Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Taxation of multinational companies

Date:	13 December 2012	**Priority:**	Medium
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Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to the recommendations	21 December 2012
Minister of Revenue	Agree to the recommendations	21 December 2012

Contact for telephone discussion (if required)

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13 December 2012

Minister of Finance
Minister of Revenue

Taxation of multinational companies

Executive summary

Recent media coverage in the UK, Australia and New Zealand has drawn attention to the amount of tax paid by large multinational companies.

This report explains these concerns and how New Zealand and other countries are responding. It also provides a brief summary of New Zealand's existing rules for ensuring multinationals are taxed on activities that they perform in New Zealand.

Key points

- Expectations that multinationals will pay tax on their business profits somewhere in the world are being thwarted by some multinationals – particularly technology companies and firms with high levels of intangible property (such as patents, IP and brands).
- These multinationals don't pay tax at source – that is, where the income is earned because many countries (including New Zealand and other OECD countries) only tax foreign companies on activities that they actually perform in their countries.
- These multinationals also don't pay tax in the countries where they are headquartered, are owned, or where the activities actually take place, because of deficiencies in domestic laws and the application of tax treaties and EU directives.
- The main concern is that these multinationals appear to be not paying tax on their business income anywhere. This raises issues of fairness, tax base protection and efficiency.
- This problem is broader than a particular structure, industry or country. It is a global problem which requires a global response which New Zealand will be actively involved in.

Developments in other countries

The OECD is currently developing a BEPS (tax base erosion and profit shifting) initiative to address this issue. Last month Germany, the UK, France and Australia made public announcements backing the OECD BEPS initiative.

In addition the Australian government has directed the Treasury to develop a scoping paper that will set out the risks to the sustainability of Australia's corporate tax base from multinational tax minimisation strategies and to identify potential responses. This report will be released for public consultation in mid-2013. Australia is also currently updating their transfer pricing and general anti-avoidance rules to address some problematic court decisions.

There is political pressure building in the UK for the multinationals to pay more tax. This has largely been reflected in media reporting and by opposition parties in the UK Parliament. To date, the UK government response has been to issue a statement backing the OECD's work on this issue and an announcement of additional funding for the revenue department to target avoidance.

What should New Zealand do?

A co-ordinated global effort will be required to address this issue. At a conceptual level we see the following broad options for tackling this issue.

1. **Identifying and addressing gaps in New Zealand's own base protection rules that apply to non-resident investment into New Zealand**.

    - Like Australia, we believe it is important to give priority to projects which protect source base taxation. For instance, there are still some gaps in our thin-capitalisation rules which we are working to address and you have recently agreed that Cabinet approval be sought for a release of an issues paper to counter this; Officials Issues Paper – Thin capitalisation (T2012/3107; PAD 2012/257). We will also report to you next year on any other proposals to ensure that income earned in New Zealand is subject to appropriate levels of source taxation.

    - Unlike Australia, New Zealand has so far not had particular difficulties applying its transfer pricing and general anti-avoidance rule. However, Australia's experience highlights the importance of ensuring these rules are up to date with international developments.

2. **Promoting best practice for residence taxation by all countries under their domestic law.**

    - Most countries tax their residents on their worldwide income, so if there are no gaps in residence taxation it will be much more difficult for multinationals to not pay tax anywhere. This in turn will reduce the incentive some multinationals have to minimise taxation in the source countries where the revenue is earned.

    - This would involve developing a shared focus by countries on promoting best practice for taxing on residence basis; i.e. addressing common gaps in CFC rules and addressing issues relating to hybrid instruments (which may be deductible in

one country and exempt in another) and hybrid entities (which may be a taxpayer in one country, but disregarded for tax purposes in another country). New Zealand will promote this through our involvement in the OECD BEPS project.

- It would also involve continuing efforts to enhance information exchange between tax authorities.

3. Participating in work to update and improve the international tax framework that is reflected in the OECD model DTA and other areas.

To quote an OECD paper on the subject, many international tax concepts *"were built on the assumption that one country would forgo taxation because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere."*

In the long run this might include looking at the allocation of taxing rights under DTAs, for example;

- Are the permanent establishment rules too limited?
- Do they apply appropriately to services provided over the internet?
- Are the withholding rates in the OECD Model DTA appropriate?
- Should the source country still be required to forego taxation if the residence country is not taxing the income?
- Effectiveness of treaty abuse rules and domestic anti-avoidance rules to challenge multinationals that try to take advantage of relief that they are not entitled to.

More broadly:

New Zealand should work with the OECD. We agree with the OECD position that it is important to examine the issue from all angles since it may be that existing tax frameworks and country practices are inadequate for addressing this problem.

We believe that New Zealand should actively participate in the work of the OECD work on BEPS. Last week we spoke with the OECD Secretariat on the process going forward and signalled a strong interest in the project. We are also currently identifying data and relevant analyses that can be provided to the OECD to assist them in developing a fuller assessment of the problem. We will be attending the meeting of the Committee of Fiscal Affairs in January and we understand this is an important item on the agenda.

New Zealand should coordinate with Australia. We should work directly with Australian officials. We have a similar approach to international tax policy design and tax treaties and it makes sense to work closely with them on possible solutions. We are exploring with the Australian Treasury how we might best work together on this topic at an official level.

We will report to you on developments in March 2013. This will include further information on the OECD BEPS project after their initial analysis is published in February 2013.

Recommended action

We recommend that you:

Agree that officials should actively participate in the work of the OECD work on BEPS (tax base erosion and profit shifting), including contributing to their February 2013 report.

Agreed/Not agreed Agreed/Not agreed

Agree that officials should continue to explore with the Australian Treasury how we might best work together on this issue, including contributing to the Australian Treasury's scoping paper.

Agreed/Not agreed Agreed/Not agreed

Note that we report back to you on further developments in March 2013.

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Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. Recent media coverage in the UK, Australia and New Zealand has drawn attention to the amount of tax paid by large multinational companies.

2. This report explains these concerns and how New Zealand and other countries are responding. It also provides a brief summary of New Zealand's existing rules for ensuring multinationals are taxed on activities that they perform in New Zealand.

Analysis

Key Points

- Expectations that multinationals will pay tax on their business profits somewhere in the world are being thwarted by some multinationals – particularly technology companies and firms with high levels of intangible property (such as patents, IP and brands).
- These multinationals don't pay tax at source – that is, where the income is earned because many countries (including New Zealand and other OECD countries) only tax foreign companies on activities that they actually perform in their countries.
- These multinationals also don't pay tax in the countries where they are headquartered, are owned, or where the activities actually take place, because of deficiencies in domestic laws and the application of tax treaties and EU directives.
- The main concern is that these multinationals appear to be not paying tax on their business income anywhere. This raises issues of fairness, tax base protection and efficiency.[1]
- This problem is broader than a particular structure, industry or country. It is a global problem which requires a global response (led by the OECD) which New Zealand will be actively involved in.
- Officials are actively involved in the OECD work. We will report further on the OECD BEPS (tax base erosion and profit-shifting) project after their initial analysis is published in February 2013. The Australian Treasury is also preparing a scoping paper on this issue, which will be released for consultation in mid-2013. We are exploring with the Australian Treasury how we might best work together on this topic at an official level.

3. These points are elaborated on below.

[1]This relates to efficiency of investment decisions from a worldwide perspective as decisions would be driven by tax rather than commercial considerations. In practice, many countries use tax settings to compete for investment -this may maximise national welfare, but reduce global welfare.

Expectations that multinationals will pay tax on their business profits somewhere in the world are being thwarted by some multinationals.

4. The global international tax framework reflected in tax treaties assumes that multinational corporations will be taxed somewhere on their cross border business income.

5. Specifically, it is envisaged that business income will be taxed either in the state where the income is earned (the source state) or the state where the taxpayer is resident (the residence state).

6. Historically, the primary international tax concern is that both states will assert a taxing right under domestic law resulting in ***double taxation*** of cross border income. This is why the focus of international tax treaties is on eliminating double taxation by allocating taxing rights as between residence and source states.

7. The problem is that some multinationals appear to be able to structure themselves so they are not paying tax anywhere. In other words there is no taxation in the state where the income is earned. Nor is there taxation in the residence state where the multinational is headquartered, is ultimately owned or controlled, or where the activities are based.

8. To quote an OECD paper on the subject, many international tax concepts *"were built on the assumption that one country would forgo taxation because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere."*

Some multinationals don't pay tax on a source basis in the country where the income is earned – e.g. in New Zealand

9. New Zealand taxes income of non-residents that is earned ("sourced") in New Zealand.

10. Whether business income of a foreign multinational is taxable under our domestic law depends on whether the non-resident carries on its business in New Zealand. Whether business is carried on in New Zealand is question of fact. However, the mere fact that a payment for goods or services is made by a New Zealander does not mean the business activity is carried on in New Zealand and therefore does not, by itself, give business income a (taxable) source in New Zealand.

11. There are strong reasons for New Zealand to be in line with international norms on international taxation. Otherwise New Zealand may become an unattractive place to base a business. However, even if we changed our domestic tax laws so that we could tax all business income earned by non-residents from any sales to New Zealanders, our tax treaties would override the new laws. This is because our bilateral tax treaties also require a non-resident business to carry on its business in New Zealand and also have a substantial physical presence in New Zealand (such as employees, offices and factories) in order for New Zealand to tax their New Zealand profits.

12. This general approach in New Zealand treaties is entrenched in both the OECD and UN model tax conventions and is a core feature of thousands of double tax agreements around the world.

13. The principle underpinning our domestic law and treaties is that a distinction should be drawn between "trading with a country" and "trading in a country". The result is that traditional exporters of goods and services do not pay income tax on their products in the country where the products are consumed. For example, goods imported into New Zealand (e.g. cars) do not give New Zealand a taxing right over the business income earned by the firm that exported the goods. This works both ways. New Zealand firms that simply export goods to other countries (e.g. meat products) will not be taxed in the foreign country on the business income that relates to the sales of those exported goods.

14. For example, under New Zealand's DTA with China, New Zealand exporters will not usually be taxed in China on their profits from sales to Chinese customers. However, if the New Zealand exporter had more significant activities in China such as a manufacturing operation, a sales office or customer support services, China would be able to tax any profits associated with those specific activities.

15. This distinction partly reflects the fact that working out what portion of a multinational's profits relate to sales to customers in a particular country is too complex. In addition, there is an argument that a non-resident who has no substantial presence in a country may not be a significant user of resources or infrastructure supplied by that country.

16. The activities carried out by technology companies can be likened to traditional exporters of goods who trade with a country, rather than in a country. The public concern this raises is that the internet has made it possible to provide an increasing range of services to New Zealand customers from remote locations. As a consequence, businesses that provide online services are able to provide services through offshore entities, such as Irish companies, that have no physical presence in New Zealand. That is, since the bulk of what these companies do, in terms of programming, designing websites, running servers and selling advertising space is done overseas, New Zealand, like other countries, may have very limited taxing rights.

These multinationals may not be paying tax on a residence basis either - resulting in no taxation anywhere

17. As explained above, in cases where business income is not taxable in the source country (e.g. New Zealand), the activities will usually be taxed in the country where the beneficial owner of the income is resident (the residence country).

18. The international norm is that residence countries do not tax income earned by foreign subsidiaries (except sometimes passive income) or tax dividends from foreign subsidiaries. This means foreign-sourced income is often never taxed by the residence country (until distributed to ultimate shareholders – but the period of deferral until distribution may be significant and in some cases indefinite).

19. Media reports that certain multinationals pay very low rates of tax on their worldwide operations suggest that these multinationals are also not effectively taxed in the state where the multinational originated, is owned, or even where the activities of the multinational take place.

20. Whilst New Zealand has rules to guard against profit-shifting (as listed in para 60 and described in annex 3), these rules can only apply when profits are shifted out of New Zealand, they do not usually apply to profits shifted between two foreign countries.

21. Other countries also have rules to tax their residents and guard against profit-shifting, but these rules can have gaps and weaknesses which may make them ineffective.

22. This could be due to the following, or a combination of the following reasons:

- Ineffective controlled foreign company rules
- Arbitrage between different countries' domestic law rules
- Related party transactions which shift profits from a high tax to a low tax country

Ineffective CFC rules

23. A multinational is a firm with a parent company in one jurisdiction with a network of subsidiaries in other countries. Most OECD countries have controlled foreign company (CFC) rules. CFC rules enable countries to tax their own residents on income they earn through offshore subsidiaries they control. They will normally give a credit for foreign tax that is paid by the subsidiary.

24. Normally CFC rules tax only passive income (interest, dividends, and royalties) and not active income (manufacturing) on the assumption that the location of active business is not tax driven and involves no risk to the domestic tax base.

25. One possibility is that standard CFC rules are proving ineffective in situations when they ought to apply. Moreover, there is constant pressure on governments to continue to relax these rules and that has been a significant trend in recent years. For example, the main reason why New Zealand introduced an active income exemption for CFCs in 2009 was that other countries, including Australia, had active income exemptions. This meant New Zealand's previous approach of taxing CFCs on all of their income created an incentive for New Zealand-based multinationals to shift their headquarters to Australia. This demonstrates the need for some international coordination to address tax structuring by multinationals.

Arbitrage between domestic law rules

26. Domestic tax law features may prevent effective taxation of these multinationals on a residence basis. Differences in countries' domestic law entity classification (including, for instance, the US check-the-box rules which allow limited liability companies to be regarded as part of a parent company for US tax purposes) and differences in domestic law distinctions

between debt and equity classifications may result in opportunities for cross-border arbitrage. Arbitrage of this nature often leads to double non-taxation (e.g. deduction in one state and exemption in the other). We recently reported to you on cross-border arbitrage using hybrid instruments between Australia and New Zealand – *Tax deductions for hybrid instruments issued by New Zealand companies* (T2012/2356; PAD 2012/216).

Related party transactions

27. In addition, multinational companies can shift profits between countries through intergroup dealings. This typically involves a company in a high tax country making a deductible payment to a related company in a low tax country. Some examples of this are:

- Royalty payments for the use of intangible property (patents, IP or brands)
- Interest payments in respect of a related party loan
- Inflated management or consulting fees for services performed offshore
- Purchasing goods or inputs from a related company at an inflated or discounted price.

28. The end result is that there is less profit in the high tax country and more profit in the low tax country and a lower overall tax bill.

29. Depending on the specific facts and circumstances, it may be possible for countries to use transfer pricing and thin capitalisation rules to challenge profit-shifting transactions. Domestic law and treaties rely on transfer pricing methods to ensure transactions between members of a multinational group are conducted at arms' length. This ensures taxable profit on cross border transactions reflect what would have occurred between unrelated parties. This means that transfer pricing may not be effective in preventing profit-shifting in cases where the price of the cross-border transaction reflects what a third party would actually pay.

30. Another way to combat profit-shifting is through the use of withholding taxes. Most countries impose withholding taxes on interest and royalty payments. However, these withholding taxes are usually reduced or eliminated under double tax agreements or EU directives relating to the free movement of capital. (Note the OECD Model Convention has no withholding tax on royalties.) As a result multinationals may be able to structure their investments to minimise or circumvent withholding taxes. Note that the OECD already has a major project underway on intangible property to address particular concerns in this area.

Many structures involve a combination of approaches

31. Many structures involve a combination of the above features. These structures can be difficult to tackle on a unilateral basis as they take advantage of complex interactions between the laws of two or more countries as well as their international tax treaties.

32. For example, it has been reported that some firms employ a structure known as the "Double Irish" or the "Dutch Sandwich".

33. This involves an Irish company selling products or services to customers outside of Ireland. The profit from these sales is taxable in Ireland, but the Irish company is required to pay a royalty for the use IP which belongs to a related company. This royalty payment substantially reduces the profits that are taxable in Ireland.

34. The royalty payments are routed through other companies in the Netherlands and Ireland in order to escape withholding taxes. The final result is that the profits ultimately end up in a jurisdiction where little or no tax is payable.

35. This is just one example of a tax minimisation structure. Cracking down on one particular structure may be ineffective if other structures can be used to achieve similar results.

Concerns with multinationals not paying tax anywhere on their business income

36. Media comment around the world has focused on the unfairness of the low levels of tax paid by some multinationals. Fairness in a tax system is critical for many reasons, including the promotion of voluntary compliance which underpins modern tax administration.

37. In addition to concerns about fairness, governments have major concerns about the erosion of their tax bases at a time of global fiscal crisis.

38. We note in this regard, that the absence of effective taxation on a residence basis is likely to undermine taxation at source and potentially distort business decisions.[2]

39. If a multinational is taxable on a residence basis their decision about whether to locate business activity in a source state will take into account tax considerations such as corporate tax rates. But assuming rates are comparable, decisions on where its activities are performed are likely to be largely determined by commercial, rather than tax considerations. For example if a US headquartered multinational is paying tax on its worldwide income under the US rules, then it would not usually be concerned with minimising the profits which are taxed in New Zealand. This is because New Zealand tax can be credited to offset the US tax, so it would make little difference to their overall tax bill whether tax is paid in New Zealand or the US.

40. But if residence taxation does **not** apply then this will substantially increase the incentive of the multinational to minimise its taxable presence in the source state. This is because the difference is between source state taxation and no taxation. Continuing the example from above, if a US headquartered company does not face tax in the US, they will have an added incentive to minimise the tax which is payable in New Zealand as the New Zealand tax cannot be used to offset US tax.

[2]This relates to the efficiency of investment decisions from a worldwide perspective as decisions would be driven by tax rather than commercial considerations. In practice, many countries use tax settings to compete for investment -this may maximise national welfare, but reduce global welfare.

This is a global problem that requires a global response

41. The problem is far broader than a particular structure, industry or country.

42. Many of the structures involve complex interactions between the laws of two or more countries as well as their international tax treaties.

43. This means a co-ordinated, comprehensive and global response is likely to be required to effectively address this issue. This response is being developed by the OECD with strong backing from the G20.

G20 and OECD

44. Last month Germany and the United Kingdom called on G20 finance ministers to work together to strengthen international standards for corporate tax regimes. Ministers Schäuble and Osborne asked their G20 colleagues to back the OECD BEPS (tax base erosion and profit shifting) initiative.

45. France and Australia have also made public announcements backing this OECD work.

46. On 30 November 2012, the OECD has published a short background brief on this work (attached as annex 1).

47. Inland Revenue officials are actively involved in the OECD work on BEPS. This builds on our existing involvement in related initiatives such as the systematic reviews of country regimes being undertaken by the Global Forum on Transparency and Exchange of Information for Tax Purposes and the OECD's Forum on Harmful Tax Practices.

48. We expect the OECD work will be broad in scope and may include identifying gaps and weaknesses in the following areas:

- Base protection rules, such as CFC rules, transfer pricing rules, thin-capitalisation rules and anti-avoidance rules.
- Mismatches in domestic law such as hybrid instruments and hybrid entities.
- Allocation of taxing rights under DTAs; for example are the permanent establishment rules too limited?
- Harmful tax regimes such as low rates and concessions which create an incentive or ability to shift profits.
- Effectiveness of other anti-abuse rules in domestic law and in tax treaties.

Australia

49. The Australian government has directed the Australian Treasury to develop a scoping paper that will set out the risks to the sustainability of Australia's corporate tax base from multinational tax minimisation strategies and to identify potential responses.

50. The paper will be informed by a specialist reference group, chaired by Rob Hefron from the Australian Treasury and made up of 13 other experts including tax professionals, academics, business tax managers and community leaders.

51. The scoping paper will be released for public consultation in mid-2013. A key objective of the work is to develop a common understanding of the problem.

52. Some earlier media reports have focused on a speech made by Australia's Assistant Treasurer David Bradbury that Australia's tax laws were being revised to ensure that companies pay tax on profits made in the country. We note that the relevant changes are to Australia's transfer pricing and general anti-avoidance rules. These changes are largely in response to some problematic court decisions in Australia (see annex 2 for more detail).

53. They are important changes to protect Australia's corporate tax base, but are not a substitute for the international co-operation required to address the broader issue of some multinationals not paying tax anywhere. For this reason, Australia has signalled it strongly supports the OECD work on BEPS.

United Kingdom

54. There is political pressure building in the UK for the multinationals to pay more tax. This has largely been reflected in media reporting and by opposition parties in the UK Parliament. Most notably, the UK Parliament's public accounts committee published a report highlighting the problem.

55. To date, the UK government response has been to issue a statement backing the OECD's work on BEPS (see para 44 above) and an announcement of additional funding of £77m for the revenue department to target avoidance.

What should New Zealand do?

56. New Zealand should work with the OECD. We agree with the OECD position that it is important to examine the issue from all angles since it may be that existing tax frameworks and country practices are simply inadequate for addressing this problem. We believe that New Zealand should actively participate in the work of the OECD work on BEPS. Last week we spoke with the OECD Secretariat on the process going forward and signalled a strong interest in the project. We are also currently identifying data and relevant analyses that can be provided to the OECD to assist them in developing a fuller assessment of the problem. We will be attending the meeting of the Committee of Fiscal Affairs in January and we understand this is an important item on the agenda. Different aspects of the BEPS work are

also being considered by a number of OECD working parties, which New Zealand is already involved in.

57. New Zealand should coordinate with Australia and work directly with Australian officials. We are exploring with the Australian Treasury how we might best work together on this topic at an official level. We have a similar approach to international tax policy design and tax treaties and it makes sense to work closely with them on possible solutions.

58. We will report to you on developments in March 2013. This will include further information on the OECD BEPS project after their initial analysis is published in February 2013.

59. Finally, we consider that it is important to give priority to projects which protect source base taxation. For instance, there are still some gaps in our thin-capitalisation rules which we are working to address and you have recently agreed that Cabinet approval be sought for a release of an issues paper to counter this; Officials Issues Paper – Thin capitalisation (T2012/3107; PAD 2012/257). We will also report to you next year on any other proposals to ensure that income earned in New Zealand is subject to appropriate levels of source taxation.

What existing measures does New Zealand use to ensure multinationals are taxed on activities they perform in New Zealand?

60. New Zealand employs a range of measures to ensure that multinational companies, or their New Zealand subsidiaries, are taxed appropriately on activities that they do perform in New Zealand. These include:

- Transfer pricing rules
- Thin capitalisation rules
- Broader permanent establishment rules in tax treaties
- Withholding tax
- Exchanging information with other tax authorities; and
- The general anti-avoidance rule

61. These measures are described in more detail in the annex 3.

ANNEX 1:

30 November 2012

The OECD Work on Base Erosion and Profit Shifting

Background

There is a growing perception that governments lose substantial corporate tax revenue because of planning aimed at eroding the taxable base and/or shifting profits to locations where they are subject to a more favourable tax treatment. Civil society and non-governmental organisations (NGOs) have been vocal in this respect, sometimes addressing very complex tax issues in a simplistic manner and pointing fingers at transfer pricing rules based on the arm's length principle as the cause of these problems.

Beyond this perception based on a number of high profile cases, there is a more fundamental policy issue: the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment. Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies. For example, some rules and their underlying policy were built on the assumption that one country would forgo taxation because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere.

Political attention

The debate over Base Erosion and Profit Shifting (BEPS) has also reached the political level and has become a very important issue on the agenda of several OECD and non-OECD countries. The G20 Leaders meeting in Mexico on 18-19 June 2012 explicitly referred to "the need to prevent base erosion and profit shifting" in their final declaration. This message was reiterated at the G20 finance ministers meeting of 5-6 November 2012 whose final communiqué states "We also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting." On the margins of the G20 meeting in November 2012, the United Kingdom's chancellor of the exchequer, George Osborne, and Germany's finance minister, Wolfgang Schäuble, issued a joint statement, since then joined by France's economy and finance minister Pierre Moscovici, calling for co-ordinated action to strengthen international tax standards and urged their counterparts to back efforts by the Organisation for Economic Co-operation and Development to identify possible gaps in tax laws. Such a concern was also voiced by US President Obama in his Framework for Business Tax Reform where it is stated that "the empirical evidence suggests that income-shifting behaviour by multinational corporations is a significant concern that should be addressed through tax reform". 2 20 November 2012

The issue in a nutshell

Corporation tax is levied at a domestic level. The interaction of domestic tax systems sometimes leads to an overlap, which means that an item of income can be taxed by more than one jurisdiction thus resulting in double taxation. The interaction can also leave gaps, which result in an item of income not being taxed anywhere thus resulting in so called "double non-taxation". Corporations have urged bilateral and multilateral co-operation among countries to address differences in tax rules that result in double taxation. Domestic and international rules to address double taxation, many of which originated with principles developed in the past by the League of Nations in the 1920's, aim at addressing these overlaps so as to minimise trade distortions and impediments to sustainable economic growth. In contrast, corporations often exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation.

Broadly speaking corporate tax planning strategies aim at moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. These strategies typically ensure: (i) minimisation of taxation in a foreign operating or source country, (ii) low or no withholding tax at source, (iii) low or no taxation at the level of the recipient, as well as (iv) no current taxation of the low taxed profits (achieved via the first three steps) at the level of the ultimate parent. The result is a tendency to associate more profit with legal constructs and intangible rights and obligations, thus reducing the share of profits associated with substantive operations involving the interaction of people with one another.

While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy.

Key pressure areas

In addition to a clear need for increased transparency on effective tax rates of MNEs, key pressure areas include those related to:

- International mismatches in entity and instrument characterisation including hybrid mismatch arrangements and arbitrage;
- application of treaty concepts to profits derived from the delivery of digital goods and services;
- the tax treatment of related party debt-financing, captive insurance and other inter-group financial transactions;
- transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- the effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes and thin capitalisation rules; and
- the availability of preferential regimes for certain activities.

The role of the OECD

When implemented effectively, the strategies used to shift profits and erode the taxable base put increased pressure on the rules and on the governments that designed them. This also reflects an important point, namely that BEPS strategies take advantage of a combination of features of tax systems which have been put in place by home and host countries. Accordingly, it may be impossible for any single country, acting alone, to fully address the issue. There is no magic recipe to address BEPS issues, but the OECD is ideally positioned to support countries' efforts to ensure effectiveness and fairness and at the same time provide a certain and predictable environment for business.

OECD member countries share a common interest in establishing a level playing field among countries while ensuring that domestic businesses are not disadvantaged vis-à-vis multinational corporations. Failure to collaborate in addressing BEPS issues could result in unilateral actions that would risk undermining the consensus-based framework for establishing jurisdiction to tax and addressing double taxation which exists today. The consequences could be damaging in terms of increased possibilities for mismatches, additional disputes, increased uncertainty for business, a battle to be the first to grab taxable income through purported anti-avoidance measures, or a race to the bottom with respect to corporate income taxes. In contrast, collaboration to address BEPS concerns will enhance and support individual governments' domestic policy efforts to protect their tax base while protecting multinationals from uncertainty or double taxation. In this regard, addressing BEPS in a coherent and balanced manner should take into account the perspectives of industrialised as well as emerging and developing countries.

Next steps

The OECD will deliver a progress report to the G20 in early 2013 on actions to tackle the issue of BEPS, including strategies to detect and respond to aggressive tax planning and ensure better tax compliance. In addition to a clear need for better data and analyses, a reflection on the very fundamentals of the current rules also appears to be warranted. The reflection would primarily focus on issues around whether rules developed in the past are still fit the purpose in today's business environment, particularly when applied to the increasingly digital economy, or whether there is a need for different solutions, as well as on options to implement reform in a streamlined manner.

ANNEX 2: Australia's domestic law reforms

Australia is currently reforming their transfer pricing and general anti-avoidance rules. These changes are largely in response to some problematic court decisions in Australia.

In announcing the changes to the general anti-avoidance rule, Australia's Assistant Treasurer explained;

> *"In recent cases, some taxpayers have argued successfully that they did not get a 'tax benefit' because, without the scheme, they would not have entered into an arrangement that attracted tax,"*
>
> *"For example, they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all. Such an outcome can potentially undermine the overall effectiveness of Part IVA* [the general anti-avoidance rule] *and so the Government will act to ensure such arguments will no longer be successful.*

The reforms to the transfer pricing rules were announced in November 2011. A media release accompanying this announcement explained:

> *"A recent court case has highlighted some difficulties for Australia to appropriately assess transfer pricing cases in a way that is consistent with our major trading partners."*

The changes will allow Australia to apply the OECD model transfer pricing guidelines when amending related party transactions under their domestic law. (The OECD guidelines and Australia's DTAs allow a wider range of transfer pricing methods to be used than existed at the time that Australia put in place its domestic law.)

The changes included retrospective amendments to confirm the transfer pricing rules in Australia's tax treaties operated as intended, consistent with OECD best practice.

The Australian experience highlights the importance of ensuring tax legislation is up to date with modern international practice.

ANNEX 3: Existing measures to ensure multinationals are taxed on activities they perform in New Zealand

New Zealand employs a range of measures to ensure that multinational companies, or their New Zealand subsidiaries, are taxed appropriately on activities that they do perform in New Zealand.

Transfer pricing rules

Transfer pricing rules apply to cross-border transactions between related parties, and substitute a price which would be agreed to if the parties were not related. The aim of these rules is to prevent companies from inappropriately inflating their costs, or minimising their income in order to reduce their taxable profits.

The rules, however, focus on ensuring there is a correct price for a transaction. This means that transfer pricing may not be effective in preventing profit-shifting in cases where the price of the cross-border transaction reflects what a third party would actually pay (for example if low-ranking debt is used a high price may be justified, even though there is little risk in related party deals).

The OECD publishes detailed Transfer Pricing Guidelines that are followed by New Zealand and other member countries. As mentioned in Annex 2, one reason why Australia is reforming their transfer pricing rules is because of a problematic court decision that made it more difficult for Australia to apply some new methods provided in the OECD guidelines. New Zealand has not experienced any problems in applying its transfer pricing rules.

Thin capitalisation rules

New Zealand, like many other countries, has thin-capitalisation rules. These rules help guard against profit shifting by denying interest deductions in cases where a multinational group has loaded too much debt into their New Zealand operations.

As part of Budget 2010, the Government tightened the inbound thin capitalisation ratio from 75% to 60%. (This means foreign-owned companies are only able to claim tax deductions for interest payments on debt up to 60 per cent of their local asset value. The only exception is if the total multinational group's debt ratio is higher than this.)

New Zealand's thin-capitalisation rules are generally more comprehensive and tighter than rules in other countries. For example, New Zealand's rules apply to both related and unrelated party debt, and although there is a growing worldwide trend to count both types of debt, many countries still only apply their rules to related party debt. In addition, New Zealand's 60% ratio is tighter than Australia's which remains at 75% (Australia consulted on reducing their ratio to 60% as part of a package of changes to fund a business tax cut, but decided against it).

However, New Zealand's thin-capitalisation have some gaps which mean certain investments are not currently subject to the rules. For example the current rules only apply to companies with a single non-resident controller, so don't apply when several unrelated investors agree to load a very high level of debt into a New Zealand company. You have recently agreed that Cabinet approval be sought for a release of an issues paper to counter these gaps; Officials Issues Paper – Thin capitalisation (T2012/3107; PAD 2012/257).

Broader Permanent establishment rules in tax treaties

Under New Zealand's double tax agreements, business income of non-resident companies is only taxable to the extent that it is derived through a permanent establishment (branch or fixed place of business) that the non-resident operates in in New Zealand.

Importantly, New Zealand's treaty policy is to secure a wider concept of permanent establishment than is contained in the OECD model –particularly in relation to services and natural resources. We have obtained this in most (but not all) of our treaties.

Most other OECD countries have DTAs with more limited permanent establishment rules.

Withholding tax

New Zealand's withholding tax rules impose tax on interest, dividend and royalty payments made by companies in New Zealand. Double tax agreements generally set out limits to the amount of withholding tax that will be deducted from amounts paid to non-residents. While New Zealand's recent DTAs have reduced withholding tax rates on dividends and royalties this change was driven by a desire to reduce tax barriers to New Zealand businesses that expand offshore.

Notwithstanding these recent reductions in rates, New Zealand, unlike most other OECD countries, retains a positive (5% or 10%) rate on royalty payments under our double tax agreements. This reduces the ability of multinationals to use royalties to reduce the profits of their New Zealand operations. It also helps Inland Revenue to identify high-priced royalties and challenge these, if necessary, by applying our transfer pricing rules.

Officials have identified several issues that can affect New Zealand's ability to collect withholding tax, particularly on interest payments. For example, interest is immediately deductible when the expense is incurred, but non-resident withholding tax only applies at the time the interest is actually paid, which may be a very long time after the deduction. We will report further on these issues next year.

Exchanging information with other tax authorities

Exchanging information with other tax authorities can be a very effective way to combat tax structures which try to take advantage of interactions between the laws of two or more countries. For example, New Zealand may become aware of a structure that appears to minimise foreign tax, rather than New Zealand tax. Sharing this information with the relevant foreign tax authority can help that country to enforce its rules or to identify and address deficiencies in its law.

Over the last few years Inland Revenue has established a trans-Tasman financing desk to facilitate real time exchange of information with the Australian Tax Office. It has also taken a leading role in an OECD pilot group on the real time exchange of information on aggressive tax schemes involving hybrid entities and instruments.

New Zealand is able to exchange information under our 38 double tax agreements, 21 tax information exchange agreements and the OECD Multi-lateral Convention on Mutual Administrative Assistance in Tax Matters. The Multi-lateral convention allows New Zealand to automatically exchange information (the foreign country does not need to request the information)

with the 42 countries that have signed and more countries will be added over time (so far 10 other countries have signalled their intention to sign).

General anti-avoidance rule

New Zealand has been successful in applying its general anti-avoidance rule to prevent profit-shifting by multinational companies. A recent example was the banking structured finance cases.

The UK is developing a general anti-avoidance rule which will be introduced in 2013. As explained in Annex 2, Australia is looking to update its general anti-avoidance rule to address some problematic court decisions.