POLICY AND STRATEGY

Tax policy report: Taxation of multinationals

Date:	15 August 2013	**Priority:**	**High**
Security Level:	In Confidence	**Report No:**	T2013/2059 PAS2013/152

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Agree** to the recommendations in this report	Thursday, August 29th 2013
Minister of Revenue	**Agree** to the recommendations in this report	Thursday, August 29th 2013

Contact for telephone discussion (if required)

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In Confidence

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15 August 2013

Minister of Finance
Minister of Revenue

Taxation of multinationals

Executive summary

Since late 2012, there has been global media and political reaction to evidence suggesting that some multinationals pay little or no tax anywhere in the world. The wide range of international tax planning techniques that are used to achieve such results are collectively referred to as "base erosion and profit shifting" or "BEPS". The Government has publicly released two tax policy reports on BEPS: one in December 2012 (T2012/3250, PAD2012/268) and one in April 2013 (T2013/927, PAS2013/63).

The central concern is that international tax standards have not kept pace with developments in the global economy. It will be difficult for any country, acting alone, to fully address the issue; it is a global problem that requires a global solution.

The OECD's *Action Plan on Base Erosion and Profit Shifting* was released on 20 July this year. New Zealand officials participated in the development of the action plan. We strongly support the approach suggested by the OECD and the particular focus and priority given to the actions recommended in the plan. This report provides a summary of some of the key items in the OECD action plan.

While we will continue to be closely involved in, and guided by, the OECD work, this does not prevent us from addressing potential deficiencies in New Zealand's own rules, which we have concerns about. To this end, we recommend that initiatives to protect the New Zealand tax base from BEPS should be a key focus when developing the next 18-month tax policy work programme.

This report outlines a number of projects that could be included in the work programme to strengthen our ability to combat profit shifting by multinationals and other investors, focusing on:

- preventing multinationals shifting profits out of New Zealand using related-party debt
- removing tax advantages from certain investment vehicles and ensuring effective taxation of offshore investments
- ensuring tax rules keep pace with changes in the global economy – including examining options for collecting GST on online shopping.

The current work programme has resources allocated to develop BEPS projects and as previously noted we recommend this remain a key focus. We will discuss with you how these projects can be prioritised and sequenced to fit within the current and future resource allocations that support the BEPS initiatives. We expect to identify an initial tranche of projects that can be added to the work programme when it is updated in September.

Once we have established a sequence we intend to report separately on each specific proposal. Every proposal needs to be evaluated on its merits taking into account relevant trade-offs. In particular, the benefit of increased base protection from a proposed reform needs to be weighed against any adverse implications in terms of overall economic efficiency including increases in compliance costs. Any resulting reform needs to be consistent with the "broad base low rate" framework.

In addition, the decision to proceed with any proposals for reforms relating to BEPS needs to be evaluated more generally in the context of all of the Government's priorities on the tax policy work programme.

Finally, if you decide a proposal for reform will be added to the work programme, it should be subject to the normal consultation process under the generic tax policy process.

Improving the disclosure of tax information

While it is important to ensure international and domestic tax rules are robust and fit-for-purpose, it is equally important that tax authorities have the information they need to assess specific revenue risks and identify any deficiencies in how these tax rules operate in practice.

We have identified a set of other measures that could be implemented to improve the quality and usefulness of tax information collected by Inland Revenue:

- Improve information disclosure for large corporates.
- Require large corporates to file their tax returns earlier.
- Align information disclosure for approved issuer levies (AIL) with non-resident withholding tax (NRWT) disclosure requirements.

In addition, we suggest that Inland Revenue should consult with corporates on introducing a voluntary code of practice to promote good behaviour.

Recommended action

We recommend that you:

(a) **Note** that the OECD has recently published its *Action Plan on Base Erosion and Profit Shifting*, which outlines 15 actions that the OECD will take in the next one to two-and-a-half years.

Noted Noted

(b) **Agree** that New Zealand officials should continue to participate in the OECD work on base erosion and profit shifting and report to you on any significant developments.

Agreed / Disagreed Agreed / Disagreed

(c) **Agree** that initiatives to protect the New Zealand tax base from base erosion and profit shifting should be a key focus when developing the next 18-month tax policy work programme.

Agreed / Disagreed Agreed / Disagreed

(d) **Note** that this report outlines a range of other potential initiatives to protect the New Zealand tax base from base erosion and profit shifting and that officials will discuss with you how these can be prioritised and sequenced.

Noted Noted

(e) **Note** that we have also identified a set of administrative measures that could be implemented to improve the quality and usefulness of tax information collected by Inland Revenue.

Noted Noted

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Background

1. The global international tax framework reflected in tax treaties and countries' domestic law assumes that multinational corporates will be taxed somewhere on their cross-border income. As mentioned in our report in December 2012, it is envisaged that income will be taxed either in the country where the income is earned (the source state) or the state where the taxpayer is resident (the residence state).

2. Since late 2012, there has been global media and political reaction to evidence suggesting that some multinationals pay little or no tax anywhere in the world. The wide range of international tax planning techniques that are used to achieve such results are collectively referred to as "base erosion and profit shifting" or "BEPS".

3. The problem is that international tax standards have not kept pace with developments in the global economy. For example, multinational profits increasingly relate to brands, intellectual property or digital services that can be located anywhere in the world. Other problems arise from complex interactions between different countries' tax rules.

4. For these reasons, it will be difficult for any single country, acting alone, to fully address the issue. This is a global problem that requires a global solution.

5. The OECD has been leading the global response and has recently produced an action plan that identifies 15 specific actions that OECD member countries and G20 nations will work together to implement.

6. Although BEPS is a global problem, it can affect New Zealand's ability to collect tax. If other countries do not effectively tax their multinationals, this may have a knock-on effect of giving these multinationals incentives to shift profits or minimise their taxable presence in New Zealand (and therefore pay no tax anywhere in the world).

7. In New Zealand, there has been significant media and corporate interest in BEPS and the Government's response. The Government has publicly released two tax policy reports on BEPS: one in December 2012 (T2012/3250, PAD2012/268) and one April 2013 (T2013/927, PAS2013/63).

The OECD's action plan

8. Inland Revenue and Treasury officials are closely involved in an OECD/G20 project that is developing measures that countries can implement to counter BEPS. This work builds on our existing involvement in the OECD tax working parties, which includes chairing the Aggressive Tax Planning Steering Group.

9. The OECD's action plan is designed to be comprehensive (given there are a wide range of BEPS concerns) and multilateral (as countries can't address many of the concerns on their own, and there is a risk that poorly co-ordinated or "knee-jerk" reactions could harm cross-border trade and investment).

10. Some of the more significant areas of work are:

- considering whether special tax rules are needed to tax digital goods and services that are provided over the internet **(Action 1)**
- reviewing hybrid mismatches, which occur because countries have different tax rules for distinguishing between debt and equity or companies and partnerships **(Action 2)**
- improving rules for controlled foreign companies (CFCs), which allow countries to tax their multinationals on passive/mobile income that they earn through foreign subsidiaries **(Action 3)**
- reviewing domestic rules for limiting interest deductions (for example, thin-capitalisation rules) **(Action 4)**
- preventing the misuse of tax treaties (for example, by investors who shouldn't qualify for tax relief under a tax treaty) **(Action 6)**
- improving the "permanent establishment" rules for determining when an overseas business has a taxable presence in a foreign country **(Action 7)**
- improving "transfer pricing" rules (which ensure that a market price is paid on related-party transactions), particularly in relation to debt **(Action 4)** and brands and intellectual property **(Actions 8 to 10)**.

11. In each area of work, the OECD will develop specific recommendations for countries to implement.

12. Some of these recommendations could be implemented through a multilateral agreement or updates to the OECD's existing guidelines and commentaries (including transfer pricing guidelines and model tax agreement commentary). Such changes will require a broad consensus among OECD and G20 countries. The challenge will be building this consensus in the proposed OECD timeframes.

13. Other recommendations will rely on countries being willing and able to make amendments to their domestic laws. This approach provides countries with more control and flexibility on the specific design of any reforms. There is a risk, however, that some countries may opt out or may delay or water-down their reforms in an effort to attract profits or mobile business activity from countries with tougher rules.

14. New Zealand officials will continue to be closely involved in the OECD work on BEPS and will report to you on any significant developments, including recommendations for improving our international tax policy settings in New Zealand.

Protecting the New Zealand tax base from base erosion and profit shifting

15. The starting point is that, like other countries, New Zealand taxes non-residents on income that is earned ("sourced") in New Zealand. However, non-resident investors who invest or have operations in New Zealand may have incentives to reduce or eliminate their tax liabilities in New Zealand by shifting income out of New Zealand.

16. New Zealand also taxes its residents on their world-wide income. (The main exception to this rule is firms that have foreign subsidiaries earning "active income" – ie income from manufacturing etc.) However, residents who have operations offshore may seek to reduce their New Zealand tax obligations by shifting income offshore – including by increasing deductions taken in New Zealand.

17. In either case, the result is that income earned in New Zealand, either by non-residents or residents, is not fully taxed in New Zealand.

18. The OECD's action plan highlights the wide variety of techniques and structures that multinational businesses can use to shift profits away from where the economic activity is carried out and into more lightly taxed entities or countries.

19. New Zealand and other countries have various rules to guard against profit shifting of this nature. The OECD action plan is focused on the use of these rules generally and how to make them work effectively. (Annex 3 provides a table comparing our rules with areas of focus of the OECD action plan.)

20. We will be closely involved in, and guided by, the OECD work. However, this does not prevent us from addressing potential deficiencies in our own rules, which we have concerns about.

21. To this end, we recommend that initiatives to protect the New Zealand tax base from BEPS should be a key area of focus when developing the next 18-month tax policy work programme.

22. Officials have identified a range of initiatives that could be considered in terms of potential additions to the tax policy work programme. These are outlined below and described in detail in Annex 1.

Preventing profit shifting using related-party debt

- Examine problems with the thin capitalisation and transfer pricing rules that are designed to prevent profit shifting by non-residents who fund their New Zealand investment using related-party debt, that gives rise to deductible interest payments.
- Explore whether New Zealand should restrict interest deductions on hybrid instruments where the interest payment is not taxed in the foreign jurisdiction.
- Address problems with the application of NRWT on interest on related-party debt.

Removing tax advantages from certain investment vehicles and ensuring effective taxation of offshore investments

- Explore the need for an anti-arbitrage rule for offshore entities which allow double non-taxation of income or double deductions of expenditure by taking advantage of differences between countries' tax rules.
- Examine incoherence relating to different tax treatment of "look-through vehicles" and structures.
- Design the active income exemption for offshore branches to ensure it does not facilitate profit shifting through repatriation of losses.

Ensuring tax rules keep pace with changes in the global economy

- Review the tax treatment of foreign trusts.
- Explore options for collecting GST on goods and services bought online.

23. The current work programme has resources allocated to develop BEPS projects and as previously noted we recommend this remain a key focus. We will discuss with you how these projects can be prioritised and sequenced to fit within the current and future resource allocations that support the BEPS initiatives. We expect to identify an initial tranche of projects that can be added to the work programme when it is updated in September.

24. Once we have established a sequence we intend to report separately on each specific proposal. Every proposal needs to be evaluated on its merits taking into account relevant trade-offs. In particular, the benefit of increased base protection from a proposed reform needs to be weighed against any adverse implications in terms of overall economic efficiency including increases in compliance costs. Any resulting reform needs to be consistent with the "broad base low rate" framework.

25. In addition, the decision to proceed with any proposals for reforms relating to BEPS needs to be evaluated more generally in the context of all of the Government's priorities on the tax policy work programme.

26. Finally, if you decide a proposal for reform will be added to the work programme, it should be subject to the normal consultation process under the generic tax policy process.

Improving disclosure of tax information

27. The availability of relevant, timely electronic tax and financial information can greatly assist tax authorities in assessing revenue risks and identifying any deficiencies in how tax rules operate in practice.

28. The OECD's action plan on BEPS has also called for improved transparency of multinationals' tax affairs. However, this improved transparency is in the context of additional collection and disclosure of information to tax authorities. This includes collecting aggregate statistical data on the extent of BEPS (Action 11), requiring taxpayers to disclose aggressive tax planning arrangements (Action 12), and requiring multinationals to provide all relevant tax authorities with information on the global allocation of their income as well as transfer pricing documentation (Action 13).

29. We have identified a set of initiatives that New Zealand could consider to improve the quality and usefulness of tax information collected by Inland Revenue. The following initiatives are described in more detail in Annex 2:

- Improve information disclosure for large corporates.
- Require large corporates to file their tax returns earlier.
- Align information disclosure for approved issuer levies (AIL) with non-resident withholding tax (NRWT) disclosure requirements.

30. Separately, other countries, including the United Kingdom, South Africa and Spain have sought to encourage large taxpayers to take a public stance against aggressive tax planning by introducing a voluntary code of practice. We believe this is an idea worth exploring, and it is discussed in more detail in Annex 2.

31. In response to public concerns about the amount of tax paid by multinationals, Australia has recently introduced legislation that will require the Australian Taxation Office to publish the tax liabilities of corporate taxpayers with accounting incomes of $100 million or more a year.[1] The rationale for this legislation is that it may put consumer or shareholder pressure on large taxpayers to refrain from aggressive tax planning. One difficulty with this approach is that reported tax liabilities can be low for a variety of other reasons such as prior-year losses or intended tax concessions and in these cases the published information may not be a good indicator of taxpayer behaviour.

32. The Financial Reporting Bill, which is currently awaiting the Committee of the Whole House stage, relaxes some current public reporting rules which apply to subsidiaries of multinationals. This would appear to move in a contrary direction to the Australian proposal by reducing the public availability of some information. We reported to Ministers on this point earlier this year (T2013/1194, PAS2013/79; and T2013/2067, PAS 2013/156 refer) and we understand the matter is under consideration. The issue is one of appropriate trade-offs: on the one hand, the compliance costs the current rules impose on businesses, and on the other, the benefits of public transparency.

[1]The legislation still needs to be passed by the Australian Senate

Annex 1

Protecting the New Zealand tax base from base erosion and profit shifting

Multinationals shifting profit using related party debt

Examine problems with tax rules (thin capitalisation and transfer pricing) designed to prevent profit shifting by non-residents who fund their New Zealand investment using related party debt

New Zealand's thin-capitalisation rules are generally more comprehensive and tighter than rules in other countries. However, the taxation of related-party debt is probably the most significant BEPS issue for New Zealand. Interest expenses paid by borrowers are tax deductible. Accordingly, multinationals have tax incentives to fund their New Zealand operations using debt rather than equity. Another way of looking at it is to view the deductions for interest payments as a means of shifting income to the non-resident parent or another related party.

One of the significant ways that multinationals can shift profits offshore is by funding New Zealand operations with excessive levels of debt or by setting a very high interest rate on the debt. Currently we use thin-capitalisation rules to limit the level of debt a New Zealand subsidiary can have.

The thin-capitalisation rules place an upper limit on the amount of debt that multi-nationals can stack into their New Zealand operations. Once this limit is breached, any additional interest deductions are denied. Recent reform has focused on strengthening these rules. In 2011 the thin-capitalisation limit on investment into New Zealand by non-residents was reduced from a 75 percent debt-to-asset ratio to a 60 percent ratio.

As part of Budget 2013, the Government announced measures to further improve the effectiveness of the thin-capitalisation rules. At present the rules apply only to companies that are majority owned (50 percent or more) by a single non-resident. However, there are situations where multiple non-resident investors, such as private equity investors, can coordinate and act together as if they were a single non-resident investor. The rules are being extended to apply to these situations where investors act together. In addition, shareholder debt will be excluded from the "worldwide group" test, as this ensures the rules are still effective in situations where the ultimate investors have little external debt. These measures will apply from the 2015/16 income year.

There may also be other areas, such as with financial intermediaries where, as was the case previously with banks, the existing thin cap rules do not enable an appropriate limitation on the debt funding of the entity.

While the thin-capitalisation rules limit levels of debt, transfer pricing rules can be used to challenge related-party transactions that are not conducted on commercial "arm's-length" terms (such as excessive interest rates). If the price (including an interest rate) for a related-party transaction is too high, we can replace it with the "arm's-length" price that would be expected from a similar transaction with a third party.

The concern we have, however, is that transfer pricing is a complex and resource-intensive process, which may only be effective for the most egregious cases. Moreover, there are structures that may allow the "arm's-length" price of debt to be artificially inflated, potentially defeating the intent of the transfer pricing rules.

An alternative approach could be to directly limit the ability to use high-priced debt. For example, many European countries have thin-capitalisation rules that are based on the ratio of interest deductions to earnings, which effectively combines a limit on the level and price of debt into the one test. New Zealand could consider the pros and cons of this type of rule with a view to possibly bolstering our existing thin-capitalisation rules with a similar approach.

As part of its action plan, the OECD will be doing a similar review of the effectiveness of different types of interest limitations (through Action 4 on limiting base erosion via interest deductions and other financial payments). Our involvement in this work will also inform our thinking on what improvements New Zealand could consider.

Another concern in terms of profit shifting using transfer pricing are investors who are "acting together". In such cases the transfer pricing rules may not apply, even though such investors may have the ability to manipulate prices in order to shift profits out of New Zealand. We plan to review the scope of the transfer pricing rules. For example, the scope of application of the transfer pricing rules could be aligned with the recently announced changes to the scope of application of the thin-capitalisation rules described above. Further analysis and consultation would be needed to consider what changes, if any, would be appropriate.

Explore whether New Zealand should restrict interest deductions on hybrid instruments where the interest payment is not taxed in the foreign jurisdiction

A hybrid instrument is an instrument that has both equity and debt characteristics. Commonly these instruments will create a tax deduction in one jurisdiction and corresponding untaxed income in another country. This usually is because the country allowing the deduction views the hybrid instrument as debt and the country receiving the payment views it as equity.

Currently New Zealand allows deductions for some hybrid instruments but not others, depending on whether or not they are part of a tax avoidance arrangement.

Last year we looked at this treatment to determine if it is appropriate. Our conclusion was that the current rules should remain unchanged. However, we noted that Australia had announced that it was planning to change its tax law for hybrid instruments. Depending on how Australia implements this change, it may make it even easier to use hybrid instruments between New Zealand and Australia.

Given this, we may need to explore whether New Zealand needs to tighten its rules on when deductions are allowed on hybrid instruments. We note the issue of hybrid instruments has been identified by the OECD as a key area for further work (Action 2 in the OECD's Action Plan).

Address problems with the application of non-resident withholding tax to related party debt

There are two ways that we tax non-residents who earn income in New Zealand. We tax net profits by applying company tax. We also apply non-resident withholding tax (NRWT) to gross payments of dividends, interest and royalties made to non-residents.

The company tax and NRWT mechanisms work together to tax non-resident investors at appropriate levels. In the absence of NRWT, there would be an increased incentive and ability for multinationals to shift profits offshore by charging interest on borrowing from a related party. This would reduce the amount of profits that would be subject to company tax in New Zealand.

Inland Revenue has identified a wide range of arrangements that can be used to defer or circumvent NRWT on related-party interest payments. The concern is that such payments can be used to shift profits out of New Zealand and into low-tax countries or entities.

Our concern is that tackling particular arrangements through the disputes process or through specific legislative amendments can be complex and resource-intensive and may not be effective if taxpayers are able to switch to another technique.

We propose to explore options for dealing with these issues in a comprehensive way. Any change would need to be carefully designed and consulted on to ensure it did not lead to unintended outcomes.

More generally, any reform would need to strike an appropriate balance between reducing the potential for companies to shift profits out of New Zealand and ensuring that New Zealand companies can raise funds for investment, particularly in cases where the funding is ultimately sourced from third-parties.

Removing tax advantages from certain investment vehicles and effective taxation of offshore investments

Explore the need for an anti-arbitrage rule for offshore entities who seek double non-taxation of income or double deductions of expenditure by taking advantage of differences between countries' tax rules.

Inland Revenue investigators have identified revenue risks associated with the use of offshore hybrid entities, which are treated as a separate company for foreign tax purposes but are considered to belong to the New Zealand investor (for example, are seen as a partnership) for New Zealand tax purposes. This type of offshore investment can be used to claim the same deduction in two countries. For example an interest payment would be deductible for the foreign company and also deductible for the New Zealand investor. The ability to claim such double deductions can lead to additional deductions being taken in New Zealand and a corresponding reduction in New Zealand income tax.

Some other countries prevent these situations from arising by having anti-arbitrage rules for offshore hybrid entities. For example, they classify offshore entities in a way that is consistent with the classification in the country where the entity is formed. Australia has a rule that treats offshore hybrid entities as partnerships for Australian tax purposes.

It is important that any measure New Zealand develops is compatible with approaches taken in other countries. The OECD's action plan includes reviewing hybrid entities and other hybrid mismatches. This review will help guide our work in this area.

Examine incoherence relating to different tax treatment of "look through vehicles" and structures

New Zealand has a variety of vehicles that are either legally or effectively fiscally transparent. That is, the vehicle or structure enables income from an investment to "flow through" to an investor without any tax imposed at the level of the vehicle. Cross-border, these vehicles can potentially allow overseas investors to earn foreign income via New Zealand without any New Zealand tax. These vehicles include some limited liability companies, look-through companies (LTCs), limited partnerships (LPs), foreign portfolio investment entities (foreign PIEs) and foreign trusts (discussed below).

The concern we have is that different tax treatments or consequences arise depending on the type of vehicle used for the investment. In other words, there is a lack of overall coherence across the different sets of rules, and we think this should be explored further.

More specifically, rules that apply to protect the New Zealand tax base when either a foreign PIE or ordinary New Zealand company is used, may not apply when an LTC or LP is used.

For instance, in 2011 the Government decided to introduce "foreign PIEs" that allow foreign investors to earn foreign income tax-free via New Zealand. But entities must meet certain criteria to become foreign PIEs and are subject to a number of base protection rules (as are companies).

Similarly, under some of New Zealand's tax treaties, a New Zealand subsidiary is able to pay a dividend to a non-resident parent company without paying any NRWT. If that dividend was funded by exempt foreign active income, no New Zealand tax will have been payable. The result is effective flow-through treatment. However, the New Zealand tax base is protected in this scenario by a number of measures that are designed to prevent profit shifting and other abuses, including:

- the active/passive distinction in the CFC rules
- the thin-capitalisation rules, which limit the amount of interest deductions the New Zealand company can make against any New Zealand income
- limitations on the use of foreign losses to offset New Zealand income
- "anti-treaty-shopping" rules in our tax treaties, which mean that artificial investment structures cannot access the lower NRWT rates
- exchange-of-information articles in our treaties that would allow us to obtain relevant information regarding the non-resident shareholder.

The base protection rules that are relevant to foreign PIEs and to New Zealand companies with foreign shareholders or offshore investments don't always apply to investors in New Zealand LPs or LTCs. This may be because when LPs and LTCs were introduced, it was not expected that they would be used by foreign investors earning foreign income. However, because LPs and LTCs can be substituted for companies, they can be used to avoid the base protection rules that apply to ordinary companies. That is, they can be used to achieve tax results that could not be obtained through the use of a company or a foreign PIE. We consider that this apparent incoherence in the tax system should be examined.

Design the active income exemption for offshore branches to ensure it does not facilitate profit shifting through repatriation of losses

New Zealand companies looking to expand into new markets will normally adopt one of two structures. The firm may set up or acquire a separate company in the foreign country, such as a subsidiary or a joint venture with a foreign investment partner. Alternatively, the company may set up a branch office in the foreign country, which would still be part of the New Zealand company.

In 2009, offshore companies controlled by New Zealand investors were granted tax relief through a new active income exemption. Most business income earned through an offshore subsidiary is no longer subject to New Zealand tax. Passive income is still taxable which limits the ability to use foreign subsidiaries for profit shifting. Similarly, business losses incurred by the offshore subsidiary would not be available to the New Zealand company. The overall effect of these reforms was to bring New Zealand's international tax rules into line with international norms. In 2011, the new rules were extended to joint ventures and other offshore companies that New Zealand companies had a substantial interest in but did not control.

Officials are currently preparing an issues paper on extending the same tax treatment to New Zealand companies which operate offshore branches. This will put New Zealand companies with offshore branches on an equal footing with New Zealand companies with offshore subsidiaries. That is, active business conducted through offshore branches will be exempt from New Zealand tax.

What this also means is that key base maintenance features that apply under the new international tax rules will be extended to the new offshore branch rules. Under both the existing active income exemption available for offshore subsidiaries, and the proposed exemption for offshore branches, the "passive" income of the business (such as interest, royalties and rents) remains liable for tax. This removes the incentive that firms would otherwise have to shift this highly mobile income out of New Zealand and into a low-tax jurisdiction.

Importantly, net losses of active branches would become non-deductible in New Zealand. Currently, net losses may be deductible in the country where the branch is located and in New Zealand.

This would also prevent a common tax planning technique, where foreign operations by a New Zealand company are first undertaken in branch form, generating losses deductible in New Zealand, but then shifted to company form when the business becomes profitable, so the profits of the same activity are not subject to New Zealand tax.

It also follows that New Zealand companies with interests in offshore companies are not able to offset New Zealand income with losses generated in those entities. Offshore branches will be subject to similar rules to prevent their losses being used to reduce New Zealand income.

Furthermore, New Zealand firms with significant shareholdings in offshore companies are also subject to the thin capitalisation rules. These rules place a cap on the amount of interest that can be deducted against New Zealand income. The rules will be extended to New Zealand firms with offshore branches.

Overall, the application of the key base maintenance features of the international tax rules is the *quid pro quo* of an active income exemption for branches. It also ensures that the decision of whether or not to invest through a subsidiary or a branch is not affected by tax considerations.

Ensuring tax rules keep pace with changes in the global economy

Review the tax treatment of foreign trusts

New Zealand taxes trusts if the settlor is, or was, a New Zealand resident. Accordingly, the question of whether the income of a trust is in the New Zealand tax base turns on the residence of the settlor as opposed to the trustee. These trust rules were originally intended to prevent New Zealand settlors avoiding tax on foreign-sourced income by establishing trusts with foreign trustees.

It follows from the general design of our trust rules that a "foreign trust" is a trust that does not have a New Zealand-resident settlor. Consistent with the general policy of not taxing the foreign-sourced income of a non-resident, the trustee income of a foreign trust is not taxable in New Zealand if it has a foreign source. (A foreign trust is therefore only taxed on New Zealand-sourced income, or if it has New Zealand-resident beneficiaries.) A foreign trust may be established under New Zealand law and/or be administered from New Zealand. It may also have one or more New Zealand resident trustees.

The fact that New Zealand does not tax the foreign income of foreign trusts has resulted in the development of a significant "offshore trust" industry in New Zealand. Other factors also contribute to the development of this industry, such as the fact that New Zealand is a stable, English-speaking country, with a strong rule of law and a well-developed body of trust case law.

There is no central registry for trusts in New Zealand. Given the size of the offshore industry that has developed, Inland Revenue introduced disclosure and record-keeping requirements for foreign trusts in 2006. These rules were intended to maintain transparency and to enable us to fulfil our exchange-of-information obligations under our tax treaties.

However, our foreign trust rules continue to attract criticism, including claims that New Zealand is now a tax haven in respect of trusts. This is largely because the mismatch between our rules and those of other countries may result in income not being taxed either in New Zealand or offshore. To protect our international reputation, it may be necessary to strengthen our regulatory framework for disclosure and record-keeping. This would result in increased administration costs for Inland Revenue and divert compliance resources away from the general business of collecting New Zealand tax. This, in turn, raises the question of whether our foreign trust rules are sustainable. We will report to you on this matter, including whether keeping the existing tax treatment of foreign trusts is sustainable in the long term.

Explore options to collect GST on goods and services bought online

The internet has made it possible for certain business activities (such as internet sales) to be performed anywhere in the world.

The OECD's action plan includes a project (action 1) to consider whether special rules are needed to tax digital goods and services. The OECD will establish a special taskforce on the digital economy will look at a range of income tax issues, as well as "how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services."

Inland Revenue, the Treasury and the New Zealand Customs Service are currently preparing an issues paper examining the growth of online shopping, its impacts on the tax system, and the potential options for improving the collection of GST on online sales. This work includes looking at physical goods that are purchased from offshore websites as well as at digital goods and services.

The issues paper will be released later this year and is intended to be the starting point for a full and open discussion on the issue. Feedback received on the paper will inform how we proceed.

Annex 2

Improving disclosure of tax information

Consider introducing a code of practice for large corporates

Codes of practice are a form of voluntary self-regulation where organisations commit to a set of principles that promote good behaviour. The codes are typically brief documents that are high-level and aspirational rather than detailed and prescriptive. Codes for large corporates have been introduced in other countries, including the United Kingdom, South Africa and Spain.

In 2009, the UK introduced the Code of Practice on Taxation for Banks, which encouraged banks to follow the spirit as well as the letter of the law. The code asks banks to:

- adopt adequate governance to control the types of transactions they enter into
- not undertake tax planning that aims to achieve a tax result that is contrary to the intentions of Parliament
- comply fully with all their tax obligations
- maintain a transparent relationship with HM Revenue & Customs.

By November 2010, the top 15 banks in the UK had adopted the voluntary code. By May 2013, over 250 institutions had signed up.

Codes of practice work best when they are transparent and visible. Organisations that sign up can publicise their adoption of the code as evidence of their good behaviour. Investors and consumers may question organisations that choose not to adopt the code, or they may choose to only invest in code-compliant organisations. Investors, consumers and media will be able to use the code as a framework to challenge decisions made by the organisation when those decisions appear contrary to the principles of the code.

Improving information disclosure for large companies

New Zealand's disclosure requirements are light compared to those of other jurisdictions. While most large corporates provide their financial statements with their returns, this information is not easily scrutinised, and Inland Revenue is unable to efficiently or effectively carry out in-depth analytical work. As these statements do not follow a prescribed format or contain a standard set of information, Inland Revenue often needs to request additional information from taxpayers. This places additional compliance costs on businesses, which, as the requests are made on an ad-hoc basis, can be difficult to plan for.

Inland Revenue envisages a short (one or two page) electronic declaration that would collect essential information only. The information could include:

- key performance metrics
- specific high-risk items (for example, cross-border interest payments)
- group membership details.

Additional compliance costs can be minimised by focusing on information that is already collected in their structure charts, financial statements and tax reconciliations. This targeted approach would compare favourably with other jurisdictions. Australia, for example, requires a very detailed 13-page disclosure from any business with overseas dealings.

In the BEPS action plan, the OECD has recommended that countries establish methodologies to collect and analyse data on the scale and economic impact of BEPS. Receiving this additional information from large corporates and multinationals will help New Zealand meet this action point.

Requiring large corporates to file their tax returns earlier

Most large corporates, including multinationals, must file their tax returns by 31 March following the end of the tax year. Depending on their balance date, this gives them six to 18 months from the end of their accounting year to prepare their returns. This length of time is generous compared to other jurisdictions.

Large corporates will generally have finalised their financial accounts well ahead of their return filing date in order to satisfy other obligations. These could include tax returns for other jurisdictions, disclosures to shareholders and returns to the Companies Office. The Financial Reporting Bill currently before the House proposes to give large companies just five months to file their annual report to the Companies Office.

Earlier filing would allow faster detection of transactions and trends that may highlight specific risks to the tax base which will lead to earlier investigations and quicker remedial law changes if required.

Aligning AIL information disclosure with NRWT disclosure requirements

Another area where information disclosure could be improved is when the approved issuer levy (AIL) is paid. The AIL is an alternative to paying NRWT on interest payments to non-resident lenders who are not related to the New Zealand borrower.

Taxpayers do not currently file NRWT withholding certificates in cases where they pay the AIL. It is proposed that AIL payers should be required to file an NRWT withholding certificate at the end of each tax year. This will make it easier for Inland Revenue to verify the correct application of the NRWT and AIL rules and to fulfil exchange-of-information requests under our tax treaties.

Annex 3

Relationship between the OECD's action plan and New Zealand's existing tax rules

BEPS technique	OECD action item	Corresponding New Zealand tax rules
Excessive debt funding or interest deductions	3	Thin-capitalisation rules Transfer pricing rules
Shifting mobile income or assets offshore	4	Rules for controlled foreign companies and foreign investment funds
Manipulating prices in related-party transactions	8–10	Transfer pricing rules
Hybrid mismatches (These occur because countries have different tax rules for distinguishing between debt and shares or companies and partnerships)	2	Taxing/reclassifying dividends that are equivalent to debt Stapled stock rules Double tax agreements with fiscally transparent entity provisions
Artificial business structures that enable economic activity to be carried out with no taxable presence	7	Source rules and permanent establishment
Structuring into lower withholding tax rates on cross-border payments of dividends, interest and royalties.	6	NRWT rules Double tax agreements with anti-treaty shopping rules