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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;

- 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.