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Deloitte.

Deloitte
Level 1
98 Customhouse Quay
Wellington 6010

PO Box 1990
Wellington 6140
New Zealand

Tel: +64 4 470 3500
Fax: +64 4 470 3501
www.deloitte.co.nz

28 April 2017

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

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.

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- 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.

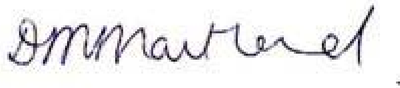
- The proposed changes should include an explicit de minimis threshold for the preparation of transfer pricing documentation or safe harbour guidance for certain transactions.

- 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 occurs[6], 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.

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[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 minims 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".

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[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).