intercompany arrangements complies with the arm’s length principle.

20. Only the fourth factor is relevant to whether a nonresident could be said to have the requisite physical presence in New Zealand, but this factor is the most radical feature of the proposal. The fourth factor allows the Inland Revenue to test whether a nonresident enterprise would have had a New Zealand PE but for the separate legal existence of the nonresident and a New Zealand affiliate. This factor is contrary to New Zealand’s treaties, which include an article based on Article 5(7) of the OECD Model, as explained in paragraph 40 of the Article 5 Commentary: “It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, *such a subsidiary company constitutes an independent legal entity.*” (emphasis added)
21. The practical consequence of this factor would be to create a New Zealand PE of a nonresident in every case in which the activity of the New Zealand affiliate is not preparatory or auxiliary, as the premises and personnel of the affiliate would be attributed to the nonresident. This factor therefore would create an almost *per se* PE rule for multinational groups with New Zealand sales support affiliates.
22. We are not aware of any other jurisdiction that has adopted a rule that eliminates the distinction between separate legal entities for the purpose of asserting a PE. This rule effectively imposes PE reporting obligations on all groups which sell remotely into New Zealand using a local affiliate. This element does not exist in other anti-avoidance rules, such as the Australian Multinational Anti-Avoidance

⁷ We assume that the last two criteria refer to attributes of the New Zealand affiliate, but there is no indication in the text as to which entity is being referenced.

Law (“MAAL”) or the UK Diverted Profits Tax (“DPT”). Accordingly, as proposed, the PE Anti-Avoidance Rule represents the most extreme unilateral PE measure in the world. We believe that such a rule would not be consistent with the historic policy and practice of New Zealand.

23. We also struggle to see the potential PE abuse in channel provider arrangements. As the Discussion Document acknowledges, multinational groups use channel provider arrangements for “good commercial reasons.”⁸ There is no doubt that the channel provider (a New Zealand taxpayer) is compensated at arm’s length for its services because it is unrelated to the nonresident. In addition, since the channel provider has taken over some or all of the sales responsibilities, the logical inference is that there is less reason for PE concern than in a pure related party arrangement on the grounds that the New Zealand affiliate is less likely to play “the principal role” leading to the conclusion of the contract with the New Zealand customer. The Discussion Document nevertheless justifies a finding of a PE on the grounds that the nonresident and the channel provider are “working together” to sell to the New Zealand customer, and that the New Zealand affiliate therefore assists the nonresident by assisting the channel provider.
24. The Discussion Document does not provide any detail on the level of activity that could give rise to a PE in connection with a channel provider arrangement, leading to the conclusion that a local affiliate merely “working together” with the channel provider to pursue a sale could give rise to a PE. That standard would be remarkably low and ambiguous (e.g., would merely accompanying a channel provider to a customer site trigger the application of the rule?). That standard also would discourage nonresidents from engaging unrelated New Zealand channel providers to support New Zealand customers since such arrangements now would give rise to PE uncertainty in addition to requiring the nonresident to compensate both the channel provider and address the PE exposure arising due to the affiliate’s activities.
25. We fully acknowledge that any tax administration must possess tools to properly address true cases of treaty abuse. The Discussion Document indicates that one such case is that in which a multinational group takes the position that a New Zealand affiliate performs only general support activities (e.g., marketing), but, in substance, the affiliate negotiates and concludes contracts on behalf of a nonresident.⁹ As the Discussion Document appears to acknowledge, New Zealand’s existing domestic and treaty law rules provide tools, including anti-abuse rules, that allow the Inland Revenue to address these arrangements. The fact that employing these tools may require resource intensive audits is not a sufficient justification for the radical legal change that the Discussion Document

⁸ Discussion Document ¶ 3.29.

⁹ See Discussion Document ¶ 3.13.

proposes. Furthermore, the introduction of the information gathering, transparency and cooperation measures the Discussion Document proposes will ultimately ease the Inland Revenue's administrative burden on audit, thereby reducing further the need for an unfocused rule of convenience like the PE Anti-Avoidance Rule.¹⁰

Profit Attribution Under the PE Anti-Avoidance Rule

26. The Discussion Document states that the Inland Revenue expects “a fairly significant amount of . . . sales income [to be] attributable to the deemed PE” under the PE Anti-Avoidance Rule.¹¹ We believe that this assumption is not likely to be correct in reality. Specifically, it is difficult to envision what additional profits could be attributed to a deemed PE with respect to in country sales activities where those activities already have been fully rewarded under the revised OECD TPG, as implemented in New Zealand law. The Discussion Document correctly acknowledges that income attributable to the nonresident's offshore activities will not be subject to direct tax in New Zealand.¹² Since in general all value other than value arising from the sales functions performed by the affiliate will have been created outside of New Zealand, the profit attribution result under the PE Anti-Avoidance Rule is likely to be zero in most, if not all, cases.
27. This result is even more likely for a deemed PE created under the proposed PE Anti-Avoidance Rule than is the case for deemed PEs arising under the current Article 5(5) or the BEPS Action 7 “the principal role” test, since the activities which give rise to a deemed PE under the PE Anti-Avoidance Rule almost invariably will create less value through the in-country functions, and involve the use of fewer assets, than deemed PEs arising under the other two rules.

The BEPS Project Addresses These Issues Through an International Consensus

28. The OECD/G20 BEPS Project constitutes “the most fundamental changes to international tax rules in almost a century.”¹³ From the beginning, the expressed goal of the BEPS Project has been to create a consensus set of revised international tax rules, and implement them consistently around the world.¹⁴ The

¹⁰ See Discussion Document, Ch. 6.

¹¹ Discussion Document ¶ 3.36.

¹² Discussion Document ¶ 3.8.

¹³ Statement of OECD Secretary-General, Angel Gurría, May 10, 2015, *available at* <http://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm>.

¹⁴ See Action Plan on Base Erosion and Profit Shifting at 13 (2013) (“This Action Plan calls for . . . the adoption of new consensus-based approaches, including anti-abuse provisions, designed to prevent and counter base erosion and profit shifting.”); Pascal Saint-Amans - The Face of BEPS, Tax Analysts, Dec. 22,

proposed PE Anti-Avoidance Rule clearly is a statement by New Zealand that it is prepared to follow the route of unilateral actions and depart from the consensus positions. With respect, we believe that decision would be shortsighted.

29. We note that many of the “in-market support structure” cases identified as “problematic” would be addressed directly by the new “the principal role” standard (and even by the current Article 5(5) standard in cases of actual abuse). The OECD/G20 consensus recommendation to change the OECD Model PE standard already has had an impact on company structures, even though the treaty ratification process has not yet been completed. Many multinational groups, including significant participants in the digital economy, have begun the process of reorganizing their commercial structures. These have included reorganizations of in-country sales and purchasing functions into resellers in multiple sales jurisdictions. Despite the commercial efficiencies of centralized sales structures noted above, groups are taking their lead from this new international tax consensus to reorganize their commercial structures in the direction encouraged by the BEPS Project.
30. Through the OECD/G20 transparency initiatives, including country-by-country reporting, these structural changes will become apparent in the coming years. These changes may not yet be visible to tax administrations which develop information through audit procedures, as those procedures necessarily focus on past years.
31. Accordingly, we believe that the ongoing implementation of the BEPS Project will address exactly the concerns identified in Examples 3 and 4 of the Discussion Document. We respectfully suggest that the more appropriate course of action at this point is to defer the consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the BEPS Project recommendations on the structures that are within the PE Anti-Avoidance Rule’s scope.
32. We note that the Discussion Document mentions that some of New Zealand’s treaty partners may not adopt the BEPS Action 7 recommendations, which the Discussion Draft asserts justifies a unilateral approach for New Zealand.¹⁵ These passages transparently communicate that New Zealand is prepared to substitute a unilateral New Zealand standard for the OECD/G20 consensus, including in trading relationships where New Zealand’s treaty partner chooses not to adopt the Action 7 recommendation. Essentially, New Zealand is challenging the OECD/G20 view that countries may choose whether or not to adopt the

2014, (“A major reason for the project’s two-year timeline, Saint-Amans said, is that the OECD had to move quickly to keep consensus among all countries and to prevent them from acting unilaterally to tackle sources of BEPS.”).

¹⁵ Discussion Document ¶ 2.9.

“principal role” rule in their treaties. In contrast with the four minimum standards to which all participants in the BEPS Project committed, participants are free to choose whether to incorporate the BEPS Action 7 recommendations in their treaties. New Zealand essentially is saying that New Zealand treaty partners do not have that choice.¹⁶

33. We observe that this approach is unusual for New Zealand, which has been a conscientious participant in the BEPS Project. This approach also is inconsistent with New Zealand’s historic active role in helping to develop an OECD consensus to be applied on a consistent basis. In addition, the rule is ultimately inconsistent with the core treaty policy of establishing a framework for taxing nonresidents to which treaty partners bilaterally agree.
34. We note that some countries may be choosing to not adopt the Action 7 recommendations broadly through the Multilateral Instrument in order that they may choose selectively which treaty partners to approach with a view towards negotiating appropriate treaty changes on a bilateral basis. The Inland Revenue might consider this approach as a more targeted response to the perceived issues.
35. We respectfully suggest that unilateral actions intended to bypass the OECD/G20 consensus recommendations will not be healthy in the long run for New Zealand. If New Zealand adopts this rule, other jurisdictions may well reference the PE Anti-Avoidance Rule as a justification for adopting their own radical, nonconsensus positions. These positions ultimately will impact New Zealand enterprises engaging in cross-border trade, creating greater possibilities of double taxation and enhanced disputes on cross-border transactions.

Interaction with Treaty Network

36. We note the statement that the PE Anti-Avoidance Rule would apply “notwithstanding anything in a DTA.”¹⁷ We assume that this statement signals that the rule would be legislated in the same way as the current General Anti-Avoidance Rule (“GAAR”), ostensibly allowing enforcement of the rule outside the scope of New Zealand’s tax treaties. We also note that the Discussion Document points to the UK DPT and the Australian DPT as prior examples of this approach.¹⁸ We note, however, that a principal element of the justification that those taxes can be imposed outside the scope of tax treaties already in force

¹⁶ We note that paragraph 2.9 of the Discussion Document suggests that additional measures to counter PE and transfer pricing avoidance are necessary as several trading partners will not adopt the BEPS treaty measures. We note that the revisions to the TPG are effective regardless of any adoption of the Action 7 proposals, so decisions by a country whether to adopt the Action 7 proposals will have no effect on the ability of New Zealand to apply the revised TPG, as incorporated into New Zealand law.

¹⁷ Discussion Document ¶ 3.45.

¹⁸ Discussion Document ¶¶ 2.15; 3.34.

is the assertion that the DPTs are not taxes on income or capital that are covered by Article 2.¹⁹ While that view is subject to considerable doubt, since both DPTs in fact impose tax by reference to the profits of the enterprise, it is important to note that this justification cannot apply to support a treaty override under the New Zealand proposal. The PE Anti-Avoidance Rule sets a different definition of which nonresident enterprises are subject to the New Zealand corporate tax, but the tax that is imposed is indeed the same tax of general applicability imposed on all corporations. Thus, we believe that the PE Anti-Avoidance Rule conflicts with New Zealand's treaties, and any override based on GAAR-type principles could apply only in the case of actual abuse of the treaty.

37. In essence, the proposal constitutes a unilateral, selective rewriting of the PE Article for certain of New Zealand's treaty partners. We respectfully suggest that changes of that sort are best left to bilateral negotiations.

Substantive Transfer Pricing Rules

38. The Discussion Document characterizes transfer pricing as a "strategy" that multinational groups can use to shift profits out of New Zealand.²⁰ Transfer pricing is not a "strategy." Transfer pricing simply is the implementation of the legal requirement that associated enterprises conduct their affairs at arm's length. Since the arm's length principle applies to all cross-border transactions, transfer pricing rules must focus on providing clear guidance to taxpayers and tax administrations alike.
39. With that objective in mind, we endorse the proposal to adopt the revised OECD TPG and conform the New Zealand transfer pricing rules to the rules in the TPG. The TPG have proven to be a useful expression of international consensus. To preserve the benefit of this consensus, we respectfully recommend that New Zealand not adopt New Zealand-specific transfer pricing rules that deviate from the consensus interpretation of the TPG. One clear example of such a deviation is the Australian non-recognition / reconstruction rules. These rules are unique to Australia, are inconsistent with the rules in the TPG, and would make New Zealand an outlier from a transfer pricing standpoint if they were to be incorporated into New Zealand law.²¹
40. Every cross-border transaction involves another jurisdiction. Thus, every New Zealand specific transfer pricing rule or interpretation is likely to result in an increase in transfer pricing controversies. Such controversies will result in a

¹⁹ Discussion Document ¶ 2.11 ("The DPTs that have been proposed in Australia and enacted in the UK tax the diverted profits of large multinationals. Their DPTs are an anti-avoidance measure and are entirely separate taxes levied at a penal rate compared with income tax.").

²⁰ Discussion Document ¶ 5.7.

²¹ See Discussion Document ¶¶ 5.34 - 5.40.

burden on cross-border trade, to the detriment of New Zealand residents.

Procedural Transfer Pricing Rules

41. The Discussion Document proposes to shift the burden of proof in transfer pricing cases from the Inland Revenue to the taxpayer.²² In many cases, the relevant comparability analysis will produce a range of results, all of which could be arm's length.²³ Accordingly, we respectfully recommend that the principle be clear that the taxpayer only needs to prove that a result is within the range of reasonable results. An alternative approach, in which the taxpayer must prove that the specific result within that range is correct, is unworkable. Under that latter approach, taxpayers could never have certainty that their transfer pricing would be accepted since the Inland Revenue always could propose a different result within the arm's length range.
42. The Discussion Document also proposes to extend the "time bar" for transfer pricing assessments from four years after the end of the year in which a company provides the relevant return to the Inland Revenue to seven years after that date.²⁴ The Discussion Document justifies this proposal on the grounds that the non-arm's length nature of certain transfer pricing arrangements only becomes apparent after a longer period of time.²⁵ We respectfully recommend that the existing statute of limitations on transfer pricing assessments be retained. If, as the Discussion Document proposes, the burden of proving that a transaction is arm's length shifts to the taxpayer, a longer time bar is not necessary, since the taxpayer must affirmatively demonstrate, using the information at its disposal, including financial projections, the arm's length nature of an arrangement. In this case, the Inland Revenue has the opportunity to assess whether or not an arrangement will give rise to an arm's length result even for periods outside the assessment period.
43. In addition, extending the time bar for transfer pricing assessments, but not for other tax items, such as income tax, withholding tax, and indirect tax, could further complicate the audit process, because transfer pricing and other tax items often are interrelated.

²² Discussion Document ¶ 5.47.

²³ See OECD Transfer Pricing Guidelines, Ch. III ¶ 3.55 ("In some cases, it will be possible to apply the arm's length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the most appropriate method or methods produces a range of figures all of which are relatively equally reliable.").

²⁴ See Discussion Document ¶¶ 5.67 - 5.72.

²⁵ Discussion Document ¶ 5.68.

Administrative Measures

44. The Discussion Document proposes to introduce new administrative measures to apply to multinational groups that are “noncooperative” with the Inland Revenue.²⁶ As a threshold matter, we note that many of the actions that the Discussion Document characterizes as “noncooperative,” such as a “[f]ailure to comply within a statutory time-frame with Inland Revenue’s reasonable requests” and a “failure to respond to Inland Revenue correspondence,”²⁷ may in fact reflect events that are beyond the taxpayer’s control. Based on our members’ experience, it is often difficult and time-consuming to procure the information that the Inland Revenue requests because of the large size of a multinational enterprise and the significant scope of the enterprise’s activities. In addition, where the Inland Revenue requests a large volume of information, the enterprise may wish to obtain and provide information to a standard that is sufficient for the legal discovery process so as to avoid duplicating the effort a second time should an inquiry progress to litigation and, if necessary, seek the Inland Revenue’s agreement to this.
45. Thus, based on our members’ experience, the perceived delay in providing information requested to the Inland Revenue within the Inland Revenue’s desired timeframe is generally attributable to the amount of time it takes any large enterprise to source information from within the organization. This delay is not attributable to any unwillingness to provide the information timely on the part of the taxpayer; rather, it typically is due to the constraints on those internal resources required to respond to large information requests received from multiple jurisdictions. Accordingly, we respectfully recommend that the Inland Revenue limit those actions that constitute evidence of “noncooperation” to actions that represent a willful, reckless, or negligent disregard of the requirement to timely produce truthful information in response to an Inland Revenue information request.
46. The Discussion Document proposes to require nonresident enterprises to pay tax that is the subject of a dispute before the dispute is resolved.²⁸ We respectfully recommend that New Zealand preserve the existing payment rule for amounts in controversy, and require taxpayers to pay the disputed tax only once the dispute is resolved.
47. Late payment interest fully compensates the New Zealand Treasury for any tax that is paid after the year to which the tax relates. Demanding payment of tax before a dispute has been resolved has been used in other jurisdictions as leverage

²⁶ Discussion Document ¶ 6.13.

²⁷ Discussion Document ¶ 6.16.

²⁸ See Discussion Document ¶¶ 6.21 - 6.26.

to compel nonresident taxpayers to settle disputes due to lack of confidence in that jurisdiction's judicial and administrative review and refund procedures. We respectfully submit that New Zealand need not align itself with such a heavy handed approach to tax compliance.

48. The Discussion Document proposes to allow the Inland Revenue to request information from the group's New Zealand affiliate regarding non-New Zealand group members.²⁹ The Discussion Document further proposes to change the New Zealand criminal rules to allow a person to be convicted of a criminal offense if that person fails to provide information in response to such a request.³⁰ In addition, the Discussion Document proposes to allow the Inland Revenue to deem income attributable to a New Zealand affiliate or PE of a multinational group if the group fails to provide information in response to such a request.³¹
49. We believe that the proposed expansion of the Inland Revenue's information-gathering powers is unnecessary. The new country-by-country reporting and automatic exchange of information requirements, once fully implemented across the world, will provide the Inland Revenue with effective tools to obtain information regarding nonresident enterprises.

* * *

For the reasons noted above, we respectfully recommend that the Inland Revenue withdraw the PE Anti-Avoidance Rule and address perceived abuses under New Zealand's existing domestic and treaty law rules. In the alternative, we respectfully recommend that the Inland Revenue defer consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the OECD/G20 BEPS Project recommendations on the common commercial structures that fall within the PE Anti-Avoidance Rule's scope. We also respectfully recommend that the Inland Revenue revise the Discussion Document's transfer pricing and administrative proposals in the manner described above.

We thank the Inland Revenue for the opportunity to provide our comments on the Discussion Document. We would welcome the opportunity to meet with the Inland Revenue to discuss our recommendations and are prepared to provide additional input as needed.

Yours sincerely,

²⁹ Discussion Document ¶ 6.33.

³⁰ Discussion Document ¶ 6.35.

³¹ Discussion Document ¶ 6.37.



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28 April 2017

BEPS – Transfer pricing and permanent establishment avoidance
C-/ Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
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Dear Cath

BEPS – TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE

The Corporate Taxpayers Group (“the Group”) is writing to submit on the Government Discussion Document “BEPS – Transfer pricing and permanent establishment avoidance” (the “discussion document”). The Group is appreciative of the opportunity to submit on this discussion document and looks forward to discussing the proposals further with officials. The Group appreciates having had the opportunity to talk to Officials¹ about the discussion document and those discussions have informed some of the comments in this submission.

We provide a summary of our submission below. Further detail is included in the attached appendices:

- Appendix One: General comments
- Appendix Two: Permanent establishment avoidance
- Appendix Three: Amendments to the source rules
- Appendix Four: Transfer pricing rules
- Appendix Five: Administrative measures

Summary of our submission

The key points in our submission are:

General comments

- The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector and other stakeholders of the tax system adequate time to fully work through the issues which may arise from these proposals.
- The Group does not support proposals which deviate from what the OECD has recommended. These proposals will result in double taxation and remove taxpayers’ rights under double tax agreements.

¹ Workshop with Sam Rowe, Gordon Witte, Steve Mack and Matt Cowen on 13 April 2017.

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We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.



- In the Group's view, many of the proposed changes negatively impact on the attractiveness of New Zealand as an investment destination. New Zealand's tax system plays a critical role in our competitive position with our major trading partners and competitors. At our workshop, Officials acknowledged that these proposals are in substance a Multinational Anti-avoidance Law ("MAAL") and they have many features of a Diverted Profits Tax (DPT).
- As inferred in paragraph 2.22 of the discussion document, many of the proposals in the document do not alter the outcomes under the existing law, should Inland Revenue use the full suite of tools currently available to it. The effect of these proposals is to potentially reduce compliance costs for Inland Revenue in enforcing the law against a very small number of taxpayers, but to significantly increase them for all taxpayers operating cross-border. Therefore the Group questions whether the changes are warranted, particularly given the negative impact that the perception of these changes may have on investment in New Zealand.
- The Group notes that if the rules governing New Zealand's tax system become too complex for foreign companies, they will no longer sell into New Zealand or may fundamentally change the way they sell into New Zealand, resulting in a loss of economic activity in relation to support functions.
- The Group appreciates that the Inland Revenue may find auditing multinational organisations "resource intensive" (as noted in paragraph 3.13), however this does not justify imposing large compliance costs on all compliant taxpayers.
- The Group considers that overall these proposals will be detrimental to tax certainty for taxpayers.
- The Group does not support the proposed application dates. Any changes implemented need to be complemented by appropriate grandparenting provisions for existing arrangements. Taxpayers need to be allowed a reasonable amount of time to undertake any necessary restructuring.

Permanent establishment ("PE") avoidance

- In the Group's view, departing from such core principles risks New Zealand falling out of step with the rest of the world, and in turn risking retaliatory action in jurisdictions in which we operate. New Zealand's best chance of ensuring that its exports are not overtaxed is to ensure that it does not act unilaterally and seek to assert taxing rights over revenue where the income earning activity (including IP) is located outside of New Zealand.
- The importance of DTAs cannot be understated: they exist to facilitate international trade. Having concluded a DTA with a foreign jurisdiction, New Zealand needs to be very cautious in implementing domestic legislation that has the effect of undermining the deal struck in a DTA. Such action risks not only undermining New Zealand's international reputation but also risks foreign jurisdictions taking retaliatory action against New Zealand companies operating "in" their jurisdiction.
- In our workshop we provided an example of a Group member with two employees in Japan. These employees are Japanese natives as it is necessary to have people on the ground who speak the language and understand the customs under which its customers operate. These employees talk to customers and translate communications back into orders that the Group member acts upon. In no way do the two Japanese employees have any role in concluding contracts or fulfilling orders. In the Group's view this type



of example should not give rise to a PE in Japan and cause allocation of profits to be taxed in Japan. However, in our workshop it was concluded by Officials that this was an example that was “close to the line” if the New Zealand proposals were to be applied to the arrangement.

- The Group submits that there are valid reasons why multinationals may conclude contracts outside of New Zealand. This is not necessarily about PE avoidance, but relates to the size and importance of New Zealand operations relative to the rest of the multinational organisation. New Zealand has a very small domestic economy, geographically remote from the rest of the world, and the activities undertaken in country reflect this. For example, in many instances it does not make sense for the multinational to have a legal team based in New Zealand. Linked to the point above, just because an individual in New Zealand is “well paid” does not mean that they are able to conclude contracts.
- A natural consequence of the introduction of these rules could be for non-residents to stop hiring any staff in New Zealand.

It is critical that, if these proposals proceed, Inland Revenue should provide clear commentary for taxpayers on how it considers profits should be attributed to PEs. The rules cannot act as a “force of attraction” principle and seek to bring into the New Zealand tax base all New Zealand sales revenues simply because some functions are carried on in New Zealand. Any attribution of profit to New Zealand must reflect the actual degree of activity and effort in New Zealand – value added outside of New Zealand cannot be taxed in New Zealand.

- The Group submits that it should be clarified what the “purpose of the DTA’s PE provisions” is in relation to the deeming of a PE in New Zealand (as per paragraphs 3.21 and 3.27). In the Group’s view, whether an organisation has a PE or not, is an ‘in or out’ test – an organisation either has enough of a presence in New Zealand or not. The Group queries whether an organisation that is close to having a PE but does not have quite enough ‘presence’ could be considered to have defeated the purpose of the provisions.
- The Group notes that there are PE rules in DTAs and then there are the PE rules in the OECD Action 5 material. In the Group’s view, the proposed rules in this discussion document are unnecessary, add complexity to the rules and disregard the purpose of DTAs.
- The rules proposed in paragraphs 3.21 and 3.27 both contain a criterion that “the arrangement defeats the purpose of the PE provisions”. The Group submits that any such criteria should refer to the dominant purpose of the arrangement.
- This proposal should not have the effect of overriding New Zealand’s DTAs. It is important that taxpayers continue to have access to MAP and arbitration procedures guaranteed in New Zealand’s network of treaties.

Amendments to the source rules

- In the Group’s view, the proposed changes to the source rules are unnecessary as the current source rules are sufficiently broad to capture any situations the Commissioner is concerned with.



Strengthening the transfer pricing rules

- Overall the Group does not believe that further strengthening of the transfer pricing rules are required. Inland Revenue already has a number of tools available to it and these tools should be applied.
- The Group does not support the extension of the time bar for transfer pricing positions to seven years. In the Group's view, this goes against Inland Revenue's Business Transformation principles and incentivises bad behaviour by Inland Revenue to not close out matters in a timely manner. In the Group's view, an adequately resourced Revenue should be able to complete this process within four years. The Group notes that there are significant costs involved in a transfer pricing dispute and extending the time bar to seven years will only increase these costs.
- The Group does not support shifting the burden of proof from the Commissioner to the taxpayer. However, if the onus does shift then it is important that the information required to prove that a particular transaction is arm's length must be limited to publicly available information / comparables. If the Commissioner seeks to rely on "secret information", then that information must be disclosed; and if such information cannot be disclosed with breaching confidentiality, then it is not appropriate that the Commissioner have regard to that information.
- The Group submits that there needs to be sufficient controls put in place when the Commissioner wishes to reconstruct a related party transaction. The Group notes that this power is essentially the Commissioner telling a company how to run its business and this kind of decision should only be made in exceptional circumstances. In the Group's view it must be clearly defined what activities / transactions are 'aggressive' and 'commercially irrational' – there needs to be structure and transparency around who decides this. Any powers of reconstruction need to be limited to only the most extreme circumstances and should only be assessed at the highest levels within Inland Revenue.
- The Group foresees difficulty in applying transfer pricing rules to investors acting in concert. The mere fact that there are unassociated parties coming together indicates there should already be arm's length pricing in place; i.e. there is natural tension to ensure each party is not receiving more than their fair share.
- It is important that Inland Revenue is appropriately resourced with skilled transfer pricing resource so that reviews can be completed efficiently (within four years) and the disputes process can run as intended - i.e. there are independent and impartial transfer pricing experts available to participate in taxpayer conferences and adjudication. There also needs to be sufficient resourcing to allow for an increase in the volume of APAs that will likely be sought if these proposals are enacted.

Administration measures

- There will need to be clear guidelines as to when a taxpayer may be deemed to be non-cooperative. In particular: (i) "non-cooperative" should have a legislated definition and that definition should confirm that a taxpayer is not considered non-cooperative merely because the taxpayer exercises its rights to dispute Inland Revenue's position or contest any steps Inland Revenue may take in an investigation; (ii) there should, in addition, be guidelines issued in the form of a Standard Practice Statement. These guidelines should record the process for determining whether a taxpayer is non-cooperative. In the Group's view this power should rest with a select few senior officials



within Inland Revenue. These officials should be independent from the officials auditing or otherwise engaged with the taxpayer.

- The Group submits that a taxpayer should have the right to apply to the High Court to challenge any decision of Inland Revenue to deem the taxpayer non-cooperative. Given the reputational damage and other consequences that could result from being deemed "non-cooperative" it is important that taxpayers have a means of challenging such a determination.
- The Group does not support the proposal to require taxpayers to pay the tax earlier in the disputes process. The general rule that disputed tax be payable only following final determination of any dispute should remain, except in cases where there is a risk of non-payment of tax found owing (in which case Inland Revenue already has power (see section 138I of the Tax Administration Act ("TAA")) to require early payment). Further, taxpayers are not incentivised to delay resolution of disputes (as suggested by the Discussion Document) given the imposition of use of money interest at rates considerably higher than commercial rates.
- The Group does not support the restriction on the use of tax pooling for disputes involving transfer pricing, the application of the source rules or tax payable under a DTA.
- The Group does not support the proposal to introduce a new statutory power to collect tax from wholly owned subsidiaries of multinationals in New Zealand. This is an unnecessary legislative amendment which may cause significant issues for New Zealand taxpayers in assessing their liabilities (in relation to lending covenants, the solvency test etc.). Inland Revenue already has powers to request assistance in the collection of tax under the *Convention on Mutual Administrative Assistance in Tax Matters*, therefore this rule is unnecessary. If the proposed rule were to proceed, Inland Revenue should be required to obtain a court order to impose on the New Zealand company liability for taxes owing by a different legal entity. The proposed rule is a major departure from the usual corporate law principle of limited liability and so requires judicial oversight in its application.
- The Group does not support a power for Inland Revenue to make a New Zealand entity legally responsible for providing information Inland Revenue may believe is held by another member of the multinational group. It is inappropriate for a New Zealand company to be subjected to monetary penalties and potentially criminal liability for failure to provide information over which that person has no control. If the proposed rule were to proceed, Inland Revenue should be required to obtain a court order to impose on the New Zealand entity or person liability for non-provision of such information. This would provide judicial oversight in respect of the breadth of the request and feasibility of complying with it, and as to whether the need for such an onerous power to be exercised is justified in the circumstances.
- The Group submits that it is not appropriate for Inland Revenue to have the power to impose a \$100,000 penalty on taxpayers who fail to comply with section 17 or 21 of the TAA. Such a power should be left to the courts. This is especially so when taxpayers could be subject to penalties when information is not provided by a member of its multinational group and may have no control over whether the member provides the information or not.
- Section 21 in any event needs to be rewritten. It is arbitrary in its application (e.g. it is triggered by the non-response to an information request after 90 days without regard to whether that time-frame is reasonable in the circumstances, and is disproportionate



in its consequences (in denying a taxpayer access to the courts to contest the correctness of Inland Revenue's assessment)).

- Any changes implemented need to be complemented by appropriate grandparenting provisions for existing arrangements. Taxpayers need to be allowed a reasonable amount of time to undertake any necessary restructuring. At the very least the proposals, to the extent that they proceed, should only apply in respect of income years for which a tax position is taken after date of enactment.

We look forward to discussing this submission further with you.

For your information, the members of the Corporate Taxpayers Group are:

- | | |
|---|---|
| 1. Air New Zealand Limited | 21. New Zealand Racing Board |
| 2. Airways Corporation of New Zealand | 22. New Zealand Steel Limited |
| 3. AMP Life Limited | 23. New Zealand Superannuation Fund |
| 4. ANZ Bank New Zealand | 24. Opus International Consultants Limited |
| 5. ASB Bank Limited | 25. Origin Energy New Zealand Limited |
| 6. Auckland International Airport Limited | 26. Pacific Aluminium (New Zealand) Limited |
| 7. Bank of New Zealand | 27. Powerco Limited |
| 8. Chorus Limited | 28. Shell New Zealand (2011) Limited |
| 9. Contact Energy Limited | 29. SKYCITY Entertainment Group Limited |
| 10. Downer New Zealand Limited | 30. Sky Network Television Limited |
| 11. Fisher & Paykel Healthcare Limited | 31. Spark New Zealand Limited |
| 12. Fletcher Building Limited | 32. Summerset Group Holdings Limited |
| 13. Fonterra Cooperative Group Limited | 33. Suncorp New Zealand |
| 14. Genesis Energy Limited | 34. T & G Global Limited |
| 15. IAG New Zealand Limited | 35. The Todd Corporation Limited |
| 16. Infratil Limited | 36. Vodafone New Zealand Limited |
| 17. Lion Pty Limited | 37. Watercare Services Limited |
| 18. Meridian Energy | 38. Westpac New Zealand Limited |
| 19. Methanex New Zealand Limited | 39. Z Energy Limited |
| 20. New Zealand Post Limited | 40. ZESPRI International Limited |

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely,

John Payne
For the Corporate Taxpayers Group



APPENDIX ONE: DETAILED SUBMISSION POINTS – GENERAL COMMENTS

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

1. General comments

Timeframes

- 1.1 The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector and other stakeholders of the tax system adequate time to fully work through the issues which may arise from these proposals.
- 1.2 The timing of release of all three BEPS related documents (3 March 2017) was unfortunate as many taxpayers are heavily committed to tax compliance activities during the month of March.
- 1.3 Given the breadth of issues being consulted on and the potential overlap of proposals between this discussion document and *BEPS – Strengthening our interest limitation rules* the Group believes that a further round of consultation should take place later in 2017, prior to any changes being included in a tax bill.

General comments

- 1.4 The Group understands the need to address the wider BEPS issues in New Zealand and is generally supportive of targeted proposals to protect New Zealand's tax base. It is pleasing to see thought being taken on this issue. However, in the Group's view, the appropriate balance needs to be found between discouraging avoidance behaviour (including by simply using existing tax rules) and encouraging genuine commercial activity. The Group does not think that this balance has been appropriately struck and does not support these proposals proceeding.
- 1.5 It is also important that New Zealand does not rush into new rules before other jurisdictions, and that any measures remain proportional to the problem. As the Commissioner noted in the 2016 Multinational Compliance Focus Document: "*In the last few years Inland Revenue has placed an increased level of scrutiny on the tax practices of multinationals. I'm pleased we have found nearly all businesses open and willing to engage with us positively, and proud to contribute to New Zealand.*"²
- 1.6 In the Group's view, these proposals adopt an approach that targets the 'lowest common denominator', in that they apply to a large number of businesses, the majority of which are compliant. The Minister of Revenue, Hon. Judith Collins, noted in her speech to IFA releasing the three BEPS consultation documents: "*It is important that these BEPS measures do not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation.*"³ The Group considers that the current proposals are too broad and it would be more appropriate to target only those taxpayers who are non-compliant.
- 1.7 As inferred in paragraph 2.22 of the discussion document, many of the proposals in the document do not alter the outcomes under the existing law. Inland Revenue should use the full suite of tools currently available to it to resolve BEPS issues. Therefore the Group does not consider these changes warranted given the negative

² <http://www.ird.govt.nz/resources/6/2/62414b82-6ab8-4017-b04d-cc5d950cab47/compliance-focus-2016.pdf> Page 1

³ <http://taxpolicy.ird.govt.nz/news/2017-03-03-beps-consultation-documents-released#speech>



impact that the perception of these changes may have on investment in New Zealand. Consideration should be given to documenting why the structures / arrangements are unacceptable in an Inland Revenue publication, such as a revenue alert. Paragraph 2.22 states (emphasis added):

Inland Revenue is currently investigating or disputing several BEPS related cases. Nothing in this document is intended to prejudice any of those disputes or investigations. In particular, none of the proposed amendments in this discussion documents should be regarded as evidence that Inland Revenue cannot address the BEPS activities it is currently investigating or disputing under the current law, or that such BEPS activities are within the policy intent of the current law.

- 1.8 In the Group's view, many of the changes proposed are being driven from a service delivery standpoint and not from a "what is best policy" point of view. Fundamental changes to New Zealand's tax system, such as those proposed in this discussion document, should have a clear policy intent behind them and must be for the benefit of New Zealand as a whole. Tax policy changes should not be overtly influenced by ease of application by Inland Revenue staff or be based on "nice to have" tax audit tools.
- 1.9 The Group's overarching concern is that the proposals contained in the issues paper have the potential to significantly impact on the cost of capital for New Zealand businesses. This will actively discourage foreign direct investment, resulting in a detrimental effect on the wider economy. The imposition of complex and burdensome tax rules will actively discourage foreign direct investment into New Zealand or multinational corporations from using New Zealand as a base for their operations. This is because other jurisdictions may become comparatively more attractive than New Zealand to invest in.
- 1.10 If foreign companies no longer invest into New Zealand because the tax rules are too onerous in comparison to the size of the potential market, this will have a direct impact on the New Zealand economy through reduced GDP (growth) and employment levels. There is an obvious negative effect of a loss of revenue for New Zealand (including GST to be claimed) and a reduction of consumer choice. In the Group's view, many of the proposed changes negatively impact the attractiveness of New Zealand as an investment destination. New Zealand's tax system plays a critical role in our competitive position with our major trading partners and competitors. The Group considers that it is important that New Zealand should provide a business environment that is at least as good as that which exists in competing countries, in particular our nearest and most significant competitor, Australia. In this respect it is important to consider the changes occurring in Australia and the perceived impact (whether negative or positive) of those changes.
- 1.11 Tax influences a company's decision to trade in a country, especially companies that are in a low margin business. For example, a member of the Group has noted that if the proposed US tax reforms go ahead and large duties are placed on imports, then it is likely that they will retreat from that market and look at other jurisdictions without such tax barriers. We do not want businesses discouraged from investing in New Zealand in a similar fashion.
- 1.12 The Group is of the view that there needs to be further analysis of the economic impact of these proposals before they can proceed, particularly in relation to the creation of a PE and attribution of profits. Tax changes that have the potential to increase the cost of capital and / or restrict the flow of foreign capital should not be made lightly and full consideration must be given to the economic impact of these



proposals. It is the Group's view that the proposals have the narrow focus of tax revenue enhancement and there is little evidence in the issues paper that the broader economic issues have been considered in any meaningful way. There must be a broader enquiry into the likely economic effect of these proposals before they proceed any further.

Certainty, compliance costs and competitiveness

- 1.13 The Group believes that a good tax system should be built around three principles in particular: certainty, compliance costs and competitiveness. As noted above, it is important that international competitiveness is maintained, especially in relation to Australia, as higher costs of doing in business in New Zealand flow through to less investment, fewer jobs and lower wealth. New Zealand's tax system plays a critical role in the attractiveness of New Zealand for both inbound and outbound investment. For New Zealand to remain competitive it is important that it is recognised that complex taxes can cause significant compliance cost for businesses.
- 1.14 The Group appreciates that Inland Revenue may find auditing multinational organisations "resource intensive" (as noted in paragraph 3.13). However this does not justify imposing large compliance costs on all compliant taxpayers. Compliance costs are a 'deadweight economic cost' that represent resources consumed for the production of very little (or nothing at all). These resources would be better employed creating jobs and raising the wealth of New Zealand. In the Group's view, these proposals will shift significant compliance costs onto taxpayers and this is only justified where the benefits outweigh the costs.
- 1.15 The Group considers that overall, these proposals will be detrimental to tax certainty for taxpayers. The proposals add unnecessary complexity to the rules and increase business risk by creating uncertain or unexpected tax outcomes. For the corporate sector, tax is not just a cost of doing business but is also a very significant risk by creating uncertain or unexpected outcomes. To lower business risks caused by the tax system, tax rules need to be administered and interpreted consistently and quickly, and should be as simple as possible to increase certainty. In the Group's view, the proposals as they currently stand increase complexity without any corresponding benefit.

Diverted Profits Tax and Multinational Anti-Avoidance Law

- 1.16 The Group is pleased to see that a diverted profits tax ("DPT") has not been recommended. In the Group's view, a DPT would discourage investment in New Zealand and may arbitrarily impose tax on compliant taxpayers. The Group supports the view in last year's Cabinet Paper that a tailored approach is more appropriate for New Zealand.⁴
- 1.17 As noted in the Cabinet Paper, a DPT "could impact on foreign investor's perceptions of the predictability and fairness of New Zealand's tax system for foreign investment". Even if a DPT has not been introduced, many of the proposed changes carry the same effect and there are elements of the proposals that are similar to a DPT (absent the punitive tax rate). Caution must be taken as the same arguments in relation to discouraging investment apply. The introduction of cumbersome and prescriptive rules reduces the attractiveness of New Zealand as an investment destination.

⁴ *Measures to strengthen transfer pricing rules and prevent permanent establishment avoidance – a Government Discussion Document.*



1.18 In our workshop, Officials indicated that the rules are intended to act as a multinational anti-avoidance law (“MAAL”). The Group cautions against introducing a MAAL for the same reasons it does not support a DPT. If it is intended that a MAAL is introduced, it should be consulted on as a MAAL and full consultation should be undertaken on its features, as was the case when Australia introduced its MAAL.

Interaction with existing treaty framework

1.19 In the Group’s view, it is unclear how the proposals will fit into New Zealand’s existing treaty framework. It is important that care is taken to consider the views of our treaty partners and their approach to this issue. If they respond in a similar way, there will be a risk that New Zealand’s tax take is reduced (rather than being increased) due to other tax authorities taking the same action. Further, New Zealand businesses trading overseas may encounter greater taxes due to the changes, leading ultimately to less global trade which is clearly contrary to the Government’s economic growth agenda.

1.20 It is noted that France has adopted a DPT, but in doing so, acknowledged that the definition of a permanent establishment in a relevant tax treaty would prevent the application of the DPT⁵.

1.21 Officials have positioned the PE proposal as an avoidance rule however at our workshop with Officials it was suggested that the rule goes beyond even the expanded definition of a PE as included in the multilateral instrument and to be included in the OECD model treaty. Officials conceded that there may be instances where the expanded treaty definition does not apply but this domestic PE avoidance rule would deem a PE to exist. In the Group’s view this takes the proposal beyond an avoidance rule and results in the fundamental shifting of the PE boundary beyond what has been agreed globally at OECD and with our treaty partners. This type of unilateral action is not justified particularly given the numerous occasions officials and successive Ministers of Revenue had publically confirmed New Zealand’s commitment to the OECD BEPS project and the actions agreed globally. This action harms our reputation as an investment destination and a place where business can be conducted with ease.

Application date

1.22 The Group does not support the proposed application date for the administrative rules being the date of enactment of the relevant legislation. In the Group’s view, it is fundamentally uncertain to have the date of enactment as the application date of a proposal. In particular, such a date is not appropriate where it introduces significant changes that may impact arrangements that have been in place for a number of years without previous challenge by the Commissioner.

1.23 As taxpayers have experienced from the recent enactment of the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 on 30 March 2017, having only two days’ lead in time before the next income year begins does not give taxpayers adequate lead in time. The Group considers that taxpayers should be able to plan their future business with a degree of certainty and be afforded the opportunity to consider their options moving forward. All existing arrangements should have appropriate grandfathering.

⁵ <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-france-23-december-2016.pdf>



1.24 The Group submits that the Commissioner should clearly establish the status of existing advanced pricing arrangements (“APAs”) as a consequence of any changes enacted. The Group notes that binding rulings are binding on the Commissioner until there is a legislative change and queries whether the position will be the same for APAs. In the Group’s view, it is important to establish a position to reduce any uncertainty taxpayers may face in light of the changing environment. The Group considers that all existing APAs should be grandfathered and allowed to run their course, particularly given they often only run three years. Without grandfathering, taxpayers are dis-incentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.



APPENDIX TWO: DETAILED SUBMISSION POINTS – PERMANENT ESTABLISHMENT AVOIDANCE

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

2. Permanent establishment avoidance

Summary

- 2.1 The Group is concerned that these proposals are inconsistent with the purpose of DTAs. At a minimum, these proposals should only apply where New Zealand does not have an applicable DTA in place.
- 2.2 The Group is concerned about the sentiments expressed in paragraph 3.36 of the Discussion Document in relation to attribution to deemed PEs.
- 2.3 Taxpayers should have certainty about when these rules will apply by having a New Zealand dollar turnover threshold or ensuring that the threshold is set with reference to a previous fiscal year.
- 2.4 There are genuine commercial reasons why contracts may not be concluded in New Zealand. For example, it is not efficient for a multinational to have a legal team in every jurisdiction in which it operates. Having efficient and centralised management functions should not be prejudged as PE avoidance.
- 2.5 Inland Revenue needs to provide clear guidance to taxpayers about how profits should be attributed to PEs. The rules cannot act as a “force of attraction” principle and seek to bring into the tax base all New Zealand sales revenue simply because some functions are carried on in New Zealand. Any attribution of profit to New Zealand must reflect the actual degree of activity and effort in New Zealand – value added outside of New Zealand cannot be taxed in New Zealand.

Large multinational threshold

- 2.6 The Group submits that the large multinational threshold (non-residents part of a multinational group with more than €750 consolidated global turnover) should be given an equivalent New Zealand Dollar value (e.g. NZ\$1.15b), as it would be inappropriate to have a large company fall in and out of the rules based on exchange rate volatility. This approach would be consistent with Australia’s adoption of an AU\$1b threshold. Alternatively, the Group submits that the threshold could adopt the wording of the OECD country-by-country threshold (*MNE groups with annual consolidated group revenue in the immediately preceding fiscal year of more than €750 million or a near equivalent amount in domestic currency*)⁶. This would also clarify the date / point at which the threshold is to be measured and provide certainty to taxpayers as to whether they meet the threshold.

Permanent establishment test

- 2.7 The Group submits that there are valid commercial reasons why multinationals may conclude contracts outside of New Zealand (for example to centralise management functions to improve management practices and reduce corporate risk). This is not necessarily about PE avoidance and obtaining a tax advantage, but relates to the size and importance of New Zealand relative to the rest of the multinational organisation.

⁶ <https://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf>



For example, in many instances it does not make sense for the multinational to have a legal team based in New Zealand (and every other jurisdiction it operates in). Any proposed rule must focus on arrangements that are artificial and contrived to ensure that legitimate commercial arrangements are not captured.

- 2.8 The discussion document notes at paragraph 3.22 that “*only activities designed to bring about a particular sale should potentially result in a deemed PE*” and any activities that are merely preparatory or auxiliary are not sufficient to trigger a possible PE. The Group submits that additional guidance should be given as to the degree of connection required with sales into the New Zealand market, and whether this requires direct connection with a specifically identifiable sale that is in the contemplation of the New Zealand related party at the time it carries out its activity. As an example, will marketing activity that directs consumers to a website operated by a non-resident amount to the New Zealand related entity carrying out activity in connection with any resulting sale by the non-resident? Similar clarification should be provided as to the meaning of the “*for purpose of bringing it about*” and the requisite connection of the activities to the ultimately successful sale by the non-resident.
- 2.9 The Group considers that a natural consequence of the introduction of these rules could be for non-residents to stop hiring any staff in New Zealand. This will have a detrimental effect to the New Zealand economy, the cost of which needs to be weighed against any proposed changes.
- 2.10 The Group submits that it is important that any avoidance rule introduced is consistent with OECD and our international obligations. The current proposals fail on that front. For example OECD standard language in relation to concluding contracts is as follows:

“habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise via an intermediary”

Whereas the proposed New Zealand rule encompasses the following:

Utilise New Zealand-based staff to support the sales function, through a New Zealand subsidiary, branch or “dependent” persons or entities contracted to an off-shore entity.

- 2.11 It does not make sense to depart from language and concepts that are already internationally recognised and understood.
- 2.12 New Zealand should not be implementing rules when it would not be comfortable with other countries imposing those same rules on New Zealand exporters. The Group believes that the application of a similar rule to that being proposed in the discussion document by overseas jurisdictions presents a real risk to New Zealand’s revenue base. This is especially relevant noting that the New Zealand economy is export driven with growing exports being the key plank in the Government’s economic growth policy.
- 2.13 At our workshop with you we discussed the example of a New Zealand company selling product into Japan (or any other country). In this example the company had two employees on the ground in Japan who are responsible for liaising with clients and facilitating orders (noting that contracts are concluded outside of Japan). The reason for adopting this sales strategy is largely cultural. Experience has shown this



company that Japanese customers prefer to deal with someone who is in country, speaks Japanese and understands local customs.

- 2.14 In the Group's view, in this example the activity in Japan should not give rise to a permanent establishment. However, at the meeting Officials noted that based on the current proposal in the discussion document they consider this scenario to be 'close to the line' and could in fact give rise to a PE in Japan. The Group submits that if this is the case New Zealand must be prepared for Japan to deem a PE to exist and take a share of the profits. It is the opinion of the Group that this is a wholly undesirable outcome, yet there doesn't appear to be any consideration of the implications of overseas jurisdictions applying this type of PE avoidance rule.
- 2.15 At the workshop, Officials indicated that pure marketing activity undertaken by an organisation is not sufficient to give rise to a PE. However, if there is customisation for a particular sale, a line is crossed and a PE may exist with profits attributed to it accordingly. In this scenario the Group would expect that all 'business development' costs should be deductible. In many business models there can often be several lost sales for every sale that is actually converted. If New Zealand wishes to take a share of the completed sales, costs associated with the unsuccessful sales in New Zealand should also be deductible against the income of the "deemed PE".
- 2.16 As the Group has discussed with Officials, New Zealand has a very small domestic market. The reality of this is that, even if a particular taxpayer were inclined to use "profit-shifting" techniques, the application of such techniques to New Zealand operations would serve very little benefit. The majority of taxpayers just want to get on with running their business, which includes complying with all relevant tax laws. To do this, laws need to be clear and certain. The Group submits that the proposed PE avoidance rule creates significant uncertainty which would be a undesirable feature of our international tax rules.
- 2.17 The Group submits that the factors in determining whether the PE test is met (see paragraph 3.24 of the Discussion Document) should be clarified. In particular, the definition of "well paid" employees should be clarified as the Group considers that just because staff are "well paid", that does not mean that they have authority to conclude contracts. Recent transfer pricing questionnaires indicate that Inland Revenue considers staff to be "well paid" if they earn over \$150,000 per annum. Members have noted that often they have a handful of New Zealand staff working overseas, managing a team of local staff in their overseas operations and that these New Zealand staff are paid well because it is necessary to have trustworthy staff overseeing operations. The level of pay does not relate to any decision-making ability. The Group also queries whether, in the case of a foreign PE of a New Zealand resident taxpayer, the Commissioner would expect a greater level of profit to be attributed to the PE on account of its employment of "well paid" staff.
- 2.18 The Group submits that guidance should be given as to the meaning of "low tax jurisdiction" (see paragraph 3.24). At this stage it is unclear what this refers to - whether it is a reference to the country's corporate tax rate, their tax system more broadly or some other measure. Given the importance of this as a factor and to provide some certainty to taxpayers, the Group submits that the Government should publish a list of countries whose tax systems it considers to have the features of a "low tax jurisdiction". The Group notes this approach was used successfully under New Zealand's former Foreign Investment Fund rules and a list of low tax jurisdictions is also included with Transfer Pricing Questionnaires issued by the Commissioner. For example, would the corporate tax rates of the important markets of the UK (17%)



and the US (15%, assuming announced reforms are enacted) deem them to be low tax jurisdictions?

2.19 Paragraph 3.36 of the discussion document states (emphasis added):

We expect that the application of these principles will result in a fairly significant amount of the sales income being attributable to the deemed PE in most cases. We also expect a material amount of net taxable profit to remain in the PE after the deduction of related expenses. In this regard, we note that New Zealand, like many countries, has not adopted the OECD's revised methodology for attributing profits to a PE. The OECD's revised methodology is also not currently reflected in many DTAs. New Zealand instead applies the earlier version of the OECD's methodology.

- 2.20 The Group is concerned about the sentiments expressed in paragraph 3.36 and considers that the application of the proposals should be clarified, in particular what is meant by “fairly significant” and “material amount” in relation to sales income being attributable to the deemed PE and the net profit to remain (see paragraph 3.36). Thought should be given to the outcome if other countries also seek to grab a “fairly significant” and “material amount” of tax from New Zealand exporters. As noted previously, in the absence of clarity, taxpayers are likely to err on the side of caution and not place any personnel in New Zealand due to the lack of certainty in profit attribution. The Group acknowledges that foreign investors are willing to accept a New Zealand tax liability, but in making their decision rely on being able to cost future commercial arrangements accurately. It is important to make New Zealand as attractive as possible to encourage future inbound investment into New Zealand.
- 2.21 The Group notes that there are PE rules in DTAs, PE rules in the OECD Action 5 material and the PE rules as proposed in this discussion document. In the Group’s view, the proposed rules as they are worded in this discussion document merely add complexity to the rules. The Group submits that the wording of Action 5 should be used where possible, as these are the standards that other countries will be implementing.
- 2.22 It is critical that, if these proposals proceed, Inland Revenue should provide clear commentary for taxpayers on how it considers profits should be attributed to PEs. The rules cannot act as a “force of attraction” principle and seek to bring into the New Zealand tax base all New Zealand sales revenues simply because some functions are carried on in New Zealand. Any attribution of profit to New Zealand must reflect the actual degree of activity and effort in New Zealand – value added outside of New Zealand cannot be taxed in New Zealand.
- 2.23 Under New Zealand’s existing profit attribution principles, it is expected that the “profit calculated as being linked to the PE is in line with that which would be expected from a comparable business operating entirely at arm’s-length.”⁷ In effect this means that the PE should earn a profit that is consistent with its functional profile. As this is not different to what is expected of legally separate entities, where a deemed PE is established by operation of the proposed rule, the profit taxable in New Zealand is unlikely to be higher than that currently provided to the New Zealand entity under the transfer pricing rules. In that event, the proposed rule would have no effect, other to impose significant and unnecessary compliance costs on the non-resident and risk non-residents eliminating jobs and investment in New Zealand.
- 2.24 In the Group’s view, departing from such core principles risks New Zealand falling out of step with the rest of the world, in turn risking retaliatory action in jurisdictions

⁷ <http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-branches.html>



in which we operate. New Zealand's best chance of ensuring that its exports are not overtaxed is to ensure that it does not act unilaterally and seek to assert taxing rights over revenue where the income earning activity (including IP) is located outside of New Zealand. It is extremely important to remember that the New Zealand rules do not stand alone and must be considered in the context of the worldwide environment.

Arrangements involving third party channel providers

- 2.25 The Group submits that the proposed rules should not cover arrangements where sale of supplies are made to a non-affiliated entity. It is intended that the proposed rules will also apply where an independent third party is interposed between the non-resident and the New Zealand customer as part of the arrangement. The discussion document suggests (at paragraph 3.29) that the non-resident and third party are working together to sell the particular goods or services to the end customer with the assistance of the related New Zealand entity.
- 2.26 In the Group's view, in the majority of these situations the non-resident *will not* have control over the sales activities of the third party and the arrangements do not amount to a "single arrangement" as discussed at paragraph 3.28, and therefore the proposed PE rules should not apply. The unrelated nature of the non-resident and the third party means that the transactions between them are at arm's length. The Group considers that distributors and retailers will operate independently and will not contravene the purpose of the DTA PE rules, noting that the sales by the third party are already within the New Zealand tax net.
- 2.27 The Group acknowledges that there may be limited situations where a related subsidiary works closely with, or directly controls, the activities of the unrelated third party. However, in the Group's experience, this arrangement does not occur in practice and if it does, then any detrimental tax effect may be able to be caught by the anti-avoidance rules in subsection GB of the Income Tax Act 2007. Accordingly, it is not justification for the proposal to fundamentally change New Zealand's approach to the concept of permanent establishment.
- 2.28 The Group submits that the proposed rules should be limited to situations where the sale is made directly by the non-resident to the New Zealand customer.

Purpose of the PE provisions

- 2.29 The rules proposed in paragraphs 3.21 and 3.27 both contain a criterion that "the arrangement defeats the purpose of the PE provisions". The Group submits that any such criterion should refer to the *dominant purpose* of the arrangement.
- 2.30 The Group also submits that it should be clarified what the "purpose of the DTA's PE provisions" is in relation to the deeming of a PE in New Zealand (as per paragraphs 3.21 and 3.27). In the Group's view, whether an organisation has a PE or not is an 'in or out' test – an organisation either has enough of a presence in New Zealand or not. The Group queries whether an organisation that is close to having a PE but doesn't have quite enough 'presence' could be considered to have defeated the purpose of the provisions.
- 2.31 The Group considers that the focus should be on artificial arrangements. There are many unusual commercial arrangements that are undertaken for genuine commercial reasons. The discussion document notes at paragraph 5.45 that there is an increasing variety of commercial arrangements being undertaken by multinationals and



consideration should be given to this. These arrangements are not inherently to avoid tax and merely represent the evolving nature of business.

- 2.32 The Group considers that this proposal should not have the effect of overriding New Zealand’s DTAs. It is important that taxpayers continue to have access to MAP and arbitration procedures guaranteed in New Zealand’s network of treaties.
- 2.33 The Group submits that these proposals should not apply to arrangements involving countries with which New Zealand has a DTA. Further, New Zealand should not be looking to impose a rule beyond what has been agreed by OECD. Any domestic PE avoidance rule should follow the language used in the OECD model treaty.

Inconsistencies

- 2.34 Paragraphs 3.21 and 3.27 set out proposed rules where PEs will be deemed to arise. Notwithstanding the Group’s comments on these paragraphs above, the Group notes there is an inconsistency in terminology between paragraphs 3.21 and 3.27 of the discussion document. 3.21 describes an activity “in connection with”, while 3.27 describes an activity “in relation to”. The Group considers that this wording should be consistent in order to avoid any confusion.
- 2.35 Similarly, the Group also submits that the inconsistency between “that particular sale” in 3.21 and “the sale” in 3.27 should be consistent.
- 2.36 The Group notes that, at paragraph 3.21, a PE will be deemed to exist where certain criteria are met, including where “some or all of the sales income is not attributed to a New Zealand PE of the non-resident”. These rules deal with deeming a PE to exist, not how to attribute profits as suggested by the above phrase. In the Group’s view, the wording of this particular criterion does not make sense and should read as “none of the income is attributed to the PE” as, if some but not all of the income is attributed to the PE, any shortfall arises due to issues with the application of the profit attribution rules, and not the PE recognition rules.

Penalties

- 2.37 The Group does not agree with the proposal at paragraph 3.38 that “the current 100% penalty for taking an abusive tax position (under section 141D of the Tax Administration Act 1994) will also apply for the purposes of the proposed PE avoidance rule.” The Group does not consider that the abusive tax position penalty, or even the unacceptable tax position penalty should automatically be applied in these situations. These penalties should only apply to extreme cases.



APPENDIX THREE: DETAILED SUBMISSION POINTS – AMENDMENTS TO THE SOURCE RULES

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

3. Amendments to the source rules

Summary

- Amendments are unnecessary as the existing source rules are comprehensive.
- The proposals unfairly penalise reinsured parties.

Proposed source rules

- 3.1 In the Group's view, the proposed changes to the source rules are unnecessary as the current source rules are sufficiently broad to capture any situations the Commissioner is concerned with. Under the current rules, if sales income has a New Zealand source under our domestic legislation it is taxable unless New Zealand is prevented from doing so under any applicable DTA.
- 3.2 Paragraphs 4.23 and 4.23 do not respect the existing source rules in part YD of the Income Tax Act 2007 which clearly contemplate apportionment through the use of the words "to the extent...". At the end of the day, New Zealand can only tax what has an actual source in New Zealand.
- 3.3 It is proposed that a new source rule be introduced under which income will have a New Zealand source if it is attributable to a PE in New Zealand. If a DTA applies in respect of the income, then the definition of a PE in that particular DTA will be used for this purpose. In the Group's view, the addition of this rule is circular and does not add anything to the rules. It is a belts and braces approach and it is hard to envisage a situation in which the proposed source rule will be employed that is not already covered.

Life insurance source rules

- 3.4 The Group understands the life insurance source rule proposal has been introduced due to the (theoretical) possibility that there may be tax relief for New Zealand sourced insurance if the reinsurer is resident in Singapore, Canada and Russia and doesn't have a PE in New Zealand. This is due to the fact that New Zealand's DTAs with these countries carve out life insurance income from the business profits exemption in Article 7 - i.e. non-resident life insurers who are residents of one of the above three countries receive an (unintended) tax advantage by being able to deduct reinsurance premiums.
- 3.5 The Group submits that the proposals unfairly penalise the reinsured by placing a significant burden on them with regard to the denial of deductions. In particular, they cannot be expected to have completeness of information regarding their insurers' place of tax residency and PE status in New Zealand.



APPENDIX FOUR: DETAILED SUBMISSION POINTS – TRANSFER PRICING RULES

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

4. Strengthening the transfer pricing rules

Summary

- Overall the Group does not believe that further strengthening of the transfer pricing rules are required. Inland Revenue already has a number of tools available to it and these tools should be applied. Inland Revenue should ensure that it is appropriately resourced with transfer pricing expertise in order to ensure that it is able to apply the rules as they currently stand, and do so within the current four year time bar period.
- Any powers of reconstruction need to be limited to only the most extreme circumstances and should only be assessed at the highest levels within Inland Revenue. The same applies for the deeming of any taxpayer to be non-cooperative.
- The Group does not support the extension of the time bar to seven years. This proposal is counter to Inland Revenue providing more certainty to taxpayers.
- The Group does not support shifting the burden of proof to taxpayers. The Group is concerned that Inland Revenue has access to comparables which are not available to taxpayers.
- The Group would like to see Inland Revenue provide an online resource setting out what OECD materials expect taxpayers to be following.
- The Group foresees difficulty in applying transfer pricing rules to investors acting in concert. The mere fact that there are unassociated parties coming together indicates there should already be arm's length pricing in place; i.e. there is natural tension to ensure each party is not receiving more than their fair share.

Time bar

- 4.1 The Group does not support the extension of the time bar for transfer pricing positions to seven years. This represents a 75% increase in the time bar, which in the Group's view, goes against Inland Revenue's customer centric approach and incentivises bad behaviour by Inland Revenue in not closing out matters in a timely manner. The Group understands that one of Inland Revenue's Business Transformation goals is to provide more "real time" advice, information and assurance, as well as to encourage taxpayers to "get it right from the start". This proposal is inconsistent with these principles.
- 4.2 The Group notes that Inland Revenue's compliance management approach for multinational enterprises has been to move to resolving issues with commercial transactions in real time. This approach has been achieved through provision of more pre-filing reviews and risk reviews and has allowed for practical certainty in a short period of time (well within the four year time bar).



- 4.3 The Group submits that the proposal to extend the time bar is particularly egregious given the nature of transfer pricing arrangements and disputes. These arrangements are fundamental part of the way a taxpayer structures their business and for this reason will generally span several income years. The Group notes these are not one-off events (like many other tax disputes) and there will be an impact year after year. To have tax years open for seven years leaves taxpayers open to far too much risk and uncertainty.
- 4.4 The discussion document asserts that the extension of the time bar will bring New Zealand in line with other countries. New Zealand operates in a smaller marketplace than these other countries, and the Group considers that an adequately resourced Revenue should be able to complete this process within four years.
- 4.5 The discussion document uses the time bar period of other jurisdictions as justification for increasing the time bar. However the Group submits that the selection of seven years is simply an example of “cherry picking” the worst option for taxpayers as this is the longest time bar (excluding China who applies a ten year time bar across all taxes, not just transfer pricing). As is shown from the table below (taken from paragraph 5.70 of the discussion document), the majority of jurisdictions do not differentiate between the time bar applying to transfer pricing vis-à-vis other tax issues. It is difficult to understand why Inland Revenue does not consider itself able to complete its transfer pricing reviews within the same time period that applies for other complicated areas of tax such as financial arrangements and tax avoidance.

Country	Transfer pricing time bar	Standard time bar for other tax matters
China	10 years	10 years
Australia	7 years	4 years
Canada	7 years	4 years
Malaysia	7 years	5 years
Hong Kong	6 years	6 years
Japan	6 years	5 years
Ireland	4 years	4 years
Germany	4 years	4 years
UK	4 years	4 years
US	3 years	3 years

- 4.6 The Group also submits that increasing the time bar puts New Zealand at risk of transfer pricing reassessments. In particular, other jurisdictions will have longer to claim a larger share of revenue which has been taxed in New Zealand. On the other hand, New Zealand businesses who find themselves subject to transfer pricing adjustments in New Zealand will not have the benefit of obtaining offsetting reassessments in the other jurisdiction if that country’s time bar period is shorter (e.g. Hong Kong, Japan, Ireland, Germany, UK and US).
- 4.7 The Group submits that if the time bar is to be raised (which we disagree with), it should only be raised by one or two years and then only for non-cooperative taxpayers (see below for more discussion on what is a non-cooperative taxpayer). The Group notes that there are significant costs involved in a transfer pricing dispute and extending the time bar to seven years will only increase these costs. These costs will be compounded by the proposed administrative measures discussed below.



- 4.8 If the time bar is extended, the Group submits that the extended time bar should only apply to tax returns filed after the date of enactment. All tax returns filed before enactment should still be subject to the four year time bar in place when those returns were filed.

Burden of proof

- 4.9 The Group does not support shifting the burden of proof from the Commissioner to the taxpayer. In the Group's view this shift, coupled with an increase in the time bar, significantly increases compliance costs imposed on taxpayers without a sufficient trade off. The Group submits that the burden of proof should remain with the Commissioner if the taxpayer has been preparing documentation and has been open and transparent with the Commissioner.
- 4.10 However, if the onus does shift, then it is important that the information required to prove that a particular transaction is arm's length must be limited to publicly available information / comparables. If the Commissioner seeks to rely on "secret information", then that information must be disclosed or it cannot be relied on in the dispute, including Court proceedings. If such information cannot be disclosed without breaching confidentiality, then it is not appropriate that the Commissioner have regard to that information.
- 4.11 The Group submits that if a taxpayer has sufficient proof that a transaction is within a range that can be considered arm's length, then Inland Revenue should not be able to tell a taxpayer that the transaction should have been completed at a different point within that range without providing the taxpayer with detailed economic analysis to support that position. For example, a taxpayer may have prepared a benchmarking study and identified an arm's length range of comparable margins between 2%-4% (supported by compliant transfer pricing documentation). The taxpayer may choose to apply the 2% margin because this is consistent with what they have done globally and is appropriate given the functional profiles of the relevant parties. However, it may be difficult for the taxpayer to negate an assertion by Inland Revenue that 4% is a more appropriate rate. In the Group's view, in this situation Inland Revenue should not be able to insist on the 4% result merely because it is also in the range supported by the taxpayer's benchmarking study.

OECD guidance

- 4.12 The Group submits that Inland Revenue should have links to the OECD Guidelines available on its website so that taxpayers can easily access this information. This will increase certainty as it is important that taxpayers have easy access to the rules that may affect them.
- 4.13 In the Group's view, if the OECD Guidelines are referenced in legislation it must be made clear what will occur if the OECD makes changes to the Guidelines. The Group submits that the legislation should contain reference to the OECD Guidelines that apply at the time a return is filed. The legislation should also reference reservations New Zealand may have entered in to and note that the guidelines will not apply to the extent of any of these.
- 4.14 Officials observe at 5.23 that "*Inland Revenue and taxpayers routinely apply the latest versions of the guidelines in cases from earlier years, as the guidelines are generally consistent with our existing law.*" The Group notes that in practice this approach is only acceptable to the extent that it is not detrimental to the taxpayer.



It is inappropriate for the Commissioner to retrospectively rely on guidance that was not available to the taxpayer at the time its tax position was taken.

Arm's length conditions

- 4.15 It is proposed that the transfer pricing rules will move away from an assessment of the appropriateness of arm's length consideration to one of the "arm's length conditions". While little detail has been provided in the discussion document, Officials propose that this change will be aligned with the provisions present in Australia.
- 4.16 The Group notes that "arm's length conditions" are a much more difficult to identify than arm's length consideration. This is because the transfer pricing methods routinely applied in assessing cross-border transactions between associated parties typically identify only a comparable price or margin (or a range thereof) for a certain type of transaction.
- 4.17 Where the Commissioner seeks to look beyond this, to the wider terms and conditions of the arrangement, it becomes more difficult to support any proposed adjustment based on anything more than hypothetical constructs. The Group therefore submits that legislation and guidance must be clear as to the situations in which the Commissioner can establish "arm's length conditions" other than those identified by the taxpayer, and what must be provided to support this.
- 4.18 The Group is also concerned that the move away from arm's length consideration to "arm's length conditions" may see investigators seeking to adjust a taxpayer's result, rather than the underlying transactions. The Group considers that it is critical that any adjustment to align a taxpayer's result with "arm's length conditions" must be aligned with an adjustment to an identifiable transaction. This is because adjustments to different transactions may have different tax implications. For example, if a taxpayer enters into both services and royalty transactions with foreign associates and the Commissioner seeks to reassess the taxpayer's tax position, it is important for the taxpayer to know whether it is the services transaction or royalty transaction that is adjusted. This is because royalties typically attract withholding tax obligations, while service fees do not. These considerations flow through any attempt to gain equal and opposite treatment in the jurisdiction of the foreign related party.

Reconstruction of transactions

- 4.19 The Group notes the Commissioner already relies on an assessment of economic substance of cross-border associated party transactions when assessing the appropriateness of the consideration paid or earned under their legal form.
- 4.20 The Group submits that there need to be sufficient controls put in place when the Commissioner wishes to reconstruct a related party transaction. The Group notes that this power is essentially the Commissioner telling a company how to run its business, and this kind of decision should only be made in "exceptional circumstances". The Group notes that there are a large number of commercial tensions that work to influence a transaction and it should not be up to the Commissioner to judge the appropriateness of these (unless there are significant enough grounds to do so). In the Group's view, "exceptional circumstances" can be tested objectively (and is not measured by "uniqueness" as suggested by the discussion document at paragraph 5.39).
- 4.21 When reviewing transactions, Inland Revenue is doing so with the benefit of hindsight – something taxpayers do not have at the time they are running their business. When



considering the appropriateness of commercial arrangements, Inland Revenue should be putting themselves in the shoes of the taxpayer at the time the transaction / arrangement took place.

- 4.22 The Group submits that it must be clearly defined what activities / transactions are “aggressive” and “commercially irrational”. It must be clear to taxpayers what the rules are and what the standard to be maintained is. The Group also submits that there needs to be structure and transparency around who decides what is an “aggressive” or “commercially irrational” transaction and the process for deciding this. This is necessary to protect taxpayers from overzealous investigators.
- 4.23 As noted for “arm’s length conditions” above, the Group considers that it is important for any reconstruction by the Commissioner under the proposed reconstruction provisions to be aligned with an actual cross-border arrangement. This is particularly important where taxpayers may enter into a number of transactions, some of which attract withholding obligations.

Transfer pricing documentation

- 4.24 The Group appreciates that Officials do not currently consider it necessary to include a legislative requirement for taxpayers to prepare contemporaneous transfer pricing documentation. However, the Group is concerned about inconsistencies between statements in the discussion document and experience in practice.
- 4.25 Specifically, the Group notes that the discussion document states at paragraph 5.65 that:

“Inland Revenue would already apply a ‘lack of reasonable care’ penalty to incorrect transfer pricing positions taken by taxpayers who have failed to adequately document their transfer pricing positions at the time those tax positions were taken.”

In practice, the Group notes that it is common for penalties to be levied only where a taxpayer has failed to provide transfer pricing documentation following a request, and prior to commencement of an audit. This does not require the documentation to have been prepared prior to the filing of the income tax return. In light of this, the Group considers that clarity is needed if the Commissioner will now pursue penalties for “*lack of reasonable care*” if a taxpayer cannot prove that its documentation was prepared prior to the filing of the tax return.

- 4.26 The Group considers that this is critical for certainty and would prefer confirmation that contemporaneous documentation is required for penalty protection (as in the Australian legislation), over potential ambiguity.

The transfer pricing team / resources

- 4.27 It is important that Inland Revenue is appropriately resourced with skilled transfer pricing resource so that audits can be completed efficiently and the disputes process can run as intended (i.e. there are independent transfer pricing experts available to participate in taxpayer conferences, adjudication and arbitration). Currently there are so few transfer pricing Principal Advisors within Inland Revenue that it is not possible to obtain an independent / impartial review of a dispute and positions become entrenched.



- 4.28 There also needs to be sufficient resourcing to allow for an increase in the volume of APAs that will likely be sought if these proposals are enacted.
- 4.29 The Group notes that for many taxpayers the costs of obtaining an APA are too great for an APA to be a realistic option. Paragraph 5.40 of the discussion document encourages taxpayers to seek APAs to increase certainty. The Group notes that to obtain an APA is a long process that can often end up being very expensive. In the Group's view, if APAs are to be encouraged, it is important that the process is as streamlined as possible (and as noted above, sufficient resources must be allocated to a team dedicated to this work). The Group also notes that any position that would be agreed under a unilateral APA should be equally acceptable if supported through transfer pricing documentation outside the APA programme.
- 4.30 As mentioned above, an adequately resourced Revenue should be able to deal with transfer pricing issues within a reasonable time. Taxpayers should not be unfairly penalised with additional compliance costs and uncertainty because there is a lack of resources available.

Investors acting in concert

- 4.31 The Group sees real difficulty with the proposal to apply transfer-pricing rules to investors acting in concert. Where the investors do not have the same economic interests, natural pricing tension will ensure pricing for goods or services by one shareholder is at an arm's length rate. Treating a different group of persons as the one economic entity would not, therefore, reflect the economic reality unless all members of that group had the same proportional economic interests (for example, all were supplying the good or service in proportion to their shareholding).
- 4.32 The Group therefore suggests that the proposal should only apply where:
- a. the New Zealand investment is 50 percent or more owned by non-residents;
and
 - b. those non-residents have the same proportional economic interest in the transaction to which the transfer pricing rules are sought to be applied to.
- 4.33 Clarification should also be provided as to whether this association would also make transactions by members of the investors' groups with the New Zealand entity subject to the transfer pricing rules.
- 4.34 The Group notes that to the extent transactions are not priced correctly, there may be a transfer of value potentially giving rise to a deemed dividend. For example, if a New Zealand subsidiary were to pay greater than market value for goods purchased from a shareholder, the dividend rules would likely apply to this arrangement as there has been a transfer of value caused by a shareholding relationship.



APPENDIX FIVE: DETAILED SUBMISSION POINTS – ADMINISTRATIVE MEASURES

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

5. Administrative measures

Summary

- There will need to be clear guidelines as to when a taxpayer may be deemed to be “non-cooperative” and ideally this should be defined in legislation. A taxpayer should not be considered non-cooperative if they are just exercising their rights.
- A taxpayer should have the right to apply to the high Court to challenge any decision of Inland Revenue to deem the taxpayer non-cooperative.
- The Group does not support the requirement to have tax collected earlier in disputes or to allow tax to be collected from associated parties. The Group does not believe that multinationals represent a real credit risk.
- The Group does not support the restriction on the use of tax pooling for disputes involving transfer pricing.
- The Group does not support implementing penalties of \$100,000 for failing to provide information.
- Any changes implemented need to be complemented by appropriate grandparenting provisions for existing arrangements. Taxpayers need to be allowed a reasonable amount of time to undertake any necessary restructuring.

Non-cooperation

- 5.1 The Group submits that a determination that a taxpayer is non-cooperative will not only have particular adverse consequences for the taxpayer under the proposed reforms, but could also have significant reputational consequences for the taxpayer. A taxpayer subject to disclosure obligations in connection with listed securities might for example (depending on the circumstances) be obliged to make public disclosure of any determination by Inland Revenue that it is non-cooperative. Given those consequences, there should be a clear statutory definition of non-cooperation as well as procedural safeguards in respect of such determination.
- 5.2 The statutory definition should state that a taxpayer is not non-cooperative merely because the taxpayer exercises its rights to dispute Inland Revenue's position or contest any steps Inland Revenue may take in an investigation. If a taxpayer were effectively subjected to detrimental consequences (in the form of a determination that the taxpayer is non-cooperative) as a consequence of contesting the validity of Inland Revenue's actions, then on the face of it the measure could be inconsistent with section 27(3) of the New Zealand Bill of Rights Act 1990 which provides that a person has the right to bring civil proceedings against, and to defend civil proceedings brought by, the Crown in the same way as civil proceedings between individuals.
- 5.3 In addition, there should be guidelines (in the form of a Standard Practice Statement) as to the process for determining that a taxpayer is non-cooperative. The power to make such a determination should rest with a relatively small number of senior officials within Inland Revenue, and any official making such a determination should



be independent from the personnel auditing/investigating or otherwise engaged with the taxpayer.

- 5.4 The statutory definition of non-cooperation and/or the Standard Practice Statement guidelines should also require advance written warning to be given prior to Inland Revenue determining that a taxpayer is non-cooperative. The taxpayer should receive written notice specifying the acts or omissions that Inland Revenue considers make the taxpayer uncooperative and affording the taxpayer a reasonable opportunity to respond to the warning and/or to remedy the actions or inactions that Inland Revenue considers may result in the taxpayer being uncooperative.
- 5.5 Finally, a taxpayer should have the right to apply to court to challenge any decision of Inland Revenue to deem it non-cooperative. As noted above, there could be significant reputational damage from being deemed "non-cooperative" and it is important that taxpayers have a means of effectively challenging such a determination.

Advance payment of tax in dispute

- 5.6 The Group considers that the proposal that taxpayers in certain cases be required to pay tax in dispute prior to determination of the dispute is unjustified. The proposal is unjustified for a number of reasons:
- The proposed rule is arbitrary, covering only disputes in relation to transfer pricing, the application of the source rules and tax payable under a double tax agreement ("DTA"). There is nothing special about these types of disputes to warrant the proposed rule;
 - The general rule that disputed tax be payable only following final determination of any dispute should remain, except in cases where there is a risk of non-payment of tax found owing. In cases in which there is a risk of non-payment of tax ultimately found to be owing, Inland Revenue already has the power (see section 138I of the TAA) to require early payment;
 - Multinational corporate taxpayers are not currently incentivised to delay resolution of disputes (as suggested at paragraph 6.21 of the Discussion Document) given the imposition of use of money interest at rates materially higher than commercial rates. While the ability to use tax pooling mitigates to some extent the effect of use of money interest being imposed at uncommercial rates, it does not eliminate it since the use of pooling involves its own costs;
 - The Government has not provided evidence in the Discussion Document of any practice of multinational groups not paying the required tax found owing at the conclusion of a dispute. To the extent there is in a particular case a perceived risk of that occurring, Inland Revenue has the power to require advance payment as noted above; and
 - Officials have suggested this measure is necessary to incentivise taxpayers to progress the dispute and resolve the matter. The Group challenges this suggestion. It is not appropriate for the time bar to be extended but then have taxpayers pay disputed tax earlier. Forcing a taxpayer to pay tax earlier (even if repayable at a later date) merely speeds up taxpayer 'burnout'.
- 5.7 The Group does not support the restriction on the use of tax pooling for disputes involving transfer pricing, the application of the source rules or tax payable under a



DTA. There appears to be no justification for tax pooling not being available in those cases. The tax pooling rules help mitigate the penal effect of use of money interest on underpaid tax applying at non-commercial rates for many taxpayers. The Discussion Document offers no justification as to why tax pooling should not be available. In the Group's view, tax pooling is a useful mechanism that allows some flexibility in situations where a taxpayer's exact liability is uncertain.

- 5.8 If this proposal does proceed the Group submits that a court order should be required to compel the earlier payment of tax in dispute. This will ensure that Inland Revenue does not require tax to be paid in advance of a dispute being resolved unless there is good reason to depart from the general rule that disputed tax should not be payable until it has been determined (or the taxpayer has accepted) that the disputed tax is in fact payable.

Collection of tax

- 5.9 The discussion document proposes allowing Inland Revenue to collect tax payable by a member of a large multinational group (as defined in the discussion document) from "any wholly owned subsidiary of the multinational in New Zealand". The proposed rule would also allow Inland Revenue to collect from a related New Zealand entity, tax on income attributed to a deemed PE of a non-resident. The discussion document states that such measures will "assist New Zealand in recovering tax payable by non-residents".
- 5.10 The Group is unaware of any existing difficulty arising from members of a multinational group not paying tax which is due and payable. The discussion document does not suggest there is (or provide any evidence of) any problem under existing law. The Group would be interested to understand the extent of any existing problem with multinational organisations not paying tax which is due and payable. The Group is sceptical that this is a real issue needing resolution, particularly when considering the relative size of these multinationals. The Group is also concerned that if other countries adopt a similar approach, New Zealand headquartered multinationals would be subject to punitive and unsubstantiated tax bills from the jurisdictions they operate in.
- 5.11 The Group is also concerned about the financial reporting and other commercial implications of a rule that would override the usual rule that members of a group are not jointly and severally liable for each other's liabilities. A rule imposing such liability could result in financial reporting implications for New Zealand members of multinational groups (e.g. the question could arise as to whether a contingent liability must be recognised). Such a rule would also complicate any assessment of risk by prospective lenders to or purchasers of the New Zealand business, since they would be required to inquire into not only the tax position of the particular New Zealand entities but the tax position of the wider group of which they form part. Significant compliance and other deadweight costs could result, in circumstances where no clear problem definition underlying the proposed rule is articulated in the discussion document.
- 5.12 Inland Revenue already has the power to request assistance from other jurisdictions in the collection of tax (see Convention on Mutual Administrative Assistance in Tax Matters). Given New Zealand's commitment to international cooperation in addressing BEPS, it is inappropriate for New Zealand to pursue a unilateral measure that cuts across an important internationally accepted norm of corporate law (that tax payable is payable by the particular company assessed, and is not subject to (in effect) a statutorily mandated guarantee by other members of the same group).



- 5.13 Finally, if the proposed rule does proceed, the Group submits that Inland Revenue should be required to obtain a court order to collect tax from an entity other than the entity against which it was assessed. The proposed rule is (for the reasons noted above) a significant departure from legal norms respecting the distinct and separate legal nature of individual entities, and as such should be subject to judicial oversight in its application.

Collection of information

The proposed power is unnecessary and has been rejected previously

- 5.14 The Group does not support the introduction of a power for Inland Revenue to make a New Zealand entity legally responsible for providing information that Inland Revenue may believe is held by another member of the multinational group. The TAA already provides that a person may be required to (and may commit an offence for omitting to) provide information held by foreign entities which that person controls. The discussion document proposes that the offence provisions in section 143 of the TAA be amended such that the New Zealand entity (a New Zealand resident or a New Zealand PE of a non-resident company) could be convicted of an offence for failing to provide information held by foreign associated persons of the New Zealand entity.
- 5.15 If the proposal proceeds, it would no longer be a defence under this offence provision that the New Zealand entity does not have possession or control of the information itself or over the entity that does hold the information. The New Zealand entity could therefore be convicted of an offence for acts or omissions of related entities which it does not control and in some cases cannot influence.
- 5.16 The Group notes that a similar provision was proposed in the Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill 2002. In that Bill, it was proposed that the Commissioner would have the power to request information from any persons "associated with the New Zealand resident".⁸ This proposal would have resulted in a New Zealand resident taxpayer being required to produce to Inland Revenue information held by non-resident entities related to the taxpayer, even if the taxpayer has no practical control over those entities, and in circumstances where the entities have no bearing on the taxpayer's New Zealand tax obligations (essentially the rule proposed in the discussion document).
- 5.17 After submissions were received on the Bill, Inland Revenue accepted that the application of the rule should be restricted to apply only to foreign entities controlled by a New Zealand resident.⁹ This narrowed rule was subsequently enacted.

The Australian and Canadian provisions referred to in the discussion document are not comparable to what the discussion document proposes

- 5.18 The discussion document (at paragraph 6.34) states that the proposed change would align New Zealand law with Australian and Canadian law and refers to section 264A of the Income Tax Assessment Act 1936 (Cth) and section 231.6 of the Income Tax Act RS C 1985 c 1. The Australian and Canadian provisions have very different consequences from what the Discussion Document proposes for New Zealand however.

⁸ Clause 75.

⁹ See Inland Revenue Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill ((November 2002) at 110.



5.19 Failure to comply with section 264A of the Income Tax Assessment Act 1936 (Cth) is not an offence. Section 264A(22) provides that:

A refusal or failure to comply with a request set out in an offshore information notice is not an offence.

5.20 The Australian Master Tax Guide states that:¹⁰

[t]he only sanction for failure to comply with a notice is evidentiary, ie the information or documents which the taxpayer fails to provide will not be admissible in subsequent proceedings disputing the taxpayer's assessment.

5.21 The consequence of not complying with the Australian rule reflects the purpose and nature of the rule. Fundamentally, it is an information gathering power to assist the Commissioner to assess the tax liability of the taxpayer, when that information is held offshore.¹¹ But unlike the general power to request information (such as in section 17 of the TAA in the New Zealand context) section 264A is obviously directed at the particular risk to the Commissioner of offshore information not being provided during an investigation and then selectively used in proceedings to dispute an assessment. The only consequence of not providing that information is that the taxpayer is not able to use that information to dispute any assessment. The Group also notes that the decision of the Australian Commissioner to issue an offshore information notice is amendable to judicial review (including as to the form and content of the notice itself).¹²

5.22 The Canadian provisions in section 231.6 of the Income Tax Act RS C 1985 c 1 specifically set out the right for the taxpayer to apply to a Judge for a review of the request for foreign based information or documentation.¹³ The Judge then has the power to:

- (a) confirm the requirement;*
- (b) vary the requirement as the judge considers appropriate in the circumstances; or*
- (c) set aside the requirement if the judge is satisfied that the requirement is unreasonable.*

5.23 Section 231.6(6) then provides:¹⁴

[f]or the purposes of paragraph 231.6(5)(c), the requirement to provide the information or document shall not be considered to be unreasonable because the information or document is under the control of or available to a non-resident person that is not controlled by the person served with the notice of the requirement under subsection 231.6(2) if that person is related to the non-resident person.

¹⁰ Michael Chow (ed) *Australian Master Tax Guide* (56th ed, CCH Australia Limited, Sydney, 2015) at [21-220].

¹¹ *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia* [1994] FCA 1492; (1994) 54 FCR 75 at [30].

¹² *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia* at [34].

¹³ Income Tax Act RS C 1985 c 1, s 231.6(5).

¹⁴ Income Tax Act RS C 1985 c 1, s 231.6(6).



- 5.24 Case law has clarified that even if the person holding the information is related to the taxpayer, that will not in itself make the request a reasonable one.¹⁵ That is, even if the information is held by a related party, there is a protection for the taxpayer in that the request must still be reasonable in the circumstances.
- 5.25 The penalty for not complying with the request is the prohibition, on the motion of the Minister, on introducing any foreign-based information or document covered by the request which was not complied with.¹⁶ Only on conviction by the court is the taxpayer liable to a fine or term of imprisonment for not complying with the information request. The maximum penalty is a fine of \$25,000 and a term of imprisonment of no more than 12 months.¹⁷

Inland Revenue can and should use existing powers

- 5.26 The discussion document acknowledges that Inland Revenue can and does seek information held by foreign entities using its exchange of information rights, but suggests that this is inadequate (at paragraph 6.32):

Recent improvements to the exchange of information between tax authorities are making it easier for Inland Revenue to request and exchange information that is held by offshore tax authorities. However, relying on an ability to request information indirectly from other tax authorities is not always adequate. In some cases, the relevant information is not held by the offshore tax authority and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.

- 5.27 The first aspect of this justification (that the foreign tax authority may not hold the information) is not compelling. DTA partners can, and do, exercise their own information-gathering powers to obtain the information that Inland Revenue requests under the DTA, just as Inland Revenue exercises its powers to obtain information requested by our DTA partners.
- 5.28 It is difficult to evaluate the second aspect of the justification (that the foreign tax authority may be slow or unhelpful in responding) without knowing how common this is. It is to be hoped that this is not often the case given that the DTA or Tax Information Exchange Agreement (as applicable) imposes an obligation on the foreign Government to comply with a valid request, and that New Zealand (presumably) complies with its obligations under the DTA or TIEA.
- 5.29 But to the extent Inland Revenue might sometimes encounter difficulties or delays in obtaining information from a foreign revenue authority, New Zealand companies may be in no better position yet (under the proposed rule) would be at risk of criminal sanctions and / or a significant monetary penalty if the information is not provided. For the New Zealand company, it is not simply a matter of requesting the information from (or forwarding on Inland Revenue's information request to) the relevant foreign affiliates and expecting that the information will be provided. The practical difficulties include:¹⁸

¹⁵ See *Fidelity Investment Canada Ltd v Canada (Revenue Agency)* 2006 FC 551 and *Soft-Moc Inc v Canada (National Revenue)* 2013 FC 291.

¹⁶ Income Tax Act RS C 1985 c 1, s 231.6(8).

¹⁷ Income Tax Act RS C 1985 c 1, s 238(1).

¹⁸ For these same reasons, the Group is concerned that a New Zealand company's inability to provide information held by an associated foreign entity may be grounds to deem a taxpayer "non-cooperative". In fact, the non-provision of the information may be due to these very real practical constraints, and not to any desire to be uncooperative.



- Multinational groups may have hundreds or more legal entities operating in a large number of countries. If Inland Revenue were to have the power to issue an information request applicable to the whole group, it may be difficult or impossible for the New Zealand subsidiary to know even which legal entities may hold the information requested (and in which countries to make inquiries).
- Inland Revenue information requests are often very broadly worded, and may call for the production of large numbers (not infrequently thousands) of emails and other documents, which in turn could necessitate the review of an even greater number of documents to determine which are within the scope of the request. For such requests to apply not only to the New Zealand group but also to foreign associated persons could make the requests so costly and burdensome to comply with that compliance is for all practical purposes impossible.
- The New Zealand company will usually have no legal right to require a foreign associate to provide information to it. And even if the foreign associate is willing (in the interests of the group) to devote the time and resources necessary to assist the New Zealand company in locating and providing relevant documents, the foreign associate will need to consider whether it is appropriate to do so. For example, some of the information may be legally privileged. Local privacy and confidentiality laws will need to be considered.¹⁹

Alternative submission: if the proposal proceeds, judicial oversight is necessary

- 5.30 If the proposed rule were to proceed, Inland Revenue should be required to obtain a court order to impose on the New Zealand entity or person liability for non-provision of such information. This would provide judicial oversight in respect of the breadth of the request and feasibility of complying with it, and as to whether the need for such an onerous power to be exercised is justified in the circumstances.
- 5.31 In addition, the Group submits that if Inland Revenue is empowered to collect more information, this information can only be requested if it meets a “necessary and relevant” test. In the Group’s view there needs to be a limit on the information that Inland Revenue can collect, especially where undue compliance costs are required to collect information that is not actually that important to the situation. In the Group’s view, at the time information is requested, Inland Revenue should provide context as to why it is collecting information and how it is relevant to the taxpayer’s New Zealand tax liability.

Penalties for not providing information

- 5.32 The Group submits that it is not appropriate for Inland Revenue to have the power to impose a \$100,000 penalty on taxpayers who fail to comply with section 17 or section 21. A power to impose such a penalty should be left to the courts. This is especially so when taxpayers could be subject to penalties when information is not provided by a member of the same multinational group but over which the taxpayer may have no control.

¹⁹ These considerations were behind the need for FATCA to be implemented through Intergovernmental Agreements, such as that concluded between New Zealand and the United States. Had New Zealand financial institutions agreed to provide information directly to the United States (pursuant to an agreement with the United States Government under section 1471 of the Internal Revenue Code) they may have been in breach of their implied contractual obligation of confidentiality and/or their obligations under the Privacy Act 1993. For them to disclose the information to another Government to avoid a financial detriment (FATCA withholding) may not have been recognised as falling within the disclosure under compulsion of law exceptions to their confidentiality and Privacy Act obligations.



- 5.33 In the alternative, if Inland Revenue is given the power to impose what is effectively a \$100,000 instant fine (without first taking proceedings), taxpayers must have the right to apply to the court seeking that the penalty be reduced or set aside. This is necessary as a minimum in order to meet the requirements of section 27 of the New Zealand Bill of Rights Act 1990.

Section 21 in any event should be rewritten or repealed

- 5.34 Section 21 of the TAA needs to be reviewed, and at a minimum rewritten (regardless of whether its scope is broadened to include situations of non-inclusion of income as suggested by the discussion document). Alternatively, section 21 should be repealed. Inland Revenue already has the power to request information under section 17 of the TAA and non-compliance with section 17 is an offence. Section 21 is arbitrary in its application (e.g. it is triggered by the non-response to an information request after 90 days without regard to whether that time-frame is reasonable in the circumstances) and is disproportionate in its consequences (in denying a taxpayer access to the courts to contest the correctness of Inland Revenue's assessment).
- 5.35 Denying a taxpayer access to the courts (and preventing a taxpayer from contesting the correctness of Inland Revenue's assessment) is an arbitrary and potentially disproportionate consequence of not responding to an information request. It is also inconsistent with section 27(3) of the New Zealand Bill of Rights Act 1990. At a minimum, this aspect of the section 21 should therefore be repealed. If a taxpayer does not comply with a request for information, the consequences should be the same as for non-compliance with section 17 and/or that information that should have been furnished in response to the request and is not cannot subsequently be used in proceedings. The consequence should not be the denial of dispute rights in respect of the relevant assessment.

Application dates for any Chapter 6 (administrative measures) proposals that do proceed

- 5.36 To the extent any of the Chapter 6 (administrative measures) proposals proceed, they should not apply from the date of enactment. The amendments would result in significant departures from legal norms and adversely affect the legal rights of taxpayers. Certain amendments could impose liability for tax, or, in respect of the obligation to provide information, on different legal entities solely because they are members of the same group.
- 5.37 The Group submits that there should be grandparenting of all existing arrangements at the time of enactment, with a five year sunset clause. A five year time period would provide a reasonable amount of time for multinationals to renegotiate agreements; noting that there will be many agreements within a single multinational which will need to be amended.
- 5.38 In the alternative, if a sunset clause as described above is not accepted, the proposals to the extent they proceed should apply only in respect of income years for which a tax position is taken after the date of enactment. In the Group's view, there should be a lead time of at least one year after the date of enactment before the amendments take effect.
- 5.39 As taxpayers have experienced from the recent enactment of the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 on 30 March 2017, having only 2 days lead in time before the next income year starts does not give taxpayers adequate lead in time.

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28 April 2017

BEPS – Transfer pricing and permanent establishment avoidance
C-/ Cath Atkins
Deputy Commissioner, Policy and Strategy
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PO Box 2198
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Dear Cath

BEPS – TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE

Deloitte welcomes the opportunity to comment on the Government Discussion Document “BEPS – Transfer pricing and permanent establishment avoidance” (the “discussion document”).

General comments

We agree that Base Erosion and Profit Shifting (“BEPS”) by multinational enterprises is a major concern, undermining tax authorities and stoking public feelings of unfairness. We appreciate that the Government is committed to taking decisive action to address BEPS issues to maintain the integrity of the New Zealand tax base.

We note that BEPS is a global problem, which requires a global solution. We are concerned that some of the proposals included in the discussion document would move the New Zealand transfer pricing environment beyond the global standard. We are of the view that unilateral action that goes beyond that established by the Organisation for Economic Cooperation and Development (“OECD”) BEPS Action Plan is as likely to harm New Zealand’s position in the global tax landscape, as it is to enhance it. In the case of some of the proposals, the Government should be conscious of the potential for retaliatory action by treaty partners that may be detrimental to New Zealand based multinationals.

While we recognise that some change is needed to ensure that the transfer pricing rules remain fit for purpose, we strongly recommend that the Government ensures that changes are clear and comprehensive, so as not to further stoke uncertainties in this complex area of our tax system.

Summary of submission

We have had opportunity to review and consider the submission prepared by the Corporate Taxpayers Group and largely concur with the submission points raised.

In addition to these points, we would also like to submit the following points:

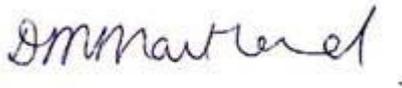
- To ensure consistency in application of the new rules and expectations, a consistency committee should be established within Inland Revenue.
- The proposed changes to the permanent establishment (“PE”) rules should be consistent with the OECD Action 7 changes and a greater level of analysis and guidance provided to alleviate uncertainty in application.
- If the transfer pricing rules are to refer to arm’s length conditions, care should be taken in the drafting of the definition, noting limitations in data available to taxpayers in making such an assessment.

- The proposed reconstruction provisions must be carefully drafted so as to only apply in exceptional circumstances (with clarity provided as to what exceptional circumstances are). Appropriate safe guards and administrative processes should be implemented within Inland Revenue to provide oversight of the application of these provisions.
- The relationship between contemporaneous documentation and penalties should be clarified in legislation, as points made in the discussion document are inconsistent with what currently occurs in practice.
- The proposed changes should include an explicit de minimis threshold for the preparation of transfer pricing documentation or safe harbour guidance for certain transactions.
- The transfer pricing methods referred to in legislation should be aligned with those included in the OECD guidelines.

The above submission points are detailed further in the attached Appendix.

For any queries in relation to this submission, please contact Bart de Gouw on (+64 9 303 0889 or bdegouw@deloitte.co.nz).

Yours sincerely



Diana Maitland
Partner | Deloitte Private
for Deloitte Limited (*as trustee for the Deloitte Trading Trust*)

APPENDIX

Consistency committee

Recognising that the proposed changes to the transfer pricing rules amount to the biggest development since the inception of the New Zealand transfer pricing regime, we are conscious that there is potential for inconsistency in how the revised rules are applied by different investigators and principal advisors.

In light of this, we submit that a consistency committee should be established within Inland Revenue such that interpretation and application of the new rules is consistent across cases and taxpayers.

The committee should consist of Inland Revenue transfer pricing principal advisor(s) independent of the case being assessed as well as appropriate representatives from Legal Technical Services, the Office of the Chief Tax Counsel and the New Zealand Competent Authority as appropriate in the given situation or case.

A committee of this nature is considered crucial to the consistent application of the proposed new transfer pricing regime, so as to improve voluntary compliance, foster cooperation by taxpayers and avoid unnecessary disputes instigated by the inconsistent application of the rules.

In order to achieve these goals, we envisage the committee performing the following core functions:

1. Moderation
2. Escalation
3. Publication

These functions would, in conjunction with the other comments made in this submission, be expected to greatly enhance the operation of the transfer pricing rules and alleviate current nervousness from taxpayers as to their expected application in practice. We expand on these functions below.

1. Moderation

We see the current practices of the Inland Revenue's transfer pricing being prone to a level of inconsistency, with taxpayer experiences varying based on the team composition examining a case. We appreciate this may arise from a lack of resourcing within the unit and from a lack of central control and oversight over the conduct of transfer pricing investigations and reviews. As a result, taxpayers are left with uncertainty as to whether their transfer pricing arrangements will be considered appropriate in the event of review and the core concept of the arm's length principle is undermined.

In order for taxpayers to have certainty of treatment during transfer pricing investigations and disputes, Inland Revenue's transfer pricing unit needs to present a standardised and united front. This includes objective reviews with the same processes employed and expectations of taxpayers.

We therefore would envisage the consistency committee performing an internal governance function within the international audit unit, with the benefit of representation outside of the core transfer pricing team. It would provide guidance to principal advisors and investigators about review procedures, risk assessments and the expectations to be placed on taxpayers.

We would also suggest that a representative or representatives from the committee be present at transfer pricing dispute conferences involving potential adjustments of more than NZD1m (or some other appropriate threshold).

2. Escalation

Outside the disputes process, Inland Revenue does not currently have a process in place by which a taxpayer under review is able to escalate issues to a third party within Inland Revenue to ensure that the actions of Inland Revenue personnel are consistent with established policies, procedures and historic approaches.

We are aware that the Australian Tax Office ("ATO") enables taxpayers in the course of an investigation to escalate disagreements to more senior officers. We consider that the consistency committee could fulfil a similar function in New Zealand, offering an avenue through which a taxpayer under review may escalate a disagreement for consideration by a non-interested party. The implementation of this approach would strongly improve consistency for taxpayers, as any controversial action or request could be referred to the committee.

This could include, for example, instances where the proposed reconstruction provisions are to be invoked, or where a taxpayer is to be deemed "uncooperative" under the proposed administrative changes.

This process would ensure consistent application of the rules across taxpayers and may avoid some cases proceeding to audit or the disputes process.

3. Publication

The sum total of Inland Revenue publication on transfer pricing matters since the 2000 transfer pricing guidelines can be found in some 20 pages forming part of Inland Revenue's website. While this guidance is very helpful, few of these pages contain any reference to how the content is informed by, based in or interacts with the legislative provisions in practice that form the New Zealand transfer pricing rules.

In contrast, the ATO has published more than 20 detailed rulings on wide array of transfer pricing issues, along with supporting statements via the ATO website.

This lack of publication and development of standardised interpretation (to certain transactions or in certain situations) has contributed to the uncertainty that currently surrounds transfer pricing in New Zealand. Given the absence of judicial consideration of transfer pricing matters, the lack of more detailed guidance by Inland Revenue significantly increases the difficulty faced by taxpayers in determining an appropriate transfer pricing position and preparing high quality documentation in the current environment. Further clarity on Inland Revenue's expectations would be helpful.

We would therefore recommend that the committee be required to publish on a regular and confidential basis, the decisions in matters referred to it under the escalation function described above.

This publication would foster a strong base of interpretive guidance for taxpayers, which while not binding, would be sufficiently grounded in the New Zealand law.

Permanent establishment avoidance

Consistency with OECD

The discussion document proposes significant changes to the domestic PE rules. These changes seek to align New Zealand's domestic PE rules with those found in the Australian Multilateral Anti-Avoidance Law ("MAAL")¹, and the UK diverted profits tax ("DPT")².

Currently the PE rules as contained in New Zealand's double tax agreement ("DTA") network generally require that a person in New Zealand *"has and habitually exercises an authority to substantially negotiate or conclude contracts on behalf of the non-resident"* in order for a PE of the non-resident to arise.³

The revised OECD requirement would require a person to *"habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"* before a PE of the non-resident arises.⁴

¹ Income Tax Assessment Act 1936, s 177DA

² Finance Act 2015, part 3

³ Article 5, New Zealand – Australia DTA used as an example

⁴ OECD, *Action 7: 2015 Final Report*, Section A

In contrast, the proposals outlined in the discussion document indicate that a PE will be deemed to exist where a person in New Zealand performs any activity in connection with sales by the non-resident where that activity has the purpose of bringing it about. The only restriction on this is that the arrangement must “defeat the purpose” of the PE provisions of the relevant DTA.

The proposed New Zealand rule as currently drafted is inherently broader than the revised OECD provision, despite the claim that this is not the intention.⁵ We consider that based on the discussion document, a significantly larger number of business arrangements may be deemed to create a PE in New Zealand than would be the case under a strict application of the OECD rule. This creates inconsistency and uncertainty for taxpayers looking to determine the tax obligations arising from their legitimate commercial operations, and may lead to an increase in double taxation or retaliatory action by treaty partners.

As such, we submit that the PE definition included in the proposals should be made consistent with that established by the OECD. Alternatively, specific and comprehensive examples should be provided as to when and how this new rule would apply.

The discussion document further indicates that the proposals are intended to be an anti-avoidance rule, which may remove recourse of affected businesses for competent authority intervention under DTA mutual agreement procedures. Assuming this is the intention, this result is unacceptable for taxpayer certainty and fairness.

In contrast to the Australian MAAL and UK DPT rules, which only apply where erosion of the tax base occurs⁶, the proposed New Zealand rule does not appear to consider the tax impact of any structure that would be deemed to create a PE.

Attribution of income and expenditure

Finally, the discussion document assumes that the application of the proposal would result in a “fairly significant amount of the sales income being attributable to the PE” with a “material amount of taxable profit to remain”.⁷ These statements neglect to consider the application of the profit attribution rules, which broadly require the level of taxable profit or loss to align with the functions, assets and risks of the non-resident in New Zealand as if it were an independent entity.

If therefore the New Zealand related party and the PE are the same functional entity, performing the same functions, utilising the same assets and incurring the same risks, there is no basis on which to expect a greater level of profit (or loss) to arise under the deemed PE proposal than already arises through the application of current legislation. However, the proposed rule would impose significant additional compliance costs for non-residents selling goods and services into New Zealand.

In light of the above, we submit that the Government should more fully analyse the proposed PE anti-avoidance rule, including providing guidance on the expectations of how income and expenditure would be attributed to the PE and the anticipated gains for the New Zealand tax base. In our view, the rule is as likely as not to be detrimental to the New Zealand tax base, as multinationals may eliminate New Zealand based jobs to ensure no deemed PE arises in the absence of further guidance.

Carve out for distributors

The discussion document states at paragraph 3.31 that the proposed rule as it applies to third party channel providers is not intended to apply to a “standard distributor type arrangement”, however no indication is given as to how this exclusion would be achieved.

We submit that in the event that the proposal is adopted, care must be taken to ensure that the legislation is sufficiently clear as to the situations that are captured and those that are not captured by the rule.

⁵ Paragraph 3.2

⁶ The MAAL requires a “tax benefit” to arise, while the DPT excludes situations where transfer pricing has resulted in the correct amount of tax being paid.

⁷ Paragraph 3.36

Arm's lengths conditions

The discussion document proposes to amend the legislation from "arm's length consideration" to "arm's lengths conditions" to allow for the consideration of all "relevant conditions" to determine whether transactions comply with the arm's length principle.

The discussion document does not elaborate on the criteria to be assessed by a taxpayer in order to satisfy the proposed burden of proof.

Care should be taken when drafting the New Zealand definition of "arm's length conditions" such that it recognises

- The availability of comparable company data;
- The fact that benchmarking does not necessarily allow for the identification and assessment of a number of the comparable circumstances listed in the Australian definition; and
- That some legitimate associated party arrangements only exist because of the related nature of the parties and may not have identifiable analogues between independent parties.

We note that it is already common practice for the broader conditions of a certain arrangement to be taken into account in determining whether an amount is an arm's length amount for the purposes of the current transfer pricing rules.

We submit that any proposed adjustment to a taxpayer's transfer prices by Inland Revenue must be supported by more than an assertion as to different conditions, and should not be simply a disagreement with the point achieved or selected within an arm's length range. An appropriate threshold might be that the actual conditions of an arrangement must be evidenced to be materially different to the arm's length conditions before any adjustment can be made.

Reconstruction of transactions

The discussion document proposes to grant the ability for Inland Revenue to reconstruct or disregard certain transactions that it believes are not commercially rational.

While we understand that economic substance is an important consideration in determining the appropriateness of transfer prices between associated parties, it is also important that the rules do not unnecessarily impede arrangements that are only possible due to the related nature of the parties.

As noted in the discussion document, OECD transfer pricing guidelines provide that reconstruction type powers should only be applied in "exceptional circumstances". However, the current proposal does not intend to include reference to this threshold, prima facie allowing Inland Revenue broader reconstruction powers. We consider that this is dangerous for taxpayer certainty.

It is noted that the discussion document suggests that the New Zealand reconstruction provision will be drafted based on the Australian rules as included at subdivision 815-130 of the Income Tax Assessment Act 1997. We submit that care should be taken to ensure that the drafting of the New Zealand provisions is sufficiently detailed such that it will only apply in "exceptional circumstances". This should include a clear set of criteria against which taxpayers may assess their arrangements in the course of determining their income tax position.

In the event that the reconstruction provisions are enacted, there must be appropriate checks and balances to ensure that the provisions are not invoked inconsistently (see above in regards to a consistency committee).

Transfer pricing documentation requirements

Contemporaneous documentation

The discussion document notes that it is not currently proposed to require taxpayers to update and file transfer pricing documentation on an annual basis or impose specific penalties for a lack of documentation. However, it also notes that "Inland Revenue would already apply a "lack of reasonable

care” penalty to incorrect transfer pricing positions to be taxpayers who have failed to adequately document their transfer pricing positions at the time those tax positions were taken”.

In essence, these statements are contradictory and inconsistent with our experience with Inland Revenue during transfer pricing reviews and disputes.

In our view, the proposal amounts to an implicit contemporaneous transfer pricing documentation requirement. Whether stated explicitly or not, the imposition of penalties for “lack of reasonable care” where taxpayers have not documented their transfer pricing positions “at the time” the position was taken creates a requirement for contemporaneous transfer pricing documentation.

We suggest that clarification is required on this point. If Inland Revenue’s position is as described above, then this should be explicitly prescribed in legislation.

We submit that an approach consistent with that taken in Australia should be adopted to clarify the relationship between contemporaneous documentation and penalties. This should be accompanied by a prescribed de minimis threshold for smaller taxpayers or safe harbour guidance for certain types of transactions, as discussed below.

De minimis threshold and safe harbour guidance

A contemporaneous transfer pricing documentation requirement, as implied by the discussion document, would impose a significant burden on smaller taxpayers and those with only small or simple cross-border associated party transactions.

While we acknowledge that it is expected for large multinationals to prepare transfer pricing documentation as part of their routine compliance practices, and for the most part they do so (though this may not currently be contemporaneous), small and medium enterprises (“SMEs”)⁸ have little guidance from which to determine whether they should prepare documentation and how comprehensive this should be (other than current references to a “cost / risk” approach).

We recommend that the proposed changes to the transfer pricing rules include a prescribed de minimis documentation threshold, with taxpayers falling below the threshold exempted from preparing transfer pricing documentation (assuming they self-assess against a relevant set of criteria), with routine business records used to establish reasonable care. The de minimis threshold could be set based on New Zealand revenue or the quantum of cross-border associated party transactions.

An alternative would be to follow the Australian approach by providing a number of safe harbour pricing guidelines (in Australia these are called “simplified record keeping options”), which if applied will not require the preparation of comprehensive transfer pricing documentation. Instead, the taxpayer must prepare sufficient documentation to evidence compliance with the safe harbour guidance (i.e. eligibility and application). This approach is considered to be pragmatic, providing certainty to taxpayers, while reducing the risk of erosion of the New Zealand tax base.

Rather than continuing the “grey area” for transfer pricing compliance, we suggest that Inland Revenue effectively sets the cost/risk analysis threshold, drawing a distinct line in the sand by implementing something similar to the suggestions above.

Transfer pricing methods

We submit that this opportunity is taken to align the transfer pricing methods referred to in legislation with those detailed in the OECD transfer pricing guidelines. Specifically, current legislation refers to the “comparable profits method”, which in practice has been replaced by the OECD’s “transactional net margin method”.

⁸ Smaller SME companies make up the majority of New Zealand companies that would be impacted by an increase in transfer pricing documentation compliance requirements (approximately only 20 New Zealand headquartered companies qualify for Country-by-Country reporting out of 575,647 NZ Limited Companies as at 30 June 2016).

1 May 2017

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Base Erosion and Profit-Shifting (BEPS) – Transfer Pricing and Permanent Establishment Avoidance

Introduction and general comments

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on *BEPS – Transfer Pricing and Permanent Establishment Avoidance: A Government discussion document* (discussion document).
2. The Law Society is concerned about the proposed approach to amending the effect of New Zealand's existing international treaties. We acknowledge that other countries have enacted similar rules to those proposed. Nevertheless, we consider that there is limited scope for New Zealand to enact changes in the name of 'avoidance rules' which have the effect of overruling the clear wording in our international treaties.
3. Under our treaties, foreign companies resident in countries with tax treaties that do not carry on business from a permanent establishment are afforded protection against New Zealand tax on their income from New Zealand. In return, that foreign country affords New Zealand companies the same protection.
4. It is generally accepted that the protections provided in the treaty must be subject to general rules that prevent their abuse. However, there is a line between such general rules and more specific provisions that are intended to simply undo the negotiated position reflected in the treaty. Legislation enacting this latter category is not appropriate.
5. On its own, a specific anti-avoidance rule of the type proposed may not contravene our treaty network, however the position is less clear when the entire package of proposed amendments is considered. Under the proposals, not only will foreign companies now be exposed to tax when, on the plain wording of the treaty this should not be the case, but it is also proposed that they will be subject to a different regime for the investigation and challenge of their taxes.
6. The Law Society submits that this is not in accordance with the spirit of our treaty network. It is also arguably not in accordance with the legal effect of our existing treaty network; particularly when one considers that the proposed multi-lateral instrument provides a mechanism for countries to amend their treaties to give effect to the substance of these changes.

7. Where countries choose not to amend their treaty, New Zealand should not be able to impose this change on them through our domestic rules.

Chapter 3: Permanent Establishment (PE) avoidance

8. Chapter 3 proposes to adopt a rule very similar to the ones found in the UK Diverted Profits Tax (UK DPT) and the Australian multinational anti-avoidance law (MAAL). The rules would purport to deem a permanent establishment (PE) to exist where one exists in substance despite what is documented under legal arrangements.
9. At a conceptual level, a move to a substance based test would not necessarily result in a different outcome than that arising under an appropriate application of the transfer pricing rules. New Zealand tax payable under a deemed PE should in essence be materially the same as that payable by the relevant New Zealand entity earning an appropriate margin determined under the transfer pricing rules. On this basis, the Law Society submits that there should be no need for a specific PE avoidance rule, in addition to an introduction of more robust transfer pricing rules.
10. If, nevertheless, this rule is implemented then it will be important to ensure that it is drafted so that taxpayers have a high level of certainty as to how it applies to their affairs. This is particularly important as the effect of this rule will directly impact on how easy it is to do business with New Zealand, as a foreign multi-national; and a poorly implemented rule will see New Zealand worse off.
11. The Law Society recommends that any legislation should include a provision similar in effect to section CD 22(8), which would allow taxpayers to seek specific confirmation from Inland Revenue that the PE avoidance rules do not apply to their structure. We expect a number of multi-nationals could seek to use this mechanism to give themselves certainty as to how New Zealand will tax their arrangements. We do not consider that the binding rulings regime would give the same level of comfort, given that the proposed legislation is an anti-avoidance rule.

Chapter 5: Strengthening the transfer pricing rules

Extension of time bar from four to seven years

12. The Government proposes to increase New Zealand's time bar for transfer pricing matters from four years to seven years.
13. The discussion document states in paragraph 5.69 that it can be difficult for tax authorities to adequately identify the risk, apply the arm's length principle and amend the relevant tax return within four years. However, the Law Society submits that the need to extend the time bar period should be much less relevant if the burden of proof shifts to taxpayers as proposed in paragraphs 5.43 to 5.48 of the discussion document.
14. The Government will already have access to improved information flows through:
 - master file and local file transfer pricing documentation under OECD recommendations; and
 - automatic exchanges of information between Revenue Authorities.
15. The Law Society is not convinced that it is necessary to have a bespoke limitation period for transfer pricing, particularly given the proposal to move the burden of proof to the taxpayer.

16. Further, although paragraph 5.71 specifically refers to the Government's proposal being limited to increasing New Zealand's time bar for transfer pricing matters to seven years, there are complications associated with an adjustment for transfer pricing interacting with other types such as income tax, withholding tax, etc. The Government should therefore ensure that any flow-on effect to other tax types arising from transfer pricing adjustments is carefully managed in drafting proposed legislation.

Shift of burden of proof to taxpayers

17. The Law Society submits that a longer transitional period is appropriate for any change to the burden of proof. The current proposal for the burden to shift from the first income year after enactment does not provide sufficient time for taxpayers to review their documentation in light of the changed rules.

Chapter 6: Administrative measures

Non-cooperation

18. It is proposed in Chapter 6 that non-cooperation from large multinationals could result in the proposed new administrative measures being applied (e.g. Inland Revenue issuing an assessment based on information held at the time, the imposition of fines of up to \$100k for failure to comply with information requests, etc.) in order to prevent a subsidiary's non-compliance from frustrating Inland Revenue's transfer pricing investigation.
19. The Law Society submits that the factors that lead to a finding that a taxpayer is "non-cooperative" are too wide. For example, one of the factors put forward in the proposal in paragraph 6.16 of the discussion document includes "failure to respond to Inland Revenue correspondence".
20. Information required by Revenue Authorities from large organisations can be onerous and take considerable time to obtain. In practice, the Law Society also expects that where large amounts of information are requested, taxpayers will often obtain and provide information to a standard akin to that of legal discovery to avoid repetition should the investigation progress to litigation. Feedback received by the Law Society indicates it is frequently difficult to obtain the level of material required by Inland Revenue within the timeframes set, owing to an apparent lack of appreciation by Inland Revenue of the practical realities of sourcing the information requested.
21. The Law Society considers that the difficulty described above would not be unique to large multinationals and expects that delays in obtaining information are generally not driven by an unwillingness to provide information, but rather result from the timeframes required to obtain information from within large organisations.
22. The Law Society does not consider that there is sufficient basis for a standalone rule applying to transfer pricing disputes, and that the existing rules provide adequate protection for Inland Revenue.

Collection of information

23. It is proposed in paragraph 6.33 of the discussion document that the Commissioner be provided with a direct power to request information or documents that are held by or accessible to a group member that is located outside New Zealand.

24. The Law Society considers that Inland Revenue has sufficient ability to collect information from large multinationals under existing rules by virtue of country-by-country (CBC) reporting and automatic exchange of information with other Revenue Authorities. In practice, the Law Society expects that delays in obtaining information are generally a result of New Zealand being a smaller jurisdiction relative to the rest of the world. This can result in a lack of resource within multinational organisations being available to prioritise information requests relating to New Zealand.
25. The Law Society therefore considers that the introduction of specific provisions enabling Inland Revenue to directly request information or documents offshore would be unlikely to result in Inland Revenue receiving information in a timelier manner. As mentioned above, the Law Society anticipates that delays tend to be attributable to the difficulty within large organisations to obtain information requested (particularly in light of the size of New Zealand relative to other jurisdictions that multinationals operate in), rather than as a result of unwillingness by large multinationals to provide information.
26. The Law Society therefore submits that officials reconsider the proposal to increase the Commissioner's ability to collect information from multinationals, given that:
 - it is unlikely that this proposal would increase Inland Revenue's ability to collect information in a more timely manner; and
 - the introduction of CBC reporting rules and automatic exchanges of information.

Penalties for not providing information

27. Paragraph 6.35 of the discussion document proposes that a person may be convicted of an offence for failing to provide information held by an associated offshore group member. This would presumably apply to officers of a New Zealand subsidiary.
28. As discussed above in the context of new administrative measures for non-cooperation and wider information collection powers, New Zealand tends to be a small subsidiary in the context of large multinationals' operations. Officers and/or directors of New Zealand subsidiaries will often have little or no ability to compel offshore parent companies to provide information. The Law Society therefore considers that it would not be appropriate to impose penalties on New Zealand officers.

Requirement to pay disputed taxes early

29. It is proposed in paragraph 6.22 of the discussion document that for large multinationals engaged in particular kinds of disputes, the time at which the tax must be paid should be brought forward. The proposal is said to intend to remove any incentive for a taxpayer to prolong a dispute with Inland Revenue.
30. The reason provided in paragraph 6.21 is not compelling, given that use of money interest (UOMI) would run from the time when the tax should have been paid and penalties would apply to late payments, as it does for any other dispute. The Law Society expects that taxpayers generally do not enter into a dispute with Inland Revenue to delay the payment of tax. Instead, it is likely to be because there is a genuine dispute over the amount of tax payable.
31. It is difficult to see the justification for large multinationals in dispute with Inland Revenue to be treated differently from any other New Zealand taxpayer in this respect. The Law Society

considers the UOMI regime to be a strong enough disincentive not to prolong a dispute and is further evidenced by taxpayers using tax pooling services to mitigate UOMI.

32. We also note that section 138I of the Tax Administration Act (TAA) previously required taxpayers to pay 50% of the amount of tax being disputed, which applied for all tax disputes. This requirement was removed on 1 April 2003 as the Government felt that UOMI provided the incentive to ensure that taxpayers do not dispute an amount payable merely to delay payment. To balance the removal of the requirement to pay 50% of the disputed tax, Inland Revenue was given the power under section 138I(2B) to require payment of all the tax in dispute in those rare cases where there is a significant risk that the amount in dispute might never be paid. The Law Society considers that this power (as it was then) should remain effective where there is a real concern from Inland Revenue in respect of their ability to collect tax.
33. The discussion document also proposes in paragraph 6.24 that purchases from a tax pooling service would not be accepted as the payment of tax for the purpose of satisfying payments of disputed taxes. No justification was provided in the discussion document and it is difficult to see any justification for this limitation.
34. Based on the above, the Law Society submits that:
 - there should be no need to require multinationals to pay disputed tax earlier than any other taxpayer in New Zealand; and
 - the ability to use tax pooling services should continue to be available to multinationals as it is for other taxpayers in New Zealand.

Economic substance approach to transfer pricing

35. As stated in paragraph 5.2 of the discussion document, the proposed new rules would disregard legal form if it does not align with the actual economic substance of the transaction. It is foreseeable that Inland Revenue and taxpayers will continue to have different views on the relevant entities' economic substance. As such, the Law Society expects that a move to an economic substance approach is still likely to ultimately lead to dispute that would not necessarily be any different to disputes under the current legal form approach.

Application dates

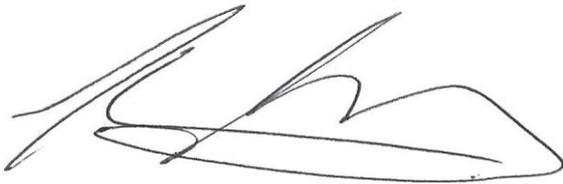
36. The discussion document states that the proposed administrative rules would apply from the date of enactment of the legislation and the proposed rules for addressing the source, PE and transfer pricing issues would apply to income years beginning on or after the date of enactment. There was no comment in the discussion paper about transitional or grandfathering rules for existing structures.
37. The Law Society understands from paragraph 3.39 of the discussion document that the ultimate objective of the proposed PE avoidance rule is to discourage non-residents from entering into PE avoidance structures in the first place. However, if the proposed changes are genuinely intended to be a disincentive, officials would presumably expect a number of restructures to occur as a result of the proposed changes. Restructures, particularly in the context of large multinationals, generally take a reasonable amount of time and resources to implement.

38. The Law Society therefore submits that provisions for transitional periods should be implemented alongside the proposed new rules in order to allow for large multinationals to consider their structures and implement any changes as a result of the proposed new rules.
39. Paragraph 2.22 notes that nothing in the discussion document is intended to prejudice any of the disputes or investigations that are currently being undertaken by Inland Revenue. However, the Law Society recommends that officials clarify the impact of the proposed transfer pricing rules on existing transfer pricing investigations that Inland Revenue is currently undertaking.

Conclusion

40. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

A handwritten signature in black ink, appearing to read 'Kathryn Beck', with a large, sweeping flourish at the end.

Kathryn Beck
President