

Taxation (Neutralising Base Erosion and Profit Shifting) Bill

Commentary on the Bill

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Overview of the Bill

BILL OVERVIEW

Since late 2012, there has been significant global media and political concern about evidence suggesting that some multinational corporations engage in aggressive tax planning strategies to pay little or no tax anywhere in the world. These strategies are known as base erosion and profit shifting or “BEPS”.

The issue of BEPS formed part of the G20 agenda in 2013, who asked the OECD to report back to it with global strategies to address international concerns. The end result was the adoption of a OECD/G20 15-point Action Plan recommending a combination of domestic reforms, tax treaty changes, and administrative measures that would allow countries to strengthen their laws in a consistent manner and work together in combatting BEPS.

Recognising our own vulnerability to BEPS and the value of working cooperatively, New Zealand actively participated in the OECD/G20 project, which was finalised at the end of 2015. In June 2016, in response to the OECD’s BEPS work, the New Zealand Government released its own BEPS programme to address BEPS issues in New Zealand.

New Zealand’s response to BEPS is generally aligned with Australia’s. It is also broadly consistent with the OECD/G20 Action Plan, although the specific proposals are tailored for the New Zealand environment. In some instances, New Zealand’s existing tax laws are already consistent with OECD recommendations. In other cases, however, tax treaty and domestic law changes are required to address BEPS.

The measures proposed in this Bill will prevent multinationals from using:

- artificially high interest rates on loans from related parties to shift profits out of New Zealand (interest limitation rules);
- hybrid mismatch arrangements that exploit differences between countries’ tax rules to achieve an advantageous tax position;
- artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand; and
- related-party transactions (transfer pricing) to shift profits into offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore.

The Bill makes amendments to the Income Tax Act 2007 and the Tax Administration Act 1994.

Each provision of the Bill comes into force on the date specified in the Bill for that provision. For most provisions this is income years beginning on or after 1 July 2018.

Interest limitation rules

OVERVIEW

The use of debt is one of the simplest ways of shifting profits out of New Zealand. Robust rules limiting the use of debt (and limiting interest payments on that debt) are therefore important base protection measures.

In March this year the Government released the discussion document *BEPS – strengthening our interest limitation rules* proposing two key changes to these rules:

- a new method for limiting the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower (referred to as the interest rate cap); and
- a change to how allowable debt levels are calculated under the thin capitalisation rules (referred to as an adjustment for non-debt liabilities).

While submitters acknowledged the need to respond to BEPS concerns, many submitters did not support the specific proposals put forward. The government has refined the proposals to address submitters concerns including better targeting the proposals at borrowers at a high risk of BEPS.

The methodology proposed in this Bill is a better way of achieving the interest rate cap's objective. Like the cap, this approach will generally result in the interest rate on the related-party debt being in line with that facing the foreign parent. This is because, under the rule, debt will generally be required to be priced on the basis that it is “vanilla” (that is, without any features or terms that could push up the interest rate) and on the basis that the borrower could be expected to be supported by its foreign parent in the event of a default.

Implementing these restrictions in legislation will address the problem that the transfer pricing guidelines, in so far as they apply to related-party debt, are open to interpretation, subjective, and fact intensive in their application.

The interest rate cap as initially proposed in the discussion document will continue to be available as a safe harbour. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable. This is expected to be an attractive option to many companies as it is both simple and provides certainty.

The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand (“deductible debt”). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer's assets as reported in its financial accounts (generally, debt up to 60 percent of the taxpayer's assets is allowable).

The Bill proposes changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

The core objectives of the thin capitalisation rules are better served with a non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a

taxpayer is limited to a commercial level of debt. A third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities. Moreover, the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company.

Certain deferred tax liabilities have been carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept – accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. However, deferred tax liabilities can also represent technical accounting entries that do not reflect tax on current accounting profits will be payable in the future.

The Bill also proposes a number of other changes to the thin capitalisation rules. One of these proposals is a special rule for infrastructure project finance. This proposal will allow full interest on third-party debt to be deductible even if the debt levels exceed the thin capitalisation limit if the debt is non-recourse with interest funded solely from project income. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously.

Further minor changes are:

- the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of \$1 million or less, will also be made available to foreign-controlled taxpayers provided they have no owner-linked debt;
- when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt will be denied to the extent the entity's debt level exceeds 60 percent;
- clarifying when a company can use a value for an asset for thin capitalisation purposes that is different from what is used for financial reporting purposes;
- introducing an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of a year to circumvent the measurement date rules; and
- clarifying how the owner-linked debt rules apply when the borrower is a trust.

RESTRICTED TRANSFER PRICING

(Clauses 35, 37 and 43(20))

Summary of proposed amendment

The Bill proposes new rules requiring related-party loans between a non-resident lender and a New Zealand-resident borrower to be priced using a restricted transfer pricing approach. Under these rules, specific rules and parameters are applied to inbound related-party loans to:

- determine the credit rating of New Zealand borrowers at a high risk of BEPS, which will typically be one notch below the ultimate parent's credit rating; and
- remove any features not typically found in third-party debt in order to calculate (in combination with the credit rating rule) the correct amount of interest that is deductible on the debt.

Separate rules will apply for financial institutions such as banks and insurance companies.

Application date

The amendments are proposed to apply to income years starting on or after 1 July 2018.

Key features

Proposed new section GC 6(1C) provides for the rules to restrict interest deductions from a non-resident on related-party debt or a loan from a person in the same control group. "Related-party debt" is an existing term in the NRWT rules in section RF 12I while a "control group" is a new term used throughout the Bill proposals and defined in proposed section FH 14.

The rules, where they apply, will alter the terms and conditions of a borrower and/or an instrument considered before applying the general transfer pricing rules, including the amendments to transfer pricing also proposed in the Bill and discussed elsewhere in this commentary.

The rules are contained in proposed sections GC 15 to GC 18:

- Section GC 15 sets out how the rules operate and also defines an "insuring or lending person" as the rules operate differently for these persons.
- Section GC 16 calculates how the credit rating of a borrower, other than an insuring or lending person, may be adjusted.
- Section GC 17 calculates how the credit rating of an insuring or lending person may be adjusted.

- Section GC 18 disregards certain features of a financial arrangement for the purpose of calculating an interest rate.

Background

New Zealand's thin capitalisation rules limit the amount of deductible debt a company can have, rather than directly limiting interest deductions. In order for the rules to be effective at actually limiting interest deductions in New Zealand to an appropriate level, allowable interest rates on debt also need to be limited.

Historically this limitation has been achieved through transfer pricing. However, this approach has not been wholly effective.

The transfer pricing rules require taxpayers to adjust the price of cross-border related-party transactions so they align with the arm's length price that would be paid by a third party on a comparable transaction. The arm's length interest rate on a debt is affected by a number of factors, including its term, level of subordination, whether any security is offered, and the credit rating of the borrower.

This Bill also proposes to update and strengthen New Zealand's transfer pricing rules including adopting economic substance and reconstruction provisions similar to Australia's rules. The proposed transfer pricing rules would disregard legal form if it does not align with the actual economic substance of the transaction. They would also allow transactions to be reconstructed or disregarded if such arrangements would not be entered into by third parties operating at arm's length.

Even with these stronger transfer pricing rules, transfer pricing will not be the most effective way to prevent profit shifting using high-priced related-party debt.

When borrowing from a third party, commercial pressures will drive the borrower to try to obtain as low an interest rate as possible – for example, by providing security on a loan if possible, and by ensuring their credit rating is not adversely affected by the amount being borrowed.

These same pressures do not exist in a related-party context. A related-party interest payment, such as from the New Zealand subsidiary of a multinational to its foreign parent, is not a true expense from the perspective of the company's shareholders. Rather, it is a transfer from one group member to another. There are no commercial tensions driving interest rates to a market rate. Indeed, it can be profitable to increase the interest rate on related-party debt – for example, if the value of the interest deduction is higher than the tax cost on the resulting interest income.

In addition, related-party transactions are fundamentally different to third-party transactions. Factors that increase the riskiness of a loan between unrelated-parties (such as whether the debt can be converted into shares or the total indebtedness of the borrower) are less relevant in a related-party context. For example, the more a third party lends to a company, the more money is at risk if the company fails. However, the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with related-party debt or equity.

Some related-party loans feature unnecessary and uncommercial terms (such as being repayable on demand or having extremely long terms) that are used to justify a high interest rate. Simply making the related-party debt subordinated or subject to optionality may also be used as justifications for a higher interest rate. In other cases, a very high level of related-party debt may be loaded into a New Zealand subsidiary to depress the subsidiary's credit rating, which also is used to justify a higher interest rate.

It can be difficult for Inland Revenue to challenge such arrangements under the transfer pricing rules as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and a similarly high interest rate. With the proposed stronger transfer pricing rules, the taxpayer would have to provide evidence that the legal form was consistent with the economic substance and that a third party operating at arm's length would agree to enter the arrangement. These new requirements should limit the use of artificial or commercially irrational funding arrangements. However, these still provide scope for taxpayers to choose to borrow from related parties using higher priced forms of debt than they would typically choose when borrowing from third parties.

In addition, the highly fact dependent and subjective nature of transfer pricing can make the rules complex and uncertain to apply. Assessing compliance with the arm's length principle requires very detailed and specific information and analysis of how a comparable transaction between unrelated parties would have been conducted. This makes complying with the transfer pricing rules a resource-intensive exercise which can have high compliance costs and risk of errors. Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue.

New Zealand is not alone in these concerns. The OECD's final report on interest limitation rules notes that thin capitalisation rules are vulnerable to loans with excessive interest rates. This was one of the reasons behind the OECD favouring the earnings before interest, tax, depreciation and amortisation (EBITDA) approach to limit interest deductions.

Detailed analysis

Borrower's credit rating

A borrower that is subject to the proposed rules will follow the process set out below in order to arrive at one of the following long-term issuer credit ratings:

- Group rating: the higher of the parent's credit rating minus one notch or the borrower's own rating.
- Borrower's credit rating: the borrower's own rating.
- Restricted credit rating: the borrower's own rating if they had no higher than 40 percent debt and the credit rating cannot be lower than BBB-.

The group rating in proposed section GC 16(9) has been referred to in earlier documents on these proposals as the safe harbour. It will apply where the borrower has an identifiable parent and either represents a high BEPS risk or chooses to use it to reduce compliance costs. A New Zealand borrower's rating, in comparison with

their foreign parent rating, is reduced by the smallest division within the credit rating categories, commonly referred to as one notch (for example, from AA to AA- or AA- to A+).

The borrower's credit rating in proposed section GC 16(7) is the rating that will apply to the borrowing including any implicit parental support. This is the rate the borrower should be using under the current rules. It will continue to be available where the borrower represents a low BEPS risk.

The restricted credit rating in proposed section GC 16(8) will apply where the borrower does not have an identifiable parent and represents a high BEPS risk. This is based on the borrower's standalone rating but adjusted to reduce their debt level to 40 percent if it is above this and subject to a BBB- minimum, or equivalent given by a rating agency approved by the Reserve Bank.

The Reserve Bank approves rating agencies for their non-bank deposit taker rules which are published at <https://www.rbnz.govt.nz/regulation-and-supervision/non-bank-deposit-takers/requirements/credit-ratings>.

There are four rating agencies currently approved by the Reserve Bank. BBB- is the lowest investment grade credit rating by Standard & Poor's, Fitch, and Equifax Australasia and is equivalent to a Baa3 Moody's rating.

What is a high BEPS risk?

A borrower will be moved away from their standalone credit rating when they have a high BEPS risk. This will occur when at least one of three factors is present:

1. A high leverage ratio

A borrower has a high leverage ratio when they have more than 40 percent debt unless their debt percentage is within 110 percent of the leverage ratio of their worldwide group under section GC 16(1)(e)(ii). Where there is no identifiable parent the 110 percent safe harbour cannot apply so the relevant test is in section GC 16(1)(b)(ii).

When a borrower is required to calculate their leverage ratio this may not be on a thin capitalisation measurement date. To reduce compliance costs of doing this calculation, section GC 16(5) allows the borrower to estimate their leverage ratio by making appropriate adjustments to the calculations done on the most recent measurement date rather than having to re-do the entire calculation. Appropriate adjustments are intended to be including the effect of the new loan as well as any actions related to that wider arrangement such as using the loan to repay an existing loan or purchase a new asset.

2. Borrowing from a low tax rate jurisdiction different from the ultimate parent

Borrowing from a low tax jurisdiction in any country where the lender is subject to a lower than 15% tax rate. These tests are in section GC 16(1)(b)(iii) and (e)(iii) for borrowers without and with an identifiable parent respectively. To be consistent with OECD recommendations, if the lender is in a jurisdiction with a lower tax rate this test is not failed provided the ultimate parent of that lender is

also in that jurisdiction. This qualification is intended to show a high BEPS risk for people routing lending through a tax haven but not simply because a lender group is based in a low tax country. This test also carves out entities that are subject to lower, or no, tax due to a policy decision (such as exempt sovereign wealth funds) by looking at the tax rate that would apply to a company with the usual tax status of a company.

3. A low income-interest ratio

A borrower has a low income-interest ratio when their earnings before interest, tax, depreciation and amortisation (EBITDA) is at least 3.3 times their interest expense. EBITDA is a well-used accounting measure to assess a company's performance without having to consider financing and accounting decisions. An income-interest ratio of 3.3 is consistent with OECD BEPS recommendations. These tests are in section GC 16(1)(b)(iv) and (e)(iv) for borrowers without and with an identifiable parent respectively and refer to the formula in section GC 16(2) which is based on the similar existing formula in section FE 5(1BC).

To address concerns about the volatility of an EBITDA test – due to earnings not necessarily being within the control of the borrower – proposed section GC 16(6) applies the income-interest ratio test looking backwards at any of the following periods:

- the four most recent quarters for which data are available;
- the twelve months prior to the most recent balance date that data are available;
- the two years prior to the most recent balance date that data are available; and
- the three years prior to the most recent balance date that data are available.

Unlike the leverage ratio, the income-interest ratio is calculated without considering the impact of the new loan. The reason for this is it would be much more difficult to accurately forecast future earnings and interest expense including the new loan than to assess the impact of the loan, including any related transactions, on the borrower's balance sheet.

De minimis

To minimise compliance costs of borrowers with smaller amounts of related-party cross-border loans, a *de minimis* has been included in proposed section GC 16(1)(a). A borrower with less than \$10 million of related-party cross-border loans will not have to consider the credit rating adjustment part of the proposed rules and will apply the borrower's credit rating as they do now. This \$10 million threshold is calculated on the date the new rules apply for existing loans and each time a loan is entered into or extended.

If the *de minimis* applies to a loan it will continue to apply to that loan in future years even if the *de minimis* is not satisfied in those future years unless the loan is renewed,

extended or renegotiated. The borrower will have to consider whether the de minimis applies each time they enter into a new related-party cross-border loan.

An equivalent de minimis also applies for proposed section GC 18 which is discussed further below.

Implicit parental support

When determining a borrower's own credit rating to calculate the borrower's credit rating it will be necessary for the borrower to include any implicit support provided by being a member of the foreign parent's worldwide group. This is consistent with the OECD transfer pricing guidelines¹ as demonstrated in paragraphs 1.157 and 1.164 to 1.167 of those guidelines, as reproduced below:

1.157 Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors...

Example 1

1.164 P is the parent company of an MNE group engaging in a financial services business. The strength of the group's consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, i.e. a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

1.165 Assume that S borrows EUR 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows EUR 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender (i.e. an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S's other borrowings including the simultaneous loan to S from T.

1.166 Under these circumstances the interest rate charged on the loan by T to S is an arm's length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from S's group membership alone and not from any deliberate concerted action of members of the MNE group.

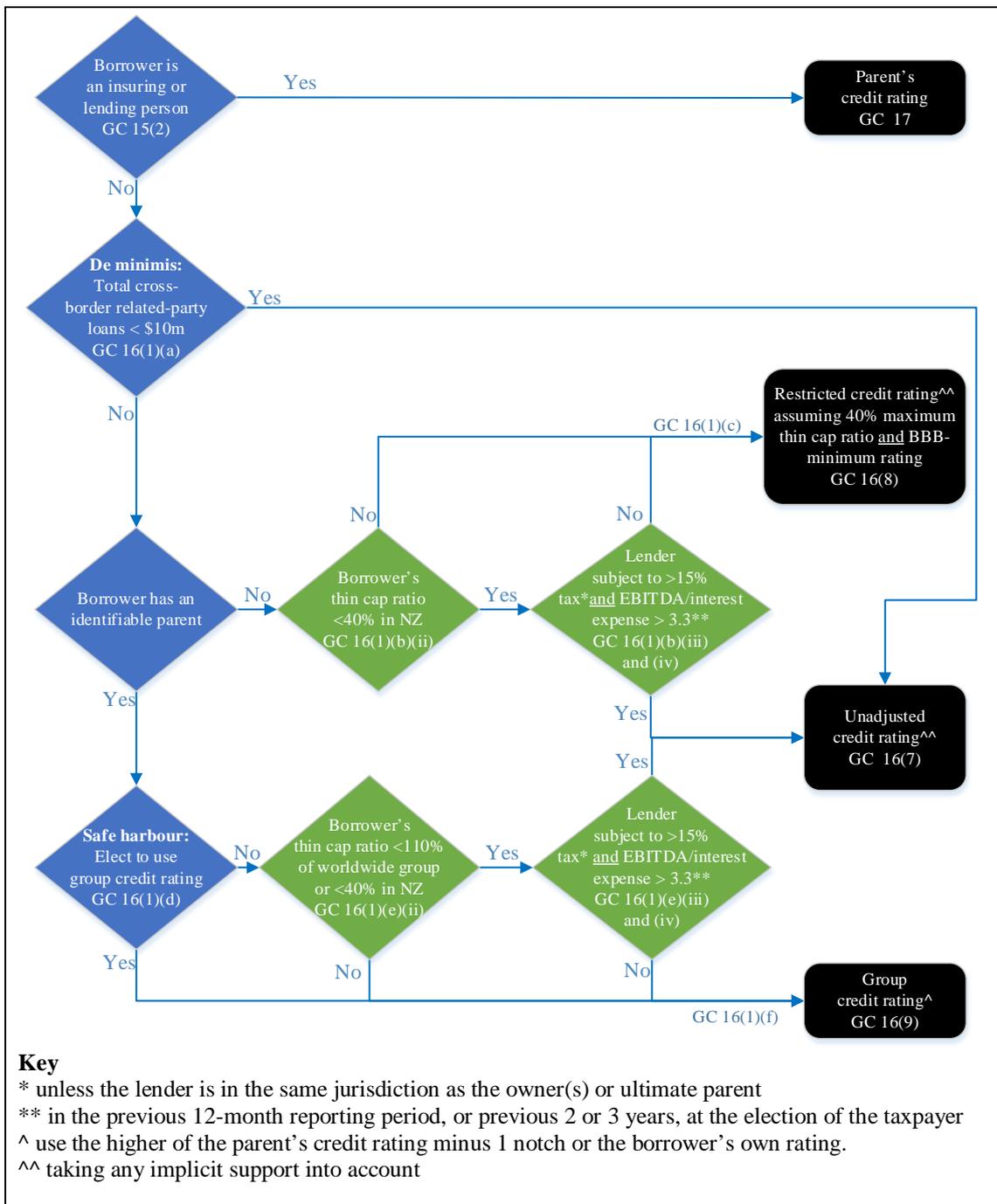
Example 2

1.167 The facts relating to S's credit standing and borrowing power are identical to those in the preceding example. S borrows EUR 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without

¹ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017).

any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA. The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

Figure 1: Flowchart 1 - Determining the credit rating to use for restricted transfer pricing



Ignoring surrounding circumstances, terms and conditions

Aside from making the borrower appear riskier, the other way interest rates can be inflated is by imposing conditions on the lending that would not normally be found in standard third-party debt. To mitigate this risk, the following features, subject to the exemptions below, will be disregarded when considering the pricing of a particular instrument:

1. The term of the loan being greater than five years

Almost all bank debt and the majority of third-party bond issues are for a term of five years or less. Due to a (generally) positive sloping yield curve and the lack of comparables with terms of over five years, debt with very long duration can be priced higher than equivalent shorter terms. If the term of the loan is more than five years, proposed section GC 18(3) and (7)(b) will price it as if its term is five years unless an exception applies. This pricing should apply for the term of the loan. Further detail is provided on this provision below.

2. Subordination

Subordination is where an instrument ranks behind other instruments in the event of default. This reduces the chance of the creditor receiving all their money back in the event the borrower runs into financial difficulty and can be used to justify a higher interest rate. Often in a related-party context, any subordination will not affect the amount the parent would receive in the event the subsidiary failed. Arrangements with subordination will have that subordination disregarded by proposed section GC 18(2)(g) for the purpose of calculating the price.

3. Exotic features

Exotic features are those generally not seen with third-party lending. Proposed section GC 18(2) provides a list of features that will be disregarded. The types of exotic features that will be disregarded include:

- payment-in-kind or other forms of interest payment deferral;
- options which give rise to premiums on interest rates (for example, on early repayment by the borrower);
- promissory notes or other instruments which do not provide rights to foreclose/accelerate repayment;
- convertibility to equity or other exchange at the option of the borrower; and
- contingencies (for example, where interest is repaid only under certain conditions).

Third party features

While the above features will generally be disregarded under the proposed rules, they will be taken into account under proposed section GC 18(8) if the borrower (or its

foreign parent, if there is one) has a significant amount of third-party debt with that feature.

The extent to which disregarded features should be taken into account depends on the structure of either the borrower's, or its worldwide group's, third-party debt. The presence of related-party debt should not change the overall character of the borrower's debt. That is:

- the borrower's related-party debt can have a disregarded feature in proportion to its third-party debt. For example, if the borrower had \$100m of senior third-party debt and \$50m of subordinated third-party debt, related-party debt that is 2:1 senior:subordinated would be allowable; or
- the character of debt owed by the borrower matches the character of the borrower's parent's third-party debt provided that type of debt is commercially appropriate in the New Zealand context. For example, say on a worldwide consolidated basis the borrower's parent has \$200m of ordinary debt and \$50m of convertible notes. If the borrower has \$40m of ordinary related-party debt, this means that up to \$10m of convertible related-party debt would be allowable (as this means the borrower's debt character – a 4:1 mix of ordinary and convertible debt – would match that of its parent).

In order for the borrower to use its own third-party debt to justify an otherwise disregarded feature, that third-party debt must be significant. That is the related-party debt with a feature cannot be more than four times the third-party debt with that feature. This is to prevent taxpayers agreeing to small amounts of third-party debt in order to justify expensive related-party debt.

Terms greater than five years

Proposed section GC 18(3) to (5) determines whether a term greater than five years is disregarded for the purposes of calculating the interest rate.

Proposed section GC 18(3) includes that the five year term restriction does not apply to instruments that qualify as regulatory capital under proposed section GC 18(9). The reason for this is Tier 2 capital of banks has a minimum term of five years at issue but provides a reduced, and declining, regulatory benefit once it has less than four years remaining to maturity. This provides a commercial incentive to issue Tier 2 capital that has a longer term than five years so will be included in calculating an interest rate. Other regulatory capital of banks, insurers and non-bank deposit takers is already required to be issued for a perpetual term so this exclusion will have no practical effect. This is explained further below.

For other New Zealand borrowers whether a term of greater than five years can be included in calculating an interest rate is determined under a similar process to the general third-party features test above.

Subject to the other conditions explained below, related-party debt will be able to have a term greater than five years if the term is less than or equal to the weighted average term of third-party debt that exceeds five years – either of the worldwide group or the New Zealand group consistent with the general third-party test. This is

defined in proposed section GC 18(5) as the threshold term. The other conditions are consistent with the general third-party test in that:

- The related-party debt with this feature must be in an equal or lesser proportion than third-party debt with this feature – defined as the threshold fraction in proposed section GC 18(4)(b).
- The related-party debt with this feature must be not more than four times the third-party debt with this feature – in proposed section GC 18(7)(b)(ii) and (iii).

If related-party debt is issued with a term greater than the threshold term the term of the related-party debt will be adjusted to the threshold term, rather than five years, provided the threshold fraction and four times tests are satisfied.

Example

Foreign Parent Ltd has debt from third parties of the following amounts and terms:

Loan	Principal	Original term at issue
#1	\$70 million	Less than 5 years
#2	\$10 million	7 years
#3	\$10 million	9 years
#4	\$10 million	11 years
Total	\$100 million	

The threshold term under proposed section GC 18(4)(a)(i) is nine years which is calculated under proposed section GC 18(5) as:

Loan	Term	Term Debt	Total Debt	Threshold Term
#2	7 years	\$10 million	\$100 million	2.3 years
#3	9 years	\$10 million	\$100 million	3.0 years
#4	11 years	\$10 million	\$100 million	3.7 years
Total				9 years

The threshold fraction under proposed section GC 18(4)(b)(i) is \$30 million/\$100 million or 3/10.

NZ Subsidiary Ltd² has existing loans of \$700,000 from Foreign Parent with a term of less than five years. It enters into three further loans with terms over five years on successive days and needs to consider what term will be included for setting the interest rate.

² For simplicity for the purpose of this example disregard the \$10 million de minimis in GC 18(1)(a).

Loan 1

A \$50,000 loan with a term of seven years.

- Section GC 18(7)(a) does not apply as the term of the loan (seven years) does not exceed the threshold term (nine years).
- Section GC 18(7)(b)(i) does not apply as related-party loans having a term of more than five years (\$50,000) as a proportion of total related-party loans ($\$700,000 + \$50,000 = 750,000$) is 6.7 percent which is less than the threshold fraction of 30 percent.
- Section GC 18(7)(b)(ii) does not apply as related-party loans having a term of more than five years (\$50,000) is less than four times the value of worldwide loans with this feature ($4 \times \$30,000,000$).
- Section GC 18(7)(b)(iii) does not apply as the threshold fraction was not determined under subsection (4)(b)(ii).

Therefore the seven year term is not adjusted and is included in calculating the interest rate.

Loan 2

A \$100,000 loan with a term of 11 years.

- Section GC 18(7)(a)(i) is met as the term of the loan (11 years) exceeds the threshold term (nine years).
- Section GC 18(7)(a)(ii) is met as related-party loans having a term of more than five years ($\$50,000 + \$100,000 = \$150,000$) as a proportion of total related-party loans ($\$750,000 + \$100,000 = \$850,000$) is 17.6 percent which is less than the threshold fraction of 30 percent.

Therefore the 11 year term is adjusted to the threshold term of nine years for the purpose of calculating the interest rate.

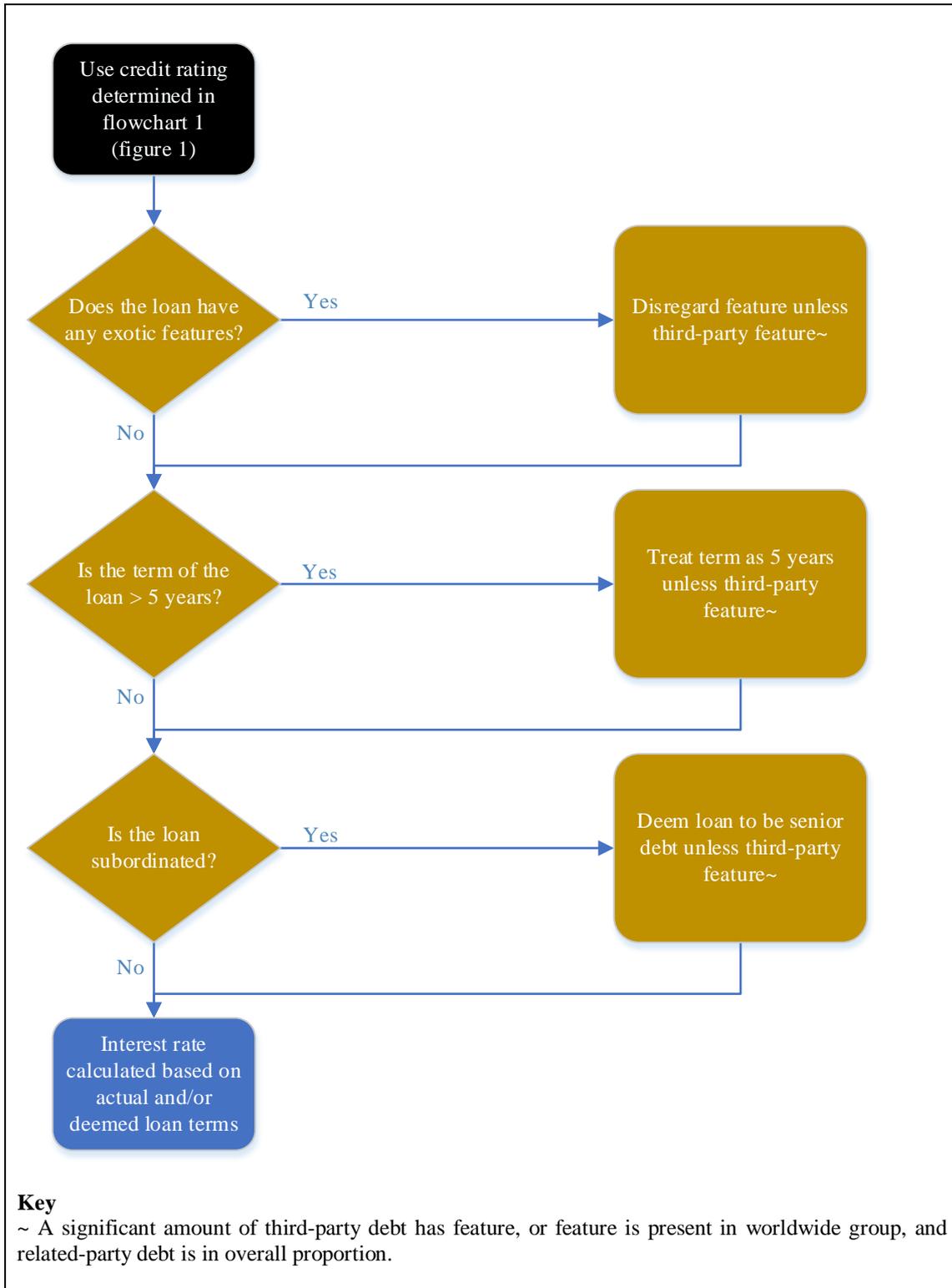
Loan 3

A \$200,000 loan with a term of nine years.

- Section GC 18(7)(a) does not apply as the term of the loan (nine years) does not exceed the threshold term (nine years).
- Section GC 18(7)(b)(i) is met as related-party loans having a term of more than five years ($\$150,000 + \$200,000 = \$350,000$) as a proportion of total related-party loans ($\$850,000 + \$200,000 = \$1,050,000$) is 33.3 percent which exceeds the threshold fraction of 30 percent.

Therefore the nine year term is adjusted to five years for the purpose of calculating the interest rate.

Figure 2: Flowchart 2 - Determining the interest rate on a particular instrument– not for insuring or lending persons



Credit ratings of insuring or lending persons

Financial institutions (referred to in the proposed legislation as an “insuring or lending person”) are required to use their parent’s long-term issuer credit rating rather than the three alternatives above. There are two reasons for this:

- Financial institutions are more integral to their worldwide group in that a default is more likely to affect the risk perception of the worldwide group. This results in a higher level of implicit support.
- Financial institutions apply a different business model with much higher levels of leverage and, as interest is their main income source, calculating earnings before interest is not a suitable measure of economic activity.

An “insuring or lending person” is defined in proposed section GC 15(2) to incorporate the following groups:

- Banks, insurance companies and non-bank deposit takers regulated by the Reserve Bank of New Zealand.
- A member of a group not regulated by the Reserve Bank of New Zealand whose main business is lending to third parties.
- An individual entity or sub-group in the business of lending to third parties where the wider group is in a business other than as a financial institution.

These last two bullet points are dealt with by section GC 15(2)(d) and (e) respectively. The distinction is subsection (e) applies where the main business activity of the group is other than providing funds to unassociated persons but there is a subsidiary that has the main business activity of providing funds to unassociated persons.

One occurrence of this may be a motor vehicle importer which also operates a finance company to allow their customers to lease their products. This will essentially require the group to be split into two for the purpose of applying the proposed rules with the finance company subsidiary having a credit rating under section GC 17 and the remainder of the group applying section GC 16.

Regulatory capital of banks, insurers and non-bank deposit takers

The Reserve Bank requires banks, insurance companies and non-bank deposit takers to hold certain levels of capital to support their continued solvency. For banks, insurance companies and non-bank deposit takers some of this regulatory capital has certain features that result in it being treated as debt with deductible interest for tax purposes.

There are legitimate commercial reasons why these entities would issue regulatory capital to a related party. However, this related-party regulatory capital would not necessarily satisfy the general third-party exception as:

- the foreign parent will often be subject to different regulatory requirements in their home jurisdiction so will have issued instruments with different features; or
- the worldwide group may have a more comprehensive range of activities in their home jurisdiction. For example, a group that operates a bank and an insurance company internationally but only operates as an insurance company in New Zealand.

It is important that the tax rules do not discourage the existence of regulatory capital as to do so would increase the risk of that business being unable to meet its obligations to depositors, policy holders and other creditors.

For banks, insurance companies and non-bank deposit takers the Bill proposes replacing the third-party test with a regulatory capital test. This test will allow a bank, insurance company or non-bank deposit taker to include features in pricing related-party debt if that feature was included so that that instrument qualified as regulatory capital for Reserve Bank purposes.

There are four further areas of detail on this test which are:

- minimum standards;
- terms;
- disqualification; and
- back-to-back loans.

Minimum standards

Banks, insurance companies and non-bank deposit takers maintain regulatory capital above the minimum standards, primarily so they can remain above the standard if a future event, including losses and payments of dividends, causes their level to drop. Banks can also issue different levels of capital depending on what features it has. Tax should not influence these behaviours. Any features that are required to meet the Reserve Bank requirements should be included in pricing even where the entity is over the minimum standard or where it issues a level of capital that has a greater risk than another level of capital.

Terms

Under the current regulatory framework banks can issue Tier 2 capital which, amongst other requirements, must have a minimum original maturity of at least five years. However, when such an instrument has less than five years to maturity the amount that is recognised as regulatory capital is amortised on a straight-line basis at a rate of 20 percent per annum as follows:

Years to maturity	Amount recognised
More than 4	100%
Less than and including 4 but more than 3	80%
Less than and including 3 but more than 2	60%
Less than and including 2 but more than 1	40%
Less than and including 1	20%

Due to this amortisation, banks are incentivised to issue Tier 2 capital for terms exceeding the minimum five years. Proposed section GC 18(3) recognises this by allowing any term of greater than five years to be included in pricing on any

instrument that is recognised as regulatory capital, even though that longer term is not required in order for the instrument to qualify as regulatory capital.

Disqualification

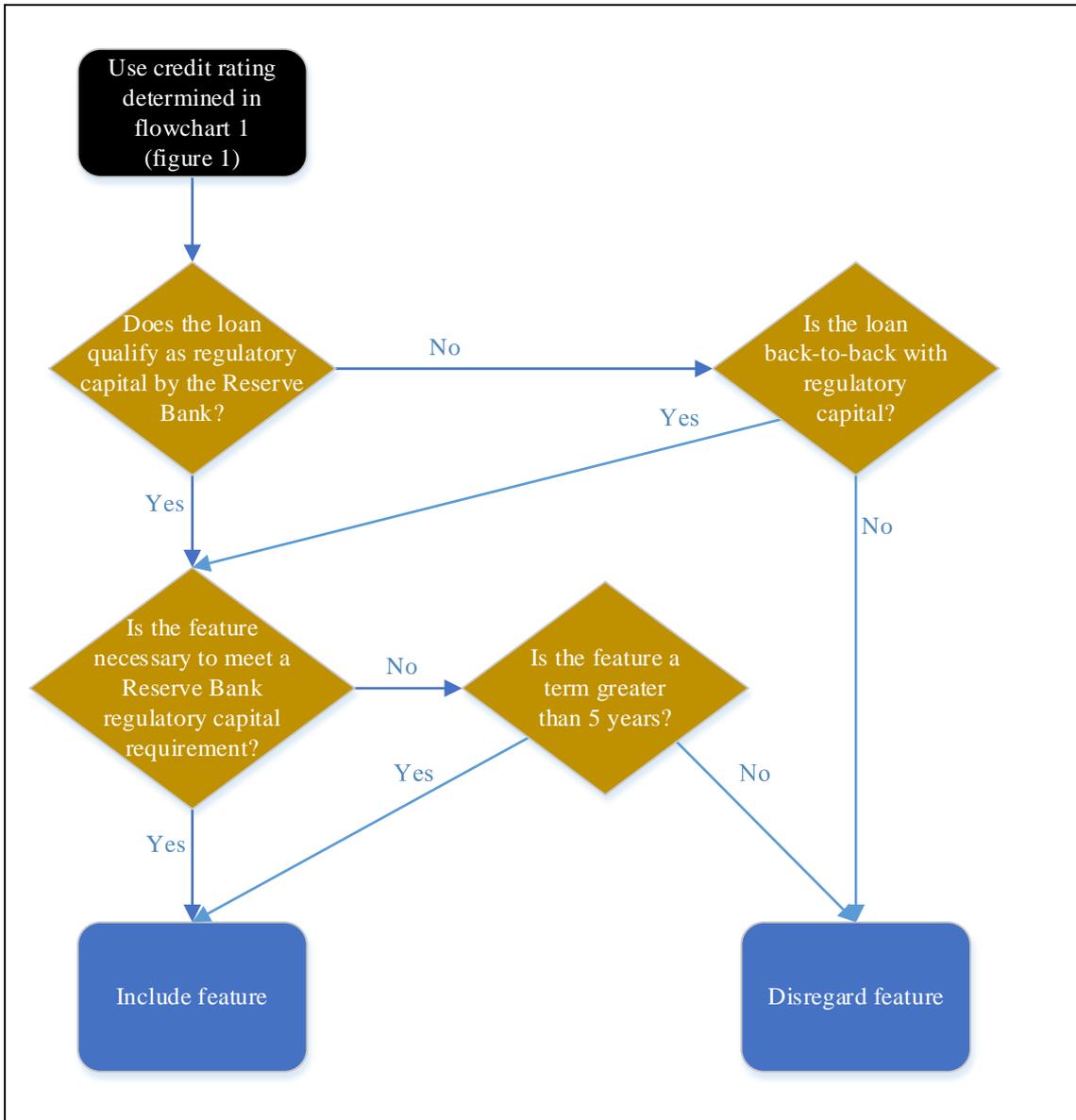
From time to time the Reserve Bank will change the regulatory capital requirements. For example, it is currently consulting on removing the requirement for regulatory capital to convert to common equity in certain circumstances. Where there is a regulatory change there will often be a transitional period where a former regulatory capital instrument will only be partially recognised and eventually it will cease to qualify as regulatory capital. Where this occurs, the bank or insurance company will not necessarily repay the instrument as there may be other commercial reasons to retain it (such as meeting the expectations of external investors). Even where an instrument ceases to qualify as regulatory capital the features that formerly qualified it will still be present. In these circumstances these features will still be included in the pricing so the test is based on the instrument qualifying as regulatory capital when it was entered into rather than any subsequent changes.

Back-to-back loans

Often banks, insurance companies and non-bank deposit takers have an entity, such as a New Zealand holding company or a New Zealand branch of the foreign parent, which is not itself regulated by the Reserve Bank but that raises funds from the worldwide group to on-lend to the regulated entity. A consequence of this is a New Zealand taxpayer may receive high priced debt with features that provide no direct benefit to it as a stand-alone entity but will match the instrument/funding on-lent to a group member which is regulated and therefore the group is provided with a regulatory benefit.

Any features included in an instrument issued by a non-regulated entity that would be necessary for it to qualify as regulatory capital (refer to the tests above) if the entity was a regulated entity will be included in pricing provided that instrument is part of a back-to-back loan to the regulated entity/group.

Figure 3: Flowchart 3 - Determining whether a feature can be included in pricing for banks, insurance companies and non-bank deposit takers



THIN CAPITALISATION

(Clauses 10, 11, 18, 19, 22 to 29, 31, 33 and 43(25))

Summary of proposed amendments

Currently, debt percentages determined under the thin capitalisation rules are based on an entity's debt relative to its gross assets. The Bill proposes to change this, so that debt percentages are based on an entity's assets net of its "non-debt liabilities".

The Bill proposes a number of other changes to strengthen the thin capitalisation rules. These are:

- a de minimis in the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;
- new rules for when a company can use an asset valuation for thin capitalisation purposes that is different from what is used for financial reporting purposes;
- an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of a year to circumvent the thin capitalisation rules; and
- a minor remedial to clarify how the owner-linked debt rules apply when the borrower is a trust.

Application date

These amendments are proposed to apply to income years starting on or after 1 July 2018. A grandparenting provision is proposed for the 110 percent debt threshold for non-residents acting together, which is set out in more detail below.

Key features

The thin capitalisation rules limit the amount of debt a foreign parent can lend to its New Zealand subsidiary. The Bill proposes several changes to strengthen these rules, which relate to the general thin capitalisation regime in subpart FE of the Income Tax Act 2007 as well as consequential changes to the CFC rules in subpart EX. The proposed changes are:

- Modify how a company's total assets are determined for the thin capitalisation rules – that is, to require assets to be determined net of a company's **non-debt liabilities**. Proposed new section FE 16B defines total group-non debt liabilities for a New Zealand group and for a worldwide group. This change is intended to better align New Zealand's thin capitalisation regime with its core objectives and with other countries' thin capitalisation rules.

- Extend the **de minimis** in section FE 6 of the outbound thin capitalisation rules (New Zealand companies with foreign subsidiaries) to the inbound thin capitalisation rules (foreign controlled New Zealand companies).
- Reduce the 110 percent worldwide debt threshold to 100 percent for a New Zealand group controlled by a group of **non-residents acting together** for the purposes of the interest apportionment rule in section FE 6.
- Strengthen the integrity of the rules that allow taxpayers to **value assets** using values not reported in their financial accounts for the purposes of determining total group assets under section FE 16.
- Provide for an **anti-avoidance rule** in proposed new section GB 51B to prevent taxpayers circumventing the thin capitalisation rules by repaying a loan just before a measurement date.
- Amend the owner-linked debt provisions in section FE 18(3B) to ensure they operate correctly for trusts.

Detailed analysis

Non-debt liabilities adjustment

The Bill proposes that in calculating its New Zealand debt percentage, an entity will be required to measure its assets net of its non-debt liabilities, as defined in new section FE 16B, excluding shareholder funding that is akin to group equity.

As this change is proposed to apply to both the inbound and outbound thin capitalisation rules, the Bill proposes consequential amendments to sections EX 20D and EX 20E to ensure the proposed non-debt liabilities adjustment to the thin capitalisation calculation also applies in relation to the CFC rules.

For a borrower's New Zealand group, non-debt liabilities are defined as *all* liabilities as shown in the company's financial accounts that are not counted as debt under section FE 15 except for:

- certain interest-free loans from shareholders;
- certain shares held by shareholders;
- provisions for dividends; and
- certain deferred tax liabilities.

These carve-outs are discussed in more detail below.

Interest-free loans from shareholders

Proposed section FE 16B(1)(b) excludes from non-debt liabilities any financial arrangements providing funding to the company from a shareholder in respect of which no deduction for interest arises if either:

- the funding is advanced pro rata with shareholding; or

- the shareholder (along with any associated persons) holds 10 percent or more of the voting interests in the company.

This exclusion does not include related-party agreements for sale and purchase of property or services (defined in section YA 1 and colloquially known as trade credits), which will therefore be treated the same way as other non-debt liabilities under the proposal.

Preference shares

Shares can be treated as liabilities for accounting purposes in some circumstances (for example, if the shares are redeemable at the holder's option or on a specific date).

Proposed section FE 16B(1)(c) excludes shares held by a shareholder from the definition of a non-debt liability if either:

- the funding is advanced pro rata with shareholding; or
- the shareholder (along with any associated persons) holds 10 percent or more of the voting interests in the company.

Such shares are akin to group equity if they are held pro rata with shareholding, or by a substantial shareholder.

Provisions for dividends

Proposed section FE 16B(1)(d) excludes a provision for dividends from the definition of a non-debt liability because it is similar in substance to an interest-free loan from shareholders.

Deferred tax liabilities

Proposed section FE 16B(1)(e) excludes a deferred tax liability from the definition of a non-debt liability if:

- it arises as a result of the difference between the value of an asset in the financial statements and the amount which is depreciable or deductible for tax purposes;
- it reflects an amount of tax that would not arise if the relevant asset were sold or otherwise realised for the value in the financial statements; and
- the value of the relevant asset in the financial statements takes into account the deduction or depreciation for tax purposes in relation to the asset (rather than the deduction or depreciation recorded in the financial statements).

Proposed changes to section FE 18 introduce a similar definition of non-debt liabilities for a company's worldwide group, being:

- all liabilities (as shown in the company's financial accounts) that are not counted as debt under section FE 18; less
- any owner-linked debt that is excluded under section FE 18(3B), as such debt is effectively treated as equity for the purposes of the worldwide group debt test.

Example

Z Co's balance sheet is as follows:

Assets	100
Interest-bearing debt	20
Non-debt liability – trade credits	10
Interest free loan from parent	20
Equity	50

Z Co's debt for the purposes of the thin capitalisation rules is \$20. Its total liabilities are \$50, but \$20 of this is an interest-free loan from Z Co's parent company. Its non-debt liabilities are \$10 and its thin capitalisation debt percentage under the proposed change is $20 \div (100 - 10) = 22.2$ percent.

De minimis for inbound thin cap

Currently section FE 6(3)(ac) provides a de minimis where a person subject to the outbound thin capitalisation rules will not derive an amount of income (equivalent to any disallowed interest) if they have a group finance cost for a year of less than \$1 million. The de minimis applies partially from \$1 million to \$2 million of group finance cost.

Proposed amendments to section FE 6(3)(ac) extend this de minimis to a person subject to the inbound thin capitalisation rules unless they have owner-linked debt – that is debt from a person with an ownership interest in the entity – under section FE 18(3B).

This proposal is intended to reduce compliance costs for smaller firms.

Worldwide debt test for non-residents acting together

The inbound thin capitalisation rules were extended in 2014, with application from the 2015–16 year, to include non-residents that act together as a group in relation to the way they fund a New Zealand investment and own 50 percent or more of that investment.

The 2014 review also tightened what is known as the “110 percent worldwide debt test” in the inbound rules, which compares the amount of debt in a group's worldwide operations to the debt in their New Zealand operations. The effect of section FE 18(3B), inserted in 2014, is that owner-linked debt (as discussed above) is excluded when calculating the debt level of a company's worldwide operations.

At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level under section FE 5(1)(a) is the greater of 60 percent of its assets and 110 percent of its worldwide debt. Because a company owned or controlled by a group of non-residents acting together has no identifiable parent, the worldwide group is deemed to be the New Zealand group itself under section FE 31D. As such, the 110 percent worldwide debt test is effectively a measure of the New Zealand group's total debt relative to its third-party debt.

This means that shareholders of firms with high levels of third-party debt have been able to invest in New Zealand predominantly through debt. For example, a project funded 90 percent with third-party debt could have nine percent shareholder debt and only one percent equity without breaching the thin capitalisation limit.

Proposed new sections FE 5(1)(ab) and FE 6(3)(e)(iii) will require that when an entity is owned or controlled by a group of non-residents acting together, interest deductions will be denied if the entity has any owner-linked debt and its total debt level exceeds 60 percent. In effect, this means that its allowable debt level would be the greater of 60 percent and 100 percent of its third-party debt rather than 110 percent of its third-party debt under the current rules.

Grandparenting

For entities affected by this change that are above 60 percent total debt and 100 percent of their third-party debt, transitional provisions are proposed in section FZ 8. The entity will be able to continue using their current percentage of third-party debt up to the 110 percent threshold for up to five years from the rules applying. The borrower's current percentage of third-party debt can be calculated at either the date of introduction of the Bill or the thin capitalisation measurement date immediately prior to this.

Example

NZ Co.'s debt level as a percentage of its worldwide debt is 109 percent in year 1. NZ Co. enters into a new loan with a third party in year 2. As a result, its debt level as a percentage of its third-party debt drops to 105 percent (because NZ Co.'s related-party debt level has not changed since year 1). NZ Co.'s maximum debt level under the transitional provisions will stay at 109 percent.

In year 3, NZ Co. repays a number of large loans and, as a result, the debt percentage of its New Zealand group drops to 55 percent. NZ Co. does not need to rely on its grandparented 109 percent of worldwide debt anymore, but is still covered by the grandparenting provisions for the remainder of the five-year period. This means that NZ Co. will not be denied interest deductions if its debt percentage exceeds 60 percent in year 4 unless its debt level also exceeds 109 percent of its worldwide debt.

Other proposals in this Bill, such as the treatment of non-debt liabilities, will increase the thin capitalisation debt percentages for a number of entities. So that the grandparenting provision reflects the position under the new rules proposed in the Bill, the calculations on either measurement date referred to in the paragraph above will measure the percentage of worldwide debt using the amended thin capitalisation rules that apply from the first balance date after 1 July 2018 as if they applied on the measurement date.

Asset valuation

In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative provided that would be allowable under generally accepted accounting principles.

Asset valuations reported in financial statements are subject to a higher level of scrutiny than asset valuations that are adopted solely for thin capitalisation purposes. Moreover, there is a concern that taxpayers may be valuing assets for thin capitalisation purposes without seeking an independent valuation.

Proposed new section FE 16(1BAA) provides that taxpayers can only use the net current value of an asset if they have received a valuation from an independent valuer or the valuation methodology, assumptions and data have been approved by an independent valuer.

Anti-avoidance rule around measurement dates

Section FE 8 provides that a taxpayer's assets and liabilities can be valued for thin capitalisation purposes on a daily, three-monthly or annual basis. An annual measurement date is the simplest and most widely-used of these approaches.

The current legislation has the potential for a taxpayer to use the annual measurement date to effectively breach the thin capitalisation debt limits for up to one year without facing any interest denial, by partly repaying a loan or converting it to equity on or before their balance date.

Existing section FE 11 prevents taxpayers from producing temporary increases or decreases in values if the change or arrangement has a purpose or effect of defeating the intent and application of the thin capitalisation rules. However, this section only applies to changes between measurement dates and does not cover the initial year when an arrangement is entered into.

The Bill proposes amendments to section FE 11 and new section GB 51B to reconstruct certain situations, transactions or arrangements where a taxpayer subject to the thin capitalisation rules substantially repays a loan or, more generally, enters into a transaction near a measurement date with the purpose or effect of manipulating the thin capitalisation rules.

Owner-linked debt when the borrower is a trust

The owner-linked debt provisions in section FE 18(3B) only count debt as owner-linked if the owner has an ownership interest in a member of the group of companies of five percent or more to reduce compliance costs. This test works correctly when the entity is a company but not when it is a trust as settlements on a trust do not convey ownership interests.

Proposed amendments to section FE 18(3B) will only count debt as owner-linked if the owner:

- has a direct ownership interests in a member of the group of five percent or more; or
- has made five percent or more (by value) of the settlements on the trust.

INFRASTRUCTURE PROJECT FINANCE

(Clauses 5, 17, 20, and 43(18))

Summary of proposed amendments

These proposed amendments will provide entities carrying out eligible infrastructure projects a limited exemption from the thin capitalisation rules by allowing them to claim deductions on debt that exceeds the thresholds set out in section FE 5(1).

The debt that is allowed to exceed the ordinary thin capitalisation thresholds under this rule would be limited to third-party debt (or debt that is from an investor but is made in the capacity of a third-party lender) that only has recourse against the assets associated with the infrastructure project and the income arising from those assets.

Application date

The amendments are proposed to apply to income years starting on or after 1 July 2018.

Background

This proposal is intended to improve the competitiveness in the bidding process for eligible infrastructure projects by ensuring that investors are subject to similar levels of thin capitalisation restrictions.

Currently, a New Zealand entity that is owned by a group of non-residents (none of which have a controlling interest in their own right) is unrestricted in how much third-party debt it can take on (provided that debt is not guaranteed by its owners). This exemption does not however extend to other entities. The amendments proposed in the Bill would provide other entities involved in eligible infrastructure projects with an exemption from the thin capitalisation rules, similar to the concessions already provided for non-residents acting together.

Detailed analysis

Public project assets

This exemption would apply only to debt that relates to public project assets – defined in proposed section FE 4B(1), which are assets arising from a project performed under a contract that meets the following criteria:

- The project is established at the request of the New Zealand Government or a public authority.
- The project is to provide, upgrade, or create assets in New Zealand and to operate or maintain those assets.

- The contract is for a period of at least 10 years.
- The public funding relating to the contract is approved by the Minister of Finance.
- The contract provides that the assets are owned by the New Zealand Government or public authority after the completion of the contract.

Public project debt

The proposed exemption would apply only to public project debt – defined in proposed section FE 4B(2). This debt must meet the following criteria:

- The debt is applied to a project in order to give rise to public project assets.
- The debt is secured against a public project asset, or the income derived from public project assets.
- The debt must not be on-lent to a party that is not associated with the performance of the project, unless the on-lending is minor or incidental, such as depositing the debt with a financial institution.
- The debt must give rise to interest expenditure that is incurred in New Zealand.

Threshold debt amount

The threshold debt amount is the amount of debt that an entity carrying on an eligible infrastructure project could have without breaching the existing thin capitalisation threshold. If the amount of public project debt exceeds this amount, only interest on debt that is eligible for the proposed rule would be deductible.

If the amount of public project debt is less than this amount, all interest on the public project debt will continue to be deductible, even if the debt is participant debt or is made on terms that give the creditor recourse over assets or income not related to the project.

Public project participant debt

Public project participant debt, defined in proposed section FE 4B(3) and used in the formula in proposed section FE 7B(4)(i), is public project debt issued by a participant in the infrastructure project that is not made in the capacity of a third-party lender and would not get the benefit of this exemption. This is in line with the existing rule for entities owned by a non-resident owning body, which can get an unlimited amount of third-party debt, but is limited in the amount of owner-linked debt it can take on.

Recourse debt

Recourse debt, defined in proposed section FE 7B(4)(f), is public project debt that is made on terms that give the creditor recourse over assets that are not public project assets or income not derived by those assets. Recourse debt does not get the benefit of this proposed rule.

Excess debt

Excess debt, defined in proposed section FE 7B(4)(b), is public project debt that exceeds the value of the public project assets and would not receive the benefit of this exemption. If, after any participant and recourse debt has been denied a deduction, an entity carrying out an eligible infrastructure project has more public project debt than public project assets, any interest expense associated with that excess debt would be denied.

Scope of exemption

Under proposed section FE 7B(1) this exemption would apply to entities controlled by a single non-resident, partnerships entered into by non-residents, and New Zealand resident entities subject to the outbound thin capitalisation rules. A similar exemption already applies (in effect) where a separate entity is controlled by a group of non-residents.

Where a person has more than one project, each would be treated separately under proposed section FE 7B(5) so that excess debt in one project cannot be sheltered by a below threshold level of debt in a second project.

Example

Infrastructure Co. is building a road in New Zealand at the request of the Government that will be worth \$100m.

Infrastructure Co. has borrowed \$80m from Bank on limited recourse terms to fund the construction of the road. The remaining \$20m of funding is from Infrastructure Co.'s shareholders, who have advanced \$15m of equity and \$5m of debt.

The loan from Bank Co. is not owner-linked debt and is on limited recourse terms, so meets the relevant conditions of this exemption. Infrastructure Co. and the road project also meet all the other requirements.

Infrastructure Co. is able to exceed the 60 percent safe harbour without facing interest denial in relation to its loan from Bank Co. However, the \$5m of shareholder debt does not qualify for the exemption. None of the interest on the shareholder debt would be deductible.

Permanent establishment rules

PERMANENT ESTABLISHMENT RULES

(Clauses 4, 34, 43 (definitions), and 44 to 48)

Summary of proposed amendment

The Bill proposes a new anti-avoidance rule for large multinationals (with over EUR €750m of consolidated global turnover) that structure to avoid having a permanent establishment (PE) in New Zealand.

The proposed rule will deem a non-resident entity to have a PE in New Zealand if a related entity carries out sales-related activities for it here under an arrangement with a more than merely incidental purpose of tax avoidance (and the other requirements of the rule are met). This PE will be deemed to exist for the purpose of any applicable double tax agreement (DTA), unless the DTA incorporates the OECD's latest PE article.³

In addition, under the proposed amendments an amount of income will be deemed to have a source in New Zealand if that income can be attributed to a PE in New Zealand. If a New Zealand DTA applies to the non-resident, the definition of a PE in that DTA will apply for this purpose. If no New Zealand DTA applies to the non-resident, then a new domestic law definition of a PE will apply.

Application date

The amendments are proposed to apply to income years starting on or after the date of enactment of the Bill.

Key features

The proposed amendments introduce a new anti-avoidance rule into New Zealand domestic tax law (PE avoidance rule). The rule will deem a PE to exist in New Zealand for a non-resident if all the following criteria are met:

- The non-resident is part of a large multinational group. The OECD has defined a large multinational group as a group with at least EUR €750m of consolidated global turnover for the purpose of filing Country-by-Country reports. The same revenue threshold is used for the PE avoidance rule.
- The non-resident makes a supply of goods or services to a person in New Zealand.
- A person (the “facilitator”) carries out an activity in New Zealand for the purpose of bringing about that particular supply.
- The facilitator is associated with the non-resident or is commercially dependent on it.

³ This is contained in Article 12(1) of the *Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting (MLI)*

- The facilitator’s activities are more than preparatory or auxiliary.
- The non-resident’s income from the supply is subject to a DTA that does not include the OECD’s latest PE article.
- A more than merely incidental purpose of the arrangement is to avoid New Zealand tax, or a combination of New Zealand tax and foreign tax, for the non-resident.

Under the proposed rule the non-resident will be deemed to make any supplies that are subject to the rule through that PE. The activities of the facilitator in relation to the supply will also be attributed to the PE. The deemed PE will exist for all the purposes of both the Act and the applicable DTA, notwithstanding anything in New Zealand’s DTAs.

The tax consequences of the deemed PE will be determined by the other provisions of the Act and the DTA. For example, New Zealand will have a right to tax the profits attributable to the PE under the business profits article of an applicable DTA.

The anti-avoidance rule may also apply in the context of a third-party channel provider arrangement. This is a single arrangement under which the non-resident supplies goods or services to an unassociated New Zealand resident and the New Zealand resident on-supplies the goods or services to identified New Zealand customers with the assistance of the facilitator. If the proposed rule applies in these circumstances, then the facilitator’s activities will give rise to a PE for the non-resident in respect of its supplies to the third-party channel provider.

The proposed amendments would also introduce a new source rule for PEs. This rule would provide that any income attributable to a PE in New Zealand has a source in New Zealand. To define a PE, the Bill contains the following provisions:

- Where a taxpayer is resident in a jurisdiction that has a DTA with New Zealand, the definition will be the same as the definition of a PE in that DTA. It will also include any PE deemed to arise under the proposed PE anti-avoidance rule (but only if the DTA does not include the OECD’s new PE definition).
- Where a taxpayer is resident in a jurisdiction that does not have a DTA with New Zealand, the definition of a PE will be that set out in the new Schedule 23 to the Act (domestic PE definition). This definition includes the OECD’s new PE definition.

The high level application of all these proposed amendments can be summarised as follows:

- If the jurisdiction where the non-resident is resident *has* a DTA with New Zealand, but that DTA does *not* incorporate the OECD’s new PE definition, then the new PE anti-avoidance rule *will* apply to determine whether the non-resident has a deemed PE in New Zealand.
- If the jurisdiction where the non-resident is resident *has* a DTA with New Zealand, and that DTA *does* incorporate the OECD’s new PE definition, then the new PE anti-avoidance rule *will not* apply. Instead the OECD’s new PE definition in the DTA will apply to determine whether the non-resident has a PE in New Zealand.

- If the jurisdiction where the non-resident is resident does *not* have a DTA with New Zealand then the new PE anti-avoidance rule will *not* apply. Instead the new domestic PE definition (which incorporates the OECD's new PE definition) will apply to determine whether the non-resident has a PE in New Zealand.

In all the above circumstances, if the non-resident has a PE in New Zealand then any income attributable to that PE will be considered to have a New Zealand source. Whether income is attributable to the PE will be determined under the standard PE profit attribution methodology applied by New Zealand.

Background

PE anti-avoidance rule

New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules in conjunction with our DTAs. Under our DTAs, New Zealand is generally prevented from taxing a non-resident's business income unless the non-resident has a PE in New Zealand. This is the case even if that income has a source in New Zealand under our domestic legislation.

A PE is basically a fixed place of business of the non-resident, but it also includes a dependant that habitually concludes contracts on behalf of the non-resident. If a PE exists, then under the DTA New Zealand may tax only the income attributable to that PE (unless that income is also subject to another DTA provision).

The non-resident must also have a PE in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax (NRWT) on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

The problem the proposed rule is trying to address is the ability of some multinationals to structure their affairs so they do not have a PE in New Zealand, despite having significant economic activity carried on for them here. This usually involves the non-resident entity establishing a New Zealand subsidiary to carry out local sales related activities.

The OECD and the G20 are also concerned about PE avoidance, and have recommended measures to address it as part of their 15 point base erosion and profit shifting (BEPS) Action Plan. This includes a new, broader definition of a PE for DTAs. Under this new PE definition, a representative of the non-resident will only need to habitually play a principal role leading to the conclusion of contracts in order to give rise to a PE for the non-resident. This contrasts with the current PE definition in most DTAs, where the representative must habitually conclude contracts on behalf of the non-resident in order to give rise to a PE.

The OECD has prepared the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) to rapidly implement the treaty changes recommended as part of its BEPS Action Plan. New Zealand signed the MLI on 7 June 2017. Under the MLI, the OECD's new widened

PE definition will be included in New Zealand's DTAs, but only if the other country signs the MLI and elects to adopt the new PE article.

This new, widened definition should be effective in addressing the kinds of PE avoidance we have seen in New Zealand. However most of New Zealand's trading partners are not expected to adopt the widened PE definition, including some countries from which significant investment into New Zealand is made. Therefore, the OECD's widened PE definition will not be sufficient to address the issue of PE avoidance in New Zealand.

Source rules

Under the current rules, there is a possibility that New Zealand may be entitled to tax a non-resident on its sales income under the PE article of a DTA, but cannot do so under our domestic source rules.

There is general international consensus that if income is derived through a PE in a country, then it is sufficiently connected with that country to be taxed there. Accordingly, any income that is derived by a PE should also have a New Zealand source under our domestic rules.

In addition, in order to tax a non-resident on its New Zealand sales income, it is currently necessary to show that the income both has a New Zealand source and is attributable to a PE under a DTA. This increases the compliance and administrative burden of determining a non-resident's tax liability for its sales to New Zealand customers.

Detailed analysis

PE anti-avoidance rule

The proposed rule will deem a PE to exist in New Zealand for a non-resident if all the listed criteria in proposed section GB 54(1) of the Income Tax Act (2007) are met. These criteria are discussed below.

The non-resident is, or is part of, a large multinational group - para (j)

A large multinational group is defined in section YA 1 of the Bill to include multinational groups that exceed the revenue threshold of EUR €750m of consolidated global turnover described in paragraph 5.53 of the OECD transfer pricing guidelines. This revenue threshold was agreed by the OECD as a way to define large multinational groups for the purpose of filing Country-by-Country reports.

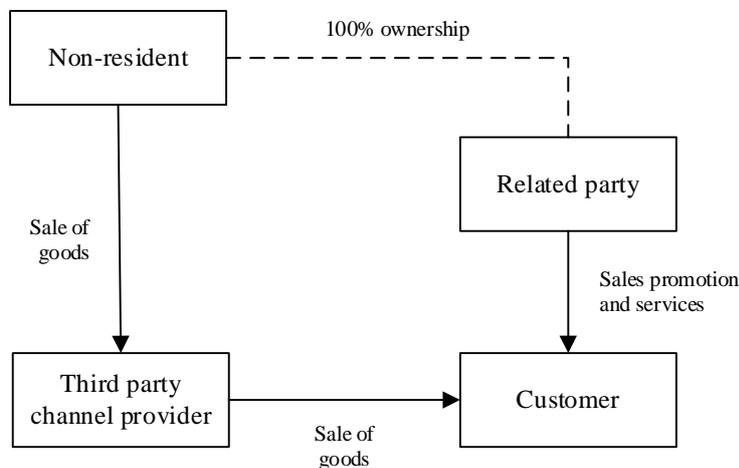
The non-resident makes a supply of goods or services to a person in New Zealand - para (a)

The definition of "goods or services" from the Goods and Services Tax Act 1985 will apply for this purpose. In addition the relevant supply may be made by the non-resident either:

- directly to a person in New Zealand; or
- to another person in New Zealand (the intermediary) under an arrangement that includes the intermediary on-supplying the goods to another person in New Zealand. The intermediary does not need to be associated or otherwise related to the non-resident.

The provision for intermediaries is intended to include third-party channel provider arrangements within the scope of the proposed rule. Specifically, the provision is intended to ensure the proposed rule can cover the sale by a non-resident to a third party where that sale is part of an arrangement under which those same goods or services are to be on-sold by the third party to an identified customer, and the non-resident’s facilitator deals with the end-customers to bring the particular sale about. Figure 4 illustrates this kind of arrangement.

Figure 4



There can be good commercial reasons for third-party channel provider arrangements. However they should also give rise to a PE for the non-resident in respect of its sale to the third party in appropriate circumstances. This is because, under such an arrangement, the non-resident and the third party are working together to sell the particular goods or services to the end customer. Further, the non-resident’s sale to the third party is wholly dependent on the customer agreeing to purchase the goods. This means that the facilitator’s activities are made in relation to the non-resident’s sale to the third party as well as the third party’s on-sale to the end customer (which makes sense given that the facilitator acts for the non-resident, not the third party). Therefore the activities of the non-resident’s facilitator should still be able to give rise to a PE for the non-resident (provided the other requirements of the proposed rule are met).

A person (the “facilitator”) in New Zealand carries out in New Zealand an activity for the purposes of bringing about the supply - para (b)

The facilitator must carry on an activity for the purpose of bringing the supply about. It is intended that only activities designed to bring about a particular sale to an identifiable person should potentially result in a deemed PE. Therefore activities that do not relate to a particular sale, such as advertising and marketing, would not be

sufficient to trigger a possible PE under this requirement. After-sales activities, such as technical support, would not be sufficient to meet this requirement, as they occur after the supply has been made.

The kinds of activities that are within the intended scope of this provision primarily include activities designed to convince a particular customer to acquire the supply.

The proposed requirement also specifies that the facilitator cannot also be the intermediary. This is to ensure that the proposed PE anti-avoidance rule does not apply to an ordinary distributor arrangement. In such a case, the distributor would be carrying out all the particular sales activities on its own behalf, rather than the non-resident's behalf (and the non-resident would not have a separate facilitator in New Zealand assisting with the sales). Accordingly, the distributor's activities should not give rise to a PE for the non-resident.

The facilitator is associated or commercially dependent on the non-resident - para (c)

The proposed rule is aimed at circumstances where the facilitator is part of the same economic or control group as the non-resident. It is these circumstances which allow the multinational to avoid having a PE by splitting its activities between related companies (for example, the non-resident supplier and the facilitator). Accordingly, for the rule to apply, the facilitator must be associated with the non-resident.

The same concern also arises where the non-resident's sales activities are carried out by a New Zealand entity that is not associated with the non-resident, but is commercially dependant on it. In this case, the non-resident is also able to have sales activities carried out by a special purpose entity over which it has significant de-facto control (by virtue of its commercial dependency). Accordingly, the proposed PE anti-avoidance rule may also apply in these circumstances.

The concept of "commercially dependant" is subjective. Therefore the criterion instead uses the more precise test of whether the facilitator derives more than 80 percent of its assessable income from the non-resident or its associates.

As a result of this criterion, any sales-related activity carried on by an unrelated independent agent will generally not give rise to a PE under the proposed rule. This also reflects the current definition of a PE in New Zealand's DTAs.

The activity is more than preparatory or auxiliary - para (d)

As stated above, only activities that are designed to bring about a particular sale should be within the scope of the proposed rules. To support this, any activities that are preparatory or auxiliary to the non-resident's supply of goods or services will not be sufficient to trigger the potential application of the rule. An example of preparatory or auxiliary activities is general marketing or advertising of a non-resident's products. Warehousing and delivery of the supplied goods would also usually be preparatory or auxiliary. However, this would not be the case for example where the main business activity of the non-resident was delivering goods.

This criterion is also intended to incorporate the exception in most DTAs, which provides that preparatory and auxiliary activities do not give rise to a PE. Therefore in interpreting the meaning of "preparatory or auxiliary" in the proposed rule, it is

intended that the OECD's Commentary on the articles of the Model Tax Convention on Income and Capital (Commentary) will be relevant.

The non-resident is relying on a DTA that does not include the OECD's new PE definition – para (e)

As discussed above, the OECD has drafted a new PE definition to counter PE avoidance. This new PE definition has been included into its Model Tax Convention on Income and Capital (Model Treaty), and will also be inserted into the DTAs of participating countries under the MLI (provided both jurisdictions elect to include it).

The OECD's new PE definition has several components. The relevant component here is that contained in article 12(1) of the MLI. In particular, the part of article 12(1) providing that a dependant agent PE will arise for a non-resident where a person habitually plays the principal role leading to the conclusion of contracts by the non-resident that are routinely concluded without material modification. The Government's view is that this amended definition should be sufficient to prevent the kind of PE avoidance we have seen in New Zealand. It is also expected that the proposed PE rule and the OECD's new PE definition will apply in broadly similar circumstances.

For this reason, the proposed new PE rule will not apply where the non-resident's income from its supplies to New Zealand customers is covered by a DTA which incorporates the OECD's new PE rule. It does not matter for this purpose whether the OECD's new PE rule is inserted into the DTA by the MLI, or is subsequently agreed by New Zealand and the other party in bilateral treaty negotiations.

The domestic law definition of a PE does not apply to a non-resident – para (f)

As part of the Bill, a definition of a PE is proposed to be included into the Act for non-residents to whom no DTA with New Zealand applies. This domestic definition includes the OECD's new PE definition. Accordingly, the proposed PE anti-avoidance rule also does not need to apply for non-residents to whom no DTA with New Zealand applies.

The income from the supply is not already attributable to a PE – para (g)

This is a mechanical provision. If the non-resident's income is already attributable to a PE under a DTA (or under the domestic law following the Bill's enactment), then there should not be any PE avoidance occurring in respect of that income. Accordingly, the proposed PE rule will not apply in these circumstances.

The arrangement does not have a more than merely incidental purpose of tax avoidance – paras (h) and (i)

In order for the proposed PE anti-avoidance rule to apply, the relevant arrangement must have a more than merely incidental purpose of avoiding tax. This requirement has been inserted for two reasons:

- to target the rule's application at BEPS activities, rather than more ordinary commercial arrangements; and

- to make the rule consistent with New Zealand’s DTA obligations. The Commentary states that, as a general rule, there will be no conflict between anti-avoidance provisions and the provisions of a DTA (as discussed further below under “other matters”).

Tax for this purpose means both New Zealand tax, and a combination of New Zealand tax and foreign tax. This is to prevent any argument that an arrangement’s avoidance of New Zealand tax was only incidental to its avoidance of foreign tax.

The general anti-avoidance rule (GAAR) in section BG 1 also requires that an arrangement has a more than merely incidental purpose of tax avoidance. However, in applying the GAAR, the courts have imposed a further requirement that the arrangement uses the relevant provisions in a manner not contemplated by Parliament (see *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115). This further requirement arises out of the need to reconcile Parliament’s purpose for the specific tax provisions (which may have been intended to confer a benefit in the circumstances) with its purpose for section BG 1 (see *Ben Nevis* at [102]). This further requirement is usually referred to as the Parliamentary contemplation test.

The proposed PE anti-avoidance rule is a specific anti-avoidance provision, rather than a GAAR. Further, the scope in which the PE anti-avoidance rule applies has been carefully circumscribed. For these reasons, there is no need to reconcile the application of the PE anti-avoidance rule with the intended application of any other provisions. Therefore, the intention is for only the merely incidental purpose test to be used in determining whether the proposed PE anti-avoidance applies. It is not intended for the Parliamentary contemplation test to also apply.

Subparagraphs (h) and (i) have been drafted in order to achieve this intention. It would not be appropriate to refer directly to the Parliamentary contemplation test in the legislation, as this is a judicial rather than a statutory requirement (and so might change in the future). Instead, to achieve its purpose the subparagraph has been drafted without reference to the definitions of “tax avoidance arrangement” or “tax avoidance” used by section BG 1. This is to make it clear that the test under subparagraphs (h) and (i) does not import the Parliamentary Contemplation test (or the earlier scheme and purpose test) associated with those definitions.

However, it is intended that only the case law relevant to whether there is a more than merely incidental purpose or effect of tax avoidance should apply (for example, excluding any Parliamentary contemplation or scheme and purpose component of the test under the GAAR) in determining whether the more than merely incidental purpose test in subparagraphs (h) and (i) is met. In this regard, the omission of the word “effect” from subparagraph (h) and (i) is not intended to have any effect.

This criterion should also ensure that the proposed PE anti-avoidance rule will only deem a PE to exist if the non-resident would have had a PE but for its arrangement with the facilitator (that is, if the non-resident had carried out all the facilitator’s activities itself using all the facilitator’s assets and personnel). In this regard, the rule is intended to prevent the avoidance of a PE. It is not intended to deem a PE to exist where one does not in substance.

Consequences of application (GB 54(2), BH 1(4))

If the proposed PE anti-avoidance rule applies, then under section GB 54(2) the non-resident is treated as having a PE in New Zealand. Supplies made by the non-resident are then treated as being made through that PE – but only if section GB 54(2) applies to them. So for example if the non-resident made some supplies in New Zealand in respect of which a related entity in New Zealand carried out sales activities (and the other requirements of the rule were met), then those supplies would be treated as made through the PE. However, if the non-resident also made other supplies in New Zealand and no related entity in New Zealand carried out any sales related activities in respect of them, then those supplies would not be treated as made through the PE for tax purposes.

The activities of the facilitator in relation to the supplies will also be attributed to the PE for the purposes of determining the profit attributable to it (and so the taxable income in New Zealand). The normal PE profit attribution rules would then apply to determine the amount of attributable profits. In this regard, New Zealand follows an earlier version of the OECD's latest PE profit attribution rules (known as the "authorised OECD approach", or AOA). This is for two reasons:

1. The AOA only applies to DTAs which incorporate the latest version of Article 7 (business profits) of the Model Treaty. None of New Zealand's DTAs incorporate this version of Article 7, so the AOA is not relevant to New Zealand's DTAs.
2. New Zealand does not agree with some aspects of the AOA and has made an explicit reservation against it.

DTAs, as international agreements, do not have any legislative effect except to the extent provided for in domestic legislation. DTAs are given legislative effect for tax purposes by section BH 1(4) of the Act. This provides that DTAs have effect, despite anything else in the Act. To make it clear that the proposed PE avoidance rule overrides any applicable DTA, the Bill proposes amending section BH 1(4) to include section GB 54 in the list of sections in respect of which a DTA does not have overriding effect. The effect of this is that section GB 54 will deem a PE to exist for all the purposes of the Act and any applicable DTA, notwithstanding anything in that DTA.

It is important to note that proposed new section GB 54 on its own simply deems a PE to exist. It does not directly impose any tax or deem any assessable income to arise. Instead the tax consequences of a deemed PE will be determined under the other provisions of the Act and any applicable DTA.

For example, if the proposed PE anti-avoidance rule applies to a non-resident subject to the New Zealand-Australia DTA, then:

- The taxpayer will be deemed to have a PE for the purposes of that DTA under Article 5.

- The business profits article of the DTA (Article 7) will apply to allow New Zealand to tax the profits attributable to that PE.⁴
- The ordinary tax rules will apply on the basis that the taxpayer has a PE in New Zealand. In particular, proposed new section YD 4(17C) will deem the income attributable to the PE to have a New Zealand source.
- The PE under section GB 54 will exist for the purposes of any other provision of the DTA. For example, it will be deemed to exist for the purposes of Article 12(5) of the DTA. This means that New Zealand could impose NRWT on any royalties paid by the non-resident that are connected with the PE and deductible in determining its profits.
- Items of income that are dealt with by other articles of a DTA will continue to be taxed in accordance with those other articles. This is because any conflicts between the tax treatment under a specific article (assuming the existence of a PE) and the tax treatment under Article 7 are dealt with under Article 7(8) of the DTA. This provides that the provisions of the other articles are not affected by the provisions of Article 7. For example, an Australian resident's profits from shipping and air transport would continue to be dealt with under Article 8 of the DTA (rather than Article 7), even if section GB 54 applied to deem the non-resident to have a PE in New Zealand.

Other matters

The Government anticipates that some multinationals may wish to restructure their New Zealand operations in response to the proposed PE anti-avoidance rule. One of the policy goals of the proposed rule is to encourage taxpayers to move away from PE avoidance structures. Therefore, the Government is happy for taxpayers to restructure their New Zealand operations in response to the rules by either adopting a formal PE, or by moving to a standard local distributor model (where the goods or services are sold by the non-resident to an associated party, who then on-sells the goods to unrelated customers).

While the proposed rule will override DTAs, it should not conflict with New Zealand's obligations under those DTAs. This is because New Zealand's DTAs are based on the OECD's Model Treaty. The OECD Commentary is an important part of the context in which these DTAs are internationally understood. The proposed rule is an anti-avoidance provision, as it only applies to an arrangement with a more than merely incidental purpose of tax avoidance. The OECD Commentary states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. It also confirms that states are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that this should not be lightly assumed).

However, it is important that the proposed PE anti-avoidance rule applies notwithstanding anything in a DTA. This is to simplify the application of the rule, otherwise it would be necessary to show that the application of the rule was consistent with a DTA in each particular case. This would be a time-consuming and resource intensive exercise. The Government also considers that taxpayers should not be able

⁴ This is unless the income is from insurance. Under the DTA income from insurance is not subject to Article 7 (see Article 7(9)). Accordingly, New Zealand will continue to tax insurance income under its domestic rules notwithstanding the existence of a deemed PE under section GB 54.

to rely on DTAs to protect their tax avoidance arrangements. This is the same position as the UK and Australia have taken in respect of their PE avoidance rules.

Finally, the Government expects the proposed rule to apply in broadly similar circumstances to the OECD's new PE definition. However, there will be differences in the application of the two rules, due to their different formulations.

PE source rule

A new source rule is proposed in new section YD 4(17C) under which income will have a New Zealand source if it is attributable to a PE in New Zealand.

If a New Zealand DTA applies in respect of the taxpayer, then the definition of a PE in that particular DTA will be used for the purpose of this source rule (proposed section YD 4B(2)). The effect of this will be that where income is attributable to a PE in New Zealand under an applicable DTA, that income will automatically have a New Zealand source. The income will also have a New Zealand source if it is attributable to a deemed PE under the proposed new PE anti-avoidance rule (proposed section YD 4B(2)(b)).

The Bill also proposes introducing a new domestic definition of a PE in schedule 23 of the Act. This definition will apply if no New Zealand DTA applies to the taxpayer. The PE definition in schedule 23 is based on New Zealand's model PE article, and incorporates the OECD's new PE definition.

Proposed section YD 4B(4) has been included to clarify that the Commentary should be used as a guide in interpreting the definition of a PE in schedule 23. However, the OECD Commentary does not itself have legislative effect. Therefore, the guidance in the Commentary should not be applied in contradiction to the words of Schedule 23.

In particular, the Commentary applies in respect of the OECD's model PE definition, which the definition in schedule 23 departs from. In addition, New Zealand has made reservations and observations on the Commentary to the PE definition (Article 5). The Commentary should be used as a guide subject to these differences, reservations and observations.

It is the Commentary, as amended from time to time by the OECD, which is to be used as a guide under the proposed section YD 4B(4). Therefore, the latest version of the Commentary should be used for this purpose, rather than the version applying when the Bill is enacted (or the version applying when the relevant amount of tax became payable etc). This is consistent with the application of the Commentary to DTAs generally.

Proposed new section YD 5B sets out how the profits attributable to a PE are to be determined. This section has been drafted to replicate the wording of the business profits articles of most of New Zealand's DTAs (adjusted to reflect differences in terminology between the Act and DTAs). Accordingly, whether income is attributable to a PE for the purposes of the new source rules should be determined under the normal PE profit attribution principles (as applied by New Zealand).

As noted above, New Zealand follows an earlier version of the AOA profit attribution method. The AOA also only applies in respect of the latest version of the business

profits article in the OECD's Model Treaty. Section YD 5B has been deliberately worded to follow the earlier version of the business profits article, rather than the latest version in respect of which the AOA applies. Accordingly the AOA should not apply to determine the profit attributable to a PE under proposed section YD 5B. Instead, the earlier version of the OECD's profit attribution method currently followed by New Zealand should be used.

It is important to note that the source rules in subpart YD only apply to determine the amount of income with a New Zealand source. They do not apply to determine the amount of net profit. Consistently with this, section YD 4(17C) and YD 5B should be applied to determine the amount of gross income attributable to the PE, before the deduction of any expenses.

A deduction for any expenditure incurred in deriving the New Zealand sourced income will be then available under the Act's usual deductibility rules. However, the net income under the Act and the amount of net taxable profit attributable to the PE under the DTA should be the same. This is because the deductibility of expenses attributed to a PE under the DTA is also determined under the Act's general deductibility rules (see paragraphs 30–34 of the Commentary to Article 7).

The Act currently has specific source apportionment rules for income from sea transport (sections YD 4(15) and YD 6), non-resident general insurers (sections YD 4(16) and YD 8(2)) and non-resident life insurers (sections YD 4(17) and EY 48). The intention is for these specific apportionment rules to still apply to income from these sources, rather than the proposed PE income apportionment rules in section YD 5B. To allow for this, the proposed new source rule in section YD 4(17C) is stated to be subject to sections YD 4(15)–YD 4(17).

We note that the Act already contains a source apportionment rule in section YD 5 for income from carrying on business in New Zealand (section YD 4(2)) or making or performing a contract in New Zealand (section YD 4(3)). A PE in New Zealand will also usually derive income from carrying on business in New Zealand or making or performing contracts in New Zealand. Accordingly without amendment section YD 5 would also apply to apportion the income attributable to a PE.

Consequently, section YD 5(1BA) is being inserted to confirm that, where there is a PE, the PE attribution rules in section YD 5B should be used, rather than the existing apportionment rules in section YD 5.

It is not expected that there would be material differences in the amount of income apportioned to New Zealand under section YD 5B or section YD 5 in most cases. However, one of the purposes of the PE source rule is to simplify the taxation of income from a PE, by not requiring taxpayers and Inland Revenue to apply two sets of rules (the DTA rules and the domestic source rules). Consequently, the Bill proposes inserting section YD 5B to remove any doubt that the PE profit attribution methodology which applies under the DTA should also be used in the domestic source rules.

Transfer pricing payments rules

TRANSFER PRICING RULES

(Clauses 35 to 36)

Summary of proposed amendments

Transfer pricing rules guard against multinationals using related-party payments to shift profits offshore by requiring these payments to be consistent with an arm's length price and conditions that unrelated parties would agree to.

The Bill proposes amendments to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules.

Application date

The proposed amendments to the transfer pricing rules generally apply from income years beginning on or after 1 July 2018. Arrangements that comply with an Advance Pricing Agreement issued by the Commissioner before 1 July 2018 will be grand-parented so they remain subject to the existing transfer pricing rules until the Advance Pricing Agreement expires.

Key features

The Bill proposes the following amendments to New Zealand's transfer pricing legislation:

- Including a reference to using the 2017 OECD transfer pricing guidelines as guidance for how the rules are applied.
- The economic substance and actual conduct of the parties will have priority over the terms of the legal contract. This is achieved by requiring the transfer pricing transaction to be "accurately delineated" consistent with section D.1 of chapter I of the new OECD transfer pricing guidelines.
- The ability to disregard or replace transfer pricing arrangements which are not commercially rational. For instance, because they include unrealistic terms that unrelated parties would not be willing to agree to. This is consistent with the guidance in section D.2 of chapter I of the new OECD guidelines.
- Referring to arm's length conditions (as per Australia's legislation) to clarify that the transfer pricing rules can be used to adjust conditions other than the price.
- The onus of proof for demonstrating that a transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the onus of proof being on the taxpayer for other tax matters).
- The time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased from four to seven years (in line with Australia).

- In addition to applying to transactions between related parties, the transfer pricing rules will also apply when non-resident investors “act in concert” to effectively control a New Zealand entity, such as through a private equity manager.

Background

New Zealand’s current transfer pricing legislation dates back to 1995 and no longer reflects modern transfer pricing practices and the associated tax risks.

In particular, New Zealand’s existing transfer pricing legislation is based on analysing the legal form of the transaction and adjusting the consideration that is paid to match an arm’s length amount.

In contrast, Australia’s transfer pricing rules and the OECD’s 2017 transfer pricing guidelines are based on broader, economic substance approach. This includes requiring the conditions of the transaction to align with the economic substance and actual conduct of the parties.

The OECD’s transfer pricing guidelines were substantially updated in 2017 as part of the OECD’s BEPS project. The updates to Chapter I of the Guidelines were designed to align transfer pricing outcomes with value creation (BEPS Actions 8–10). The OECD has noted that the new guidance ensures that:

- actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;
- contractual allocations of risk are respected only when they are supported by actual decision-making;
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance; and
- tax administrations may disregard transactions which are commercially irrational.

The proposed amendments to New Zealand’s transfer pricing legislation are intended to allow New Zealand to implement these BEPS recommendations.

Detailed analysis

GC 6(1B): Applying the OECD Transfer Pricing Guidelines

New Zealand has contributed to and applied the OECD’s transfer pricing guidelines since they were first published in 1995. As transfer pricing practices have become more sophisticated, the OECD through its BEPS work has updated its guidelines to represent the agreed international best practice.

The Bill proposes that New Zealand's transfer pricing legislation explicitly refer to the OECD transfer pricing guidelines by requiring the rules to be applied consistently with these guidelines.

The OECD transfer pricing guidelines are defined in section YA 1 as the guidelines published by the Organisation for Economic Co-operation and Development as *OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris. This definition refers to the July 2017 edition of the guidelines available on OECD's website at <http://www.oecd.org/tax/transfer-pricing>.

The OECD transfer pricing guidelines are periodically updated. These updates are developed by OECD's Working Party 9, which New Zealand participates in, and are approved by the OECD's Committee of Fiscal Affairs. When these updates occur, we will review the revisions to the guidelines with a view to updating the definition of the OECD transfer pricing guidelines in section YA 1 so it refers to the latest version of the guidelines. Future taxation bills would be used to include these updates to the definition in section YA 1.

The proposed application date for new section GC 6(1B) is income years beginning on or after 1 July 2018. This means transfer pricing positions taken on or after 1 July 2018 will need to be analysed in a way that is consistent with the July 2017 version of the OECD transfer pricing guidelines.

GC 6(2)(b): Application of transfer pricing rules to suppliers and acquirers in the same control group

In addition to applying to transactions between associated parties, the proposed new transfer pricing rules will also apply when non-resident investors "act together" to effectively control a New Zealand entity, such as through a private equity manager.

This is achieved through the introduction of a new definition of "control group" which is defined in new section FH 14. The definition of control group includes associated persons (as defined in section YA 2), but is also broader than just associated persons.

The definition of "control group" includes companies that are consolidated for accounting purposes or associated companies (under section YA 2), as well as investors who are "related" or "act together" to effectively control another person. "Related" and "act together" are also defined in new section FH 14.

GC 13(1) and (4): Adding a requirement to apply "arm's length conditions"

The transfer pricing rules require an amount of consideration to be replaced with an arm's length amount of consideration.

The Bill retains the existing wording of section GC 13(1) which describes the process for determining an arm's length amount of consideration. However, the proposed new section GC 13(1) supplements the existing wording of section GC 13(1) of the transfer pricing rules by clarifying that the arm's length amount of consideration must be calculated by applying "arm's length conditions".

This reflects the fact that in some cases, before the arm's length amount of consideration can be correctly determined, it will first be necessary to make adjustments to some non-numerical conditions of the transfer pricing arrangement.

The term "conditions" is not a defined term in the Bill but is intended to include financial values such as the price, gross margin, net profit, and the division of profit between the acquirer and supplier as well as other conditions which may not involve a numerical value such as the absence or presence of a loan guarantee. This is consistent with paragraph 1.7 of the 2017 OECD transfer pricing guidelines which refers to "...conditions (including prices, but not only prices)."

Arm's length conditions are defined in section GC 13(4)(b) as the conditions that would apply for an uncontrolled transaction in circumstances comparable to the accurately delineated transfer pricing arrangement and that might be expected to be agreed upon by independent parties after real and independent bargaining. The second part of this definition is intended to be similar to the definition of "arm's length conditions" in section 815.125 of Australia's Income Tax Assessment Act 1997.

GC 13(2): Updating names of approved transfer pricing methods

Section GC 13(2) of the Income Tax Act 2007 currently refers to the five transfer pricing methods that are described in Chapter III of the OECD transfer pricing guidelines.

However, the names used for the two methods in (d) and (e) are based on terminology used in the 1995 version of the OECD transfer pricing guidelines that do not reflect the modern OECD terminology that is used for these methods in the 2010 and 2017 OECD guidelines. The Bill therefore proposes replacing the references to "the profit split method" and "the comparable profits methods" with references to "the transactional net margin method" and the "transactional profit split method".

GC 13(4)(a): Accurately delineating the transfer pricing arrangement

The proposed new transfer pricing rules require the overall economic substance of the arrangement to be considered. The analysis is not limited to the legal contracts and takes into account the wider economic arrangement and commercial environment. In particular, if the legal contracts do not reflect the actual conduct of the parties, the actual conduct of the parties will be used to apply the transfer pricing rules.

Proposed new section GC 13(4)(a) achieves these outcomes by requiring the transfer pricing arrangement to be "accurately delineated using the approach described in section D.1 of Chapter I of the OECD transfer pricing guidelines.

Section D.1 of the OECD transfer pricing guidelines describes the process for accurately delineating the transaction. This process involves identifying the following economically relevant characteristics:

- The contractual terms of the transaction (as described in section D.1.1).
- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including:

- how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction; and
- industry practices (D.1.2).
- The characteristics of property transferred or services provided (D.1.3).
- The economic circumstances of the parties and of the market in which the parties operate (D.1.4).
- The business strategies pursued by the parties (D.1.5).

When deciding what characteristics are economically relevant, the test is to ask what characteristics two independent enterprises would take into account when dealing with each other. This test is explained in paragraph 1.38 of the guidelines which states that:

“Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. ...identifying the economically relevant characteristics is essential in accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction in reaching the conclusion that there is no clearly more attractive opportunity realistically available to meet their commercial objectives than the transaction adopted.”

As part of accurately delineating the controlled transaction, the terms of the legal agreement may be disregarded to the extent that they are inconsistent with the actual conduct of the parties. This is explained in paragraphs 1.45 and 1.46 of the OECD transfer pricing guidelines.

The OECD transfer pricing guidelines provide several examples that illustrate particular aspects of how to accurately delineate transactions. This includes examples of clarifying and supplementing the terms of the written contract with the actual conduct of the parties (see paragraph 1.44) and examples of how risks should be assumed according to how the parties actually manage and control these risks (see paragraphs 1.83–1.85 and 1.89).

GC 13(5): Disregarding or replacing commercially irrational transactions

Where the transfer pricing arrangements entered into are not commercially rational there is consequently no price which would be acceptable to independent parties in exchange for the relevant goods or services being supplied and acquired.

In such cases it is not possible to apply a transfer pricing analysis as transfer pricing relies on being able to identify the arm’s length price which would be agreed between independent parties.

To address this problem, section D.2 of chapter I of the OECD transfer pricing guidelines provides guidance about the circumstances where a transaction can be

disregarded or replaced with an alternative transaction that allows for a transfer pricing analysis to be performed.

Proposed new section GC 13(5) applies when the requirements of paragraph 1.122 of the OECD transfer pricing guidelines are met. In summary, this paragraph states that the accurately delineated transaction can be disregarded, if it would not be commercially rational for independent enterprises to enter into the transaction, because it would not be possible to determine a price which would be acceptable to both of the independent parties at the time that the transaction was entered into.

In cases where the transaction is replaced it should be replaced with a new arrangement that enables a price that would be commercially rational for independent enterprises to agree on. As noted in paragraph 1.124 of the OECD transfer pricing guidelines, the new arrangement should preserve the relevant facts of the original transfer pricing arrangement (as accurately delineated) to the extent that this is possible.

Paragraph 1.128 of the OECD transfer pricing guidelines provides an example where an arrangement is replaced. The example involves a lump sum payment for all future intangibles developed by an associated company over the next 20 years. This arrangement would not be commercially rational for independent parties to agree on as it is not possible to value these future intangibles. In this example, a number of potential replacement transactions could be considered including a financing arrangement, a contract for research services or a licencing agreement for some specific identified intangibles.

If the alternative transaction that independent parties could agree on would have involved no supply or acquisition occurring, then the transaction can be replaced with a transaction involving no supply and acquisition. This is provided for by new section GC (13)(5)(a). This means that the transaction is effectively disregarded and is null and void for determining the person's New Zealand income tax liability. Note that there may still be NRWT on the payments as existing section GC 12 means that transfer pricing adjustments do not affect NRWT obligations.

Paragraphs 1.126 and 1.127 of the OECD transfer pricing guidelines provide an example of a transaction which is disregarded and not replaced. This example involves a property prone to flooding which an independent insurer would not agree to insure as evidenced by there being no active insurance market for properties in that area.

Onus of proof shifted to the taxpayer

When New Zealand's transfer pricing rules were introduced in 1995 they placed the onus of proof on the Commissioner. That is, the arm's length amount of consideration is generally determined by the taxpayer under section GC 4 of the Income Tax Act 2007.

The Bill proposes replacing sections GC 13(4) and (5) of the Income Tax Act 2007. This means that the general onus of proof in section 149A(2)(b) of the Tax Administration Act 1994 will place the onus of proof for transfer pricing issues onto the taxpayer. This proposal is consistent with the fact that the onus of proof is already on the taxpayer for other tax matters.

It also reflects the practical reality of transfer pricing analysis. As transfer pricing is driven by specific facts and circumstances and involves comparisons with similar arm's length transactions, the taxpayer is far more likely to hold the relevant information to support its pricing than Inland Revenue.

The onus of proof is on the taxpayer for transfer pricing matters in most OECD and G20 countries, including Australia. This means most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries. For this reason, the additional compliance costs that would be imposed under New Zealand's transfer pricing rules from shifting the burden of proof onto taxpayers are not expected to be substantial.

Extending the time bar to seven years

Inland Revenue currently has four years from the end of the tax year in which a taxpayer files an income tax return to investigate and amend the tax position taken by the taxpayer in their return. This four year limit is known as the time bar.

The Bill proposes inserting a new section GC 13(6) that will apply despite the general four year time bar in section 108 of the Tax Administration Act 1994. This new section will extend the time bar for the purposes of the transfer pricing rules by allowing the Commissioner to amend an assessment of tax, under the transfer pricing rules, within a seven year period after the tax year in which the relevant tax return was originally filed. The proposed seven year time bar will also apply in respect of "cross-border related loans" that are subject to new section 6(1C) and sections GC 15 to 18.

The extension of the time bar applies from income years beginning on or after 1 July 2018. This means that tax positions taken in returns relating to income years that began before 1 July 2018 will continue to be subject to the existing four year time bar.

COUNTRY-BY-COUNTRY REPORTS

(Clause 52)

Summary of proposed amendments

Inland Revenue already requires New Zealand headquartered multinational groups with annual consolidated group revenue of EUR €750m or more in the previous financial year to file a Country-by-Country report using the IR 1032 prescribed form for all income years beginning on or after 1 January 2016.

The Bill proposes inserting a specific provision in the Tax Administration Act which will codify the requirement for large multinationals to file a Country-by-Country report.

Application date

The Country-by-Country reporting requirements apply to income years beginning on or after 1 January 2016.

This means groups with 31 December balance dates are impacted first, with data to be collected for the 12 months beginning 1 January 2016. For 31 March balance date and 30 June balance date groups, data needs to be collected for the 12 months beginning 1 April 2016 and 1 July 2016 respectively.

Background

One of the OECD's BEPS recommendations was to require large multinational groups (those with annual consolidated group revenue of EUR €750m or more in the previous financial year) to provide a Country-by-Country report which contains certain high-level information on the groups' global activities to tax authorities who would then exchange this information with each other.

The following aggregate information will need to be collected for 2016 and subsequent years for **each jurisdiction** in which the impacted groups operate:

- gross revenues (broken down into related party and unrelated party categories);
- profit (loss) before income tax;
- income tax paid (on cash basis);
- income tax accrued (current year);
- stated capital;
- accumulated earnings;
- number of employees; and
- tangible assets other than cash and cash equivalents.

In addition, impacted groups will need to list all of their entities that are resident in each jurisdiction, noting also the main business activity of each entity.

While this information is too high level to be used to make tax assessments, it will assist tax authorities in providing them with a starting point for assessing risk and potentially requesting more detailed information that could be used to investigate a multinational's tax position.

Inland Revenue already requires New Zealand headquartered multinational groups with annual consolidated group revenue of EUR €750m or more in the previous financial year to file a Country-by-Country report using the IR 1032 prescribed form for all income years beginning on or after 1 January 2016.

This requirement applies to about 20 multinational groups, who have been notified by Inland Revenue.

A specific legislative provision to require multinationals to file Country-by-Country reports is not strictly necessary as Inland Revenue is already able to use sections 17 and 35 of the Tax Administration Act 1994 to enforce these requirements.

Section 17 allows the Commissioner to request a taxpayer to provide specific information. Section 35 is a general power that enables the Commissioner to prescribe a form. In the case of Country-by-Country reporting an IR 1032 form has been prescribed.

The OECD transfer pricing guidelines includes a template for the Country-by-Country report and instructions and definitions for the compiling the information in the template in Annex III of Chapter V of the guidelines.

However, the Bill proposes including a specific provision in the Tax Administration Act 1994 that requires Country-by-Country reports to be filed. A specific provision is useful because it will provide a more explicit signal to the affected multinationals and other countries of New Zealand's commitment to Country-by-Country reporting. For example, accounting firms produce information about each country's relevant reporting requirements and they may not realise New Zealand is requiring Country-by-Country reports to be prepared and filed if they are not mentioned in our relevant tax legislation.

Detailed analysis

Proposed new section 78G applies to large multinational groups with an ultimate parent that is a resident of New Zealand.

A large multinational group is defined in section YA 1 of the Bill to include multinational groups that exceed the revenue threshold of EUR €750m of consolidated global turnover described in paragraph 5.53 of the OECD transfer pricing guidelines. This revenue threshold was agreed by the OECD as a way to define large multinational groups for the purpose of filing Country-by-Country reports.

Large multinational groups with an ultimate parent that is a resident of New Zealand are required to disclose a Country-by-Country report to the Commissioner that includes:

- The information described in Annex III of Chapter V of the OECD transfer pricing guidelines. This annex includes the OECD template for the Country-by-Country report.
- Other information as may be required by the Commissioner. This provides flexibility for future changes to the Country-by-Country report or any additional information that the Commissioner may require.

The deadline for filing a Country-by-Country report is within the 12 months after the 12 month period to which the information in the report relates.

This means that a Country-by-Country report relating to 1 January 2016 to 31 December 2016 would need to be filed with Inland Revenue on or before 31 December 2017, Inland Revenue would then exchange this report with other countries by July 2018.

Hybrid and branch mismatch rules

OVERVIEW

Hybrid and branch mismatch arrangements are cross-border arrangements that exploit differences in the tax treatment of an instrument, entity or branch under the laws of two or more countries.

A hybrid or branch mismatch arrangement can result in a deduction with no corresponding taxable income inclusion or a single payment leading to a double deduction. The result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

The OECD in its BEPS Action Plan made a number of recommendations to help countries deal with hybrid and branch mismatches. This Bill includes a comprehensive adoption of the OECD recommendations with suitable modification for the New Zealand context.

Some of the OECD's recommended rules are divided into "primary" and "defensive" responses. A defensive response will generally only apply if the other country affected by the arrangement does not have hybrid rules.

Where there are two or more parties to a mismatch, the mismatch rules generally only apply if there is some degree of association between the relevant parties to the arrangement, or if the arrangement has been structured to achieve a mismatch.

This Bill contains proposed rules designed to address the following hybrid and branch mismatches:

- hybrid financial instruments;
- disregarded hybrid payments;
- structures producing double deductions;
- reverse hybrids;
- dual resident entities;
- imported mismatches; and
- deemed branch payment and payee mismatches.

HYBRID FINANCIAL INSTRUMENT RULE

(Clause 30, section FH 3 and FH 4)

Summary of proposed amendments

A payment under a hybrid financial instrument is a deductible interest payment in the jurisdiction of the payer, and is not fully taxed as interest in the jurisdiction of the payee, or is taxed at a later time. As the payment will result in a deduction for the payer and no corresponding income inclusion (or delayed or less than full inclusion) for the payee, this is a deduction/non-inclusion hybrid mismatch.

Proposed sections FH 3 and FH 4 implement recommendation 1 of the OECD Hybrid Report. They are respectively the primary and defensive rules relating to hybrid financial instruments (generally, financial arrangements plus shares). Section FH 3 denies a New Zealand tax deduction for a payment under a hybrid financial instrument. Section FH 4 taxes a payment under a hybrid financial instrument which would otherwise not be subject to tax, or would be taxable on a deferred basis.

Application date

The sections apply for income years beginning on or after 1 July 2018 (clause 30(2)). This means that section FH 3 applies to payments for which deductions are claimed in that income year or subsequently. The date on which the payment giving rise to the deduction is paid is not relevant. Section FH 4 on the other hand applies only to payments received on or after the start of a person's income year.

There is an exception from sections FH 3 and FH 4 in clause 30(3) of the Bill for payments under a financial instrument entered into on or before 6 September 2016 which:

- are intended to qualify as regulatory capital for purposes of the requirements imposed under the Reserve Bank Act 1989 or equivalent legislation in another country; and
- are for the direct or indirect purpose of complying with the regulatory capital requirements imposed under the Insurance (Prudential Supervision) Act 2010 or equivalent legislation in another country.

Expenditure, and payments received, in respect of such instruments are not subject to sections FH 3 and FH 4 until the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

Detailed analysis

Section FH 3

Section FH 3 applies to a person who is party to a financial instrument and incurs expenditure in relation to a payment under the instrument if:

- the tax law of a country outside New Zealand treats the payment as received by a person in that country (who may be a resident of that country or a non-resident carrying on business there). It should not matter that the other country will not treat the payment as received until a later year than the year in which the deduction is claimed;
- the financial instrument is or is part of a structured arrangement or the payer and payee are related;
- the tax treatment of the payee in its country meets either subsection (2) or subsection (3).

Subsection (2) applies to what might be called character mismatches. It applies, if under the law in the payee country in the year the deduction is claimed, any portion of the payment is not treated as ordinary income, and would have been so treated if the classification of the payment or the instrument were varied. Ordinary income is defined in subsection (9). It is income taxed at the full (or usual) marginal rate of a person for income from financial instruments, and which is not eligible for any exemption, exclusion, credit or tax relief, other than for withholding tax imposed on the payment.

Although the legislation may require the tax status of the payment in the other country to be determined before the payment is in fact treated as received in the other country, in determining whether a character mismatch arises, the treatment of the payment by the actual payee must be determined. This is different from the approach proposed in the Final Report, which asks how the payment would be taxed to a payee of ordinary status.

Example 1

An offshore parent tax resident in Country A lends money to a New Zealand subsidiary on the basis that the loan is subordinated to general creditors and interest payments are subject to a solvency requirement. If the interest is not paid, it compounds. The loan is treated as a share under Country A tax law, and payments are treated as dividends. Country A taxes only 10 percent of any dividend received from a foreign subsidiary. The tax rate imposed on this 10 percent is the same as the tax rate imposed on interest income.

In this case, 90 percent of the interest payment is not taxed as ordinary income. However, it would be taxed as ordinary income if the loan were treated as a debt instrument for purposes of Country A tax law. Accordingly, the entire amount of the payment meets the requirements of subsection (2).

Alternative 1

However, Country A also has a rule that denies the 90 percent exclusion to dividends from foreign subsidiaries if they are deductible to the subsidiary (similar to section CW 9(2)(c) of the Income Tax Act 2007). In this case section FH 3 would not apply. The dividend would remain deductible, since it is taxable as ordinary income to the offshore parent.

Alternative 2

The loan is to the New Zealand branch of a subsidiary also resident in Country A, and the offshore subsidiary and the offshore parent are in a tax consolidated group, pursuant to which payments between the two companies are disregarded for Country A tax purposes. In that case, the payment would not be included in the offshore parent's income regardless of the classification of the payment or the loan. Accordingly the payment is not subject to section FH 3 (though it may well be subject to section FH 5).

Subsection (3) applies to what might be called “timing mismatches”. These arise if an amount of a payment:

- is recognised as ordinary income;
- the financial instrument does not have an explicit term of three years or less; and
- the payee is not using a reasonable accrual method to recognise income from the amount and the amount is not, or is not reasonably expected to be, recognised in the payee country in an accounting period beginning within 24 months of the year in which the amount is deductible.

Example 2

An offshore parent makes an advance to a New Zealand subsidiary, with interest accruing but payable only if demanded by the parent. The loan has no specified maturity date. The New Zealand subsidiary deducts interest as it accrues, but the parent only has to recognise the interest when it is paid.

In this case, although demand for repayment of the advance could be made at any time, there is no requirement for the advance to be repaid within three years, so the de minimis does not apply. In the absence of section FH 3, the group can expect to generate a tax advantage by the subsidiary not paying the interest. Accordingly, unless there is some evidence to support an expectation that the interest will be paid within the required period, the interest payment will be subject to deduction denial under section FH 3.

Subsection (4) defines the amount for which the payer is denied a deduction when subsection (1) is satisfied. The deduction has two components.

The first component is for the incurred amount. This is the expenditure incurred by the payer relating to the amount received by the payee (which expenditure may be different from the amount of the payment itself). The payment is the amount of the payment received by the payee as referred to in subsection (1)(b).

In relation to expenditure which is subject to section FH 3 because of subsection (2), if the financial instrument is denominated in a foreign currency, the expenditure may be calculated taking into account the effect of changes in the NZ\$ value of both the principal amount and the payment itself. In this case, the incurred amount in subsection (4) is also intended to include both amounts. This inclusion does not apply to expenditure which is subject to section FH 3 because of subsection (3). In that case, changes in the NZ\$ value of the foreign currency principle should be recognised in the usual way. Only the portion of the deduction relating to the payment is denied.

The second component is a fraction, which is payee tax divided by ordinary tax.

Payee tax is intended to be the total of:

- the tax to which the payment is liable in the payee country in the year the deduction is claimed, calculated by determining the amount of the payment that is recognised as income by the applicable rate of tax; and
- the amount of income tax actually imposed on the income under CFC rules in another country. In relation to this second component, there must be actual tax payable on the income. This test will not be met if the CFC tax is reduced by losses or credits, other than credits for withholding tax imposed by New Zealand on the payment.

The requirement that payee tax only includes payee or CFC country tax on income which arises from the payment received by the payee in the income year means that tax payable on income arising in a later year is not included in this component of the formula.

Ordinary tax is the amount of tax which would be imposed on the payment if it were ordinary income in the payee country.

Example 3

Take the facts of example 1 above. In this case:

- the incurred amount is the deduction claimed by the payer in a given year
- if a payment is made in the same income year in which the deduction is claimed, “payee tax” will include an amount equal to 10 percent of the payment \times the payee’s ordinary tax rate. The formula in section FH 4 will deny a deduction for the incurred amount \times 90 percent. Otherwise payee tax will be zero, even if tax is paid in a later year.

Example 4

Take the facts of example 2 above. It is determined that the amount for which a deduction is claimed is not likely to be included in the offshore parent’s income within the required time period, so that section FH 3 does apply to the expenditure. In this case:

- the incurred amount is the deduction claimed by the payer in a given year
- as no payment is made within the year in which the deduction is claimed (if it were, there would be no timing mismatch), there will be no payee tax.

Proposed subsection (7) applies to amounts for which a deduction is denied because of a timing mismatch (that is., the amounts fall within subsection (6)). Once the payment is recognised as ordinary income in the payee country, the payer is allowed a deduction for the amount previously denied under subsection (4).

The intention of subsection (8) is to deal with the effect of foreign currency gains of a person who, but for such gains, would be denied a deduction for a payment under a financial arrangement because it falls within subsection (2). If such a person has net

income from the financial arrangement due to the foreign currency gain, subsection (8) provides that the income will be excluded income. If the deduction for the payment would have been only partially denied, the income is excluded income in the same proportion.

Section FH 4

Section FH 4 is the defensive rule for hybrid financial instrument mismatches. It applies when a person subject to New Zealand tax receives a payment under a financial instrument of an amount that would not give rise to assessable income but for this section and section FH 6 (relating to disregarded payments by a hybrid payer and discussed below), if:

- the payment is treated in another country as deductible (or entitled to equivalent tax relief) to a person in that country;
- that country does not have an equivalent to section FH 3 (the primary rule for hybrid financial instruments);
- the financial instrument is part of a structured arrangement or the payee and payer are related; and
- the payment meets the requirements of subsection (2) or (3).

A payment meets the requirements of subsection (2) if it does not give rise to assessable income to the payee, but would do so if the classification of the payment or the financial instrument were varied.

Generally, it is not expected that subsection (2) would apply to a dividend, since New Zealand already taxes deductible dividends. Nor is it intended that section FH 4 would apply to payments under a finance lease where the payer in another country treats the lease as an operating lease and claims a deduction for the entire amount of the payment. In this case, so long as the instrument remains a financial instrument, there is no variation to its terms that would result in the payments being assessable to the extent they represent a payment of principal in respect of the deemed loan under the finance lease.

Subsection (3) deals with timing mismatches. It applies to a payment under a financial instrument which does not have an explicit term of three years or less. It applies if the payment gives rise to assessable income, but the gap between the year in which the deduction is claimed by the payer in its country and the derivation of assessable income in New Zealand meets the requirements of subsection (7). An amount meets the requirements of subsection (7) if it is not included, or is not reasonably expected to be included, in income in New Zealand in an income year beginning within 24 months of the end of the accounting period in which it is deductible in the payer country.

Subsection (4) is the main operative subsection for a character mismatch. It provides that a payment which is subject to the section gives rise to assessable income equal to the amount that would be assessable if the classification of the financial instrument were varied. Under subsection (6), this income is allocated to the year in which:

- it would be derived if the terms of the instrument were varied so that the payment gave rise to income; or
- in the case of a timing mismatch, the payment is received.

Subsection (5) provides for the case where a New Zealand taxpayer receives a replacement payment under a returning share transfer. Replacement payments are taxable income. However, if the returning share transfer is also a share lending arrangement, the replacement payment can carry an imputation credit (section OB 64 of the Income Tax Act 2007). If the share borrower is entitled to a deduction in its country for the replacement payment, the attachment of such a credit would give rise to a hybrid mismatch. In order to reverse this, the imputation credit is denied.

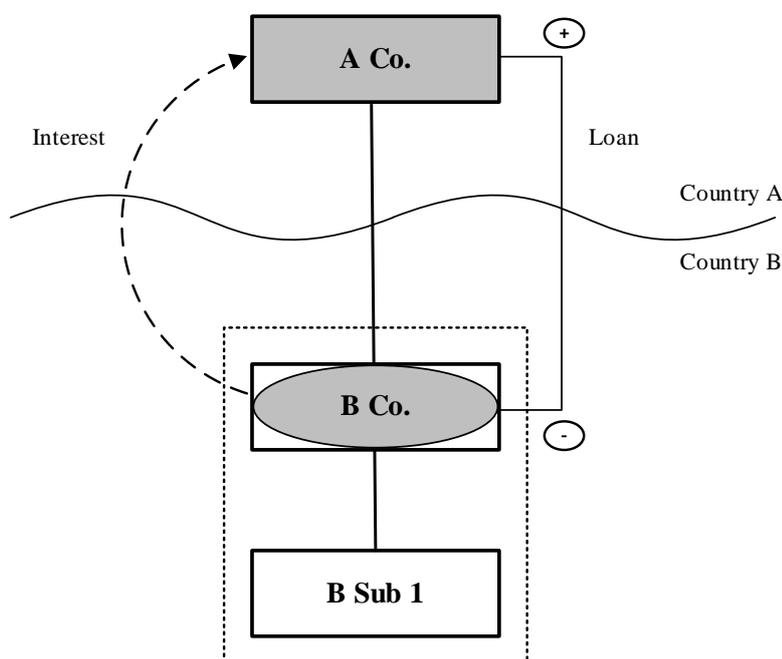
DISREGARDED HYBRID PAYMENTS AND DEEMED BRANCH PAYMENTS

(Clause 30, sections FH 5 and FH 6)

Background

A hybrid entity is an entity which is transparent for tax purposes in the jurisdiction of an investor (Country A) but opaque for tax purposes in another jurisdiction, generally where it is established (Country B). In figure 5, B Co. is the hybrid entity.

Figure 5



An interest payment from a hybrid entity (B Co.) to its investor (A Co.) will be deductible in Country B and disregarded in Country A. This can result in a deduction/non-inclusion hybrid mismatch and results in double non-taxation if B Co. groups its tax loss with the income of another entity (B Sub 1) whose income is not taxable in Country A.

The same outcome can arise if B Co. is instead a branch of A Co. in Country B and is entitled in Country B to a deduction for a charge made to it by A Co. in Country A, if that charge is not also recognised in Country A.

Summary of proposed amendments

Proposed sections FH 5 and FH 6 introduce recommendation 3 of the OECD Hybrid Report and recommendation 3 of the OECD Branch Report. They are respectively primary and defensive rules designed to deal with disregarded hybrid payment and deemed branch payment mismatches which produce deduction/no inclusion (D/NI) outcomes.

The provisions identify amounts of expenditure relating to:

- payments that are deductible in the country of the payer and are disregarded in the country of the payee due to the status of the payer; and
- mismatches in the deductibility and recognition of charges by a head office to a branch in another country which are recognised for tax purposes, generally as a way of a branch country ensuring that it taxes only that portion of a multinational entity's income that corresponds to the activities undertaken in the branch country.

Section FH 5 applies where the relevant deduction is in New Zealand, whereas FH 6 applies where New Zealand is not including a payment as income and the payment is deductible in another country.

These identified amounts are made non-deductible under FH 5 or are included as assessable income under FH 6. However a deduction for them is provided under section FH 12 to the extent they do not exceed surplus assessable income under the offsetting rule in proposed section FH 12.

Application date

The rules will apply to income years beginning on or after 1 July 2018. Section FH 5 applies to payments for which deductions are claimed in that income year or subsequently. Section FH 6 applies only to payments that are treated by the payer jurisdiction as paid on or after the start of a person's income year.

Detailed analysis

Primary rule (proposed section FH 5) – disregarded payments

The primary rule concerns New Zealand residents and New Zealand branches of non-residents that incur an amount of expenditure relating to disregarded hybrid payments and deemed branch payments.

Subsection (1) sets out the conditions that must be satisfied before the primary rule applies. They are that:

- the expenditure is deductible in New Zealand;
- the amount is treated as not being received in a foreign country due to the status of the payer;
- the amount would be treated as received in a foreign country if the tax status of the payer were different;
- the amount does not give rise to tax under CFC rules in a foreign country; and

- either:
 - the relevant parties are a New Zealand branch and a part of the entity located outside New Zealand or a New Zealand resident who makes a payment to another person in the same control group; or
 - the payment is part of a structured arrangement.

For the primary rule to apply to a deduction claimed by a New Zealand branch for a charge paid to a non-New Zealand part of the legal entity (deemed branch payments) that charge must satisfy the requirements of subsection (1) and some further requirements set out in subsection (2). The charge must:

- be in relation to non-New Zealand activities;
- exceed expenditure or loss of the head office that belongs to the same category of expenditure; and
- not relate to a payment by the head office (or a member of the same control group) to a person outside of the control group.

The payer of the payment has a mismatch amount for all expenditure (that is, including foreign exchange gains and losses) relating to the payment. This mismatch amount is non-deductible. However, under proposed section FH 12, if the payer has surplus assessable income the mismatch amount may be set off against that amount.

Example 1

Jefferson Co., a foreign company resident in Washington Country (a foreign jurisdiction) owns 100 percent of Hamilton Co., an unlimited liability company resident in New Zealand. Jefferson Co. provides Hamilton Co. a foreign currency loan under which interest is payable annually. In the relevant income year, the foreign currency strengthens relative to the New Zealand dollar.

The interest payments and any foreign currency movements on the loan are deductible to Hamilton Co. in New Zealand. The laws of Washington Country allow Jefferson Co. to treat Hamilton Co.'s income and expenditure as attributable to Jefferson Co. because of Hamilton Co.'s unlimited liability. This means that the interest payment is disregarded in Washington Country due to the status of the payer (Hamilton Co.). If Hamilton Co. were treated differently, for example if it were treated as a separate entity in Washington Country, the interest payment would be treated as received by Jefferson Co.

Under proposed section FH 5(3), Hamilton Co. has a mismatch amount for its incurred expenditure on the debt instrument. This expenditure will be non-deductible under section FH 5(5). Hamilton Co. would have to apply section FH 12 to determine whether a deduction can be claimed.

Example 2

Root Co., a foreign company resident in Ashes Country (a foreign jurisdiction) operates through a branch in New Zealand. Root Co. manufactures cricket bats in Ashes Country, and sells them to retail stores in various countries, generally via branches in those countries, including the one in New Zealand. Root Co. transfers its cricket bats from Ashes Country to its branch in New Zealand. Each cricket bat transfer is compensated for tax purposes by a \$250 charge from the branch to Root Co. representing \$150 of costs per cricket bat to Root Co. as well as a \$100 mark up in recognition of the profit generating activities of the manufacturing process in Ashes Country.

Currently, the entirety of the \$250 charge is deductible to Root Co.'s branch in New Zealand and can be offset against income earned by the branch for cricket bat sales. Ashes Country exempts active branch income from taxation.

The \$250 is potentially within scope of proposed section FH 5 as a deemed branch payment.

The \$150 cost component of the charge is not within scope of section FH 5. This is because it does not satisfy proposed section FH 5(2)(b) due to the amount being determined by reference to the actual costs of Root Co. (though this amount may be subject to proposed section FH 9). However, the \$100 mark up component of the charge meets the requirements of section FH 5(2)(b) as it is a profit-based amount and so it is not determined by reference to any payments made by Root Co. or any other person in a control group with Root Co.

To the extent that the \$100 mark up portion of the transfer price for each bat is not treated as income of Root Co. in Ashes Land, it will be considered a mismatch amount under section FH 5(3) and it will be denied a deduction under section FH 5(5).

Defensive rule (proposed section FH 6)

The defensive rule mirrors the primary rule and is targeted at payments that are deductible to a foreign entity but disregarded in New Zealand and foreign branches of New Zealand persons making deemed branch payments.

Subsection (1) of proposed section FH 6 sets out the requirements for the defensive rule to apply:

- a non-resident, or foreign branch of a New Zealand resident, must be treated by the relevant foreign jurisdiction as having made a payment to a person in New Zealand;
- the relevant foreign jurisdiction allows the payer a deduction for the payment or equivalent tax relief;
- the person in New Zealand does not derive assessable income from this payment;
- the payment would result in assessable income for the person in New Zealand if:
 - in the case of a hybrid mismatch, the tax status of the payer were different. New Zealand tax law does not generally provide for foreign entities to be entirely disregarded. Even if they are fiscally transparent, such as partnerships, a payment by the entity to a member is generally taken account of for tax purposes (albeit that inclusion by the member of the payment may be largely offset by attribution of a share of the deduction –

this means the payment is potentially subject to section FH 9). One case where a payment can be disregarded in this way is where it is made by one member of a tax consolidated group to another member – see section FM 8(2); or

- in the case of a branch mismatch, the payer and payee were separate persons; and
- the defensive rule applies where the relevant parties are a New Zealand person and its foreign branch, the New Zealand person is in the same control group as the payer, or where the payment is part of a structured arrangement.

Additionally, subsection (1)(b) provides that the defensive rule does not apply where the relevant foreign country has hybrid mismatch rules (that is, that country's primary rule, equivalent to section FH 5, would take priority).

In the case of deemed branch payment made by a foreign branch of a New Zealand person, the amount of the payment is determined in proposed section FH 6(2) by reference to amounts allocated to the branch relating to New Zealand activities, to the extent they exceed expenditure or loss of the New Zealand person that belongs to the same category of expenditure. Additionally, the amount of the payment cannot relate to a payment by the New Zealand person (or a member of the same control group) to a person outside of the control group.

The payee of the payment has a mismatch amount for the amount of the payment. This amount is assessable income, derived in the year in which it would be derived if the payer and payee were separate persons or the payer's tax status were different. This assessable income can be reversed by proposed section FH 12.

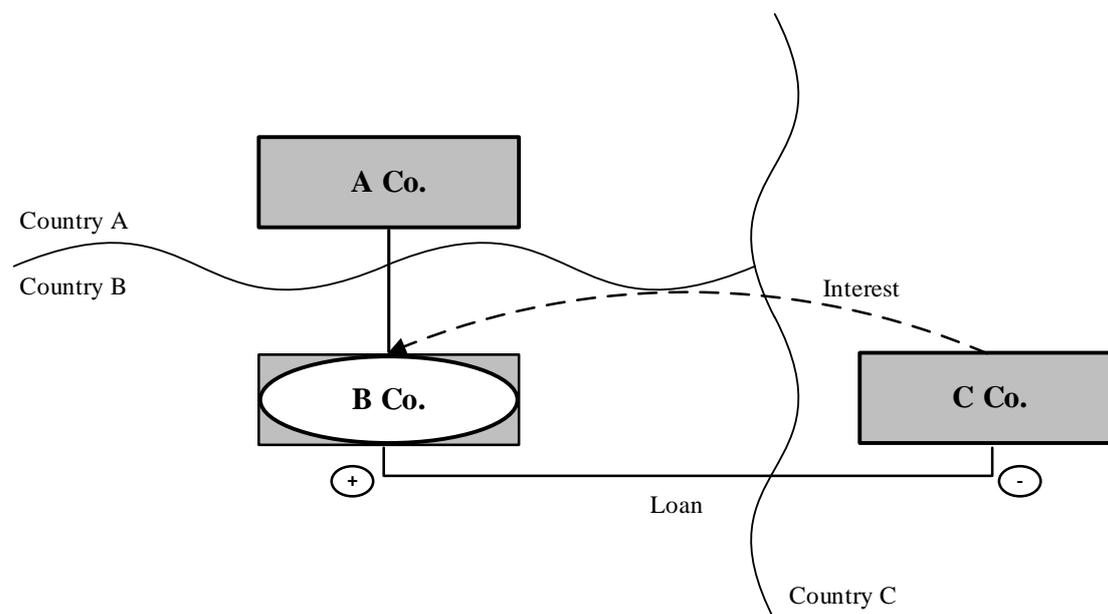
REVERSE HYBRID RULE AND BRANCH PAYEE MISMATCH RULE

(Clause 30, section FH 7)

Background

A reverse hybrid entity is an entity which is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In figure 6, B Co. is the reverse hybrid.

Figure 6



If B Co. receives a payment that is deductible for the payer (C Co.), that payment may not be taxed in Country A or B. This is because Country B views the payment as being earned by A Co., while Country A views the payment as being earned by B Co. If the payment would have been taxable had it been made directly from C Co. to A Co., this is a deduction/no inclusion hybrid mismatch outcome.

A similar outcome can arise as a result of a branch mismatch. For example, if figure 6 is modified so that:

- there is no B Co., but Country A treats C Co.'s payment as received by a Country B branch of A Co., and exempts it under a territorial approach to active income; and
- Country B does not recognise the payment as received by a permanent establishment in Country B

the result will be that the payment by C Co. is not taxed anywhere.

Summary of proposed amendments

Section FH 7 implements recommendation 4 of the OECD Hybrid Mismatch Report, denying a deduction for a payment to a reverse hybrid in certain cases. It also implements recommendation 2 of the OECD Branch Mismatch Report, denying a deduction for a payment which is not taxed due to a branch mismatch in certain cases.

Application date

Section FH 7 applies to deductions claimed in income years beginning on or after 1 July 2018.

Detailed analysis

Section FH 7(1) denies a deduction for a payment:

- to a person who “exists” under the law of another country (the “payee jurisdiction”). This requirement assumes that the person is not a natural person, and owes their existence to the laws of a particular country. For example, in the case of a company, the company must be formed or otherwise owe its existence to a particular country’s laws;
- treated in the payee jurisdiction as either:
 - received in another country. This will be the case where there is a potential branch mismatch. A branch mismatch requires that the payee treats the payment as attributable to operations outside its residence country; or
 - income of another person in the same control group as the payer. This second limb will apply in the case of a reverse hybrid. The payee jurisdiction treats the reverse hybrid as fiscally transparent, so that the payment is treated as the income of its owners. The requirement is only met in the case of an owner who is in the same control group as the New Zealand payer;
- where the payee and payer are also in the same control group, or the payment is made under a structured arrangement;
- the payment is not subject to taxation of a person in the same control group as the payee. This will be the case where:
 - in the case of a potential branch mismatch, the branch country does not tax the payment;
 - in the case of a reverse hybrid, the owner country does not tax the payment;
- the payment would have been taxable if it were made:
 - in the case of a branch mismatch to the payee directly in the payee jurisdiction;
 - in the case of a reverse hybrid, directly to the owner.

If these requirements are met, section FH 7(2) denies a deduction for the payment. If the payment relates to a foreign currency loan, the payer is also denied a deduction for any other expenditure relating from foreign currency movements. There is no reference to income arising from such movements.

DEDUCTIBLE HYBRID AND BRANCH PAYMENTS RULE

(Clause 30, sections FH 8 and FH 9)

Summary of proposed amendments

In addition to disregarded hybrid payments, a hybrid entity can also generate a double deduction mismatch if it makes a deductible payment to a third party. This is because the expenditure of a hybrid entity is attributed to its owners under the laws of the owner country, while the same expenditure is treated as deductible in the country of the hybrid entity. Branch structures can also achieve the same result, particularly if the country where the entity with the branch is resident taxes the branch income (as New Zealand does).

Proposed sections FH 8 and FH 9 implement recommendation 6 of the OECD Hybrid Report and recommendation 4 of the OECD Branch Report. They are respectively primary and defensive rules designed to deal with hybrid and branch payment mismatches which produce double deduction (DD) outcomes.

The primary rule applies where the hybrid entity or branch is owned by a New Zealand resident and located in a foreign country, whereas the defensive rule applies where the hybrid entity or branch is in New Zealand and owned by a person in another country. Notably, the primary rule's application is restricted such that only foreign branches or hybrid entities that are capable of offsetting their losses against the income of a foreign (non-hybrid) entity are within scope of the rule. This means that simple offshore structures, such as a New Zealand company with (only) a foreign branch in a country are excluded from the rule. The primary rule also contains a transitional rule that ensures that a person that transitions into the scope of the rule will not benefit from the restricted scope in relation to previous year foreign losses.

The effect of these provisions is to identify gross amounts of expenditure relating to a person's branch or hybrid entity. These identified amounts are non-deductible in New Zealand unless they can be offset under proposed section FH 12 (see below).

Application date

The rules will apply to income years beginning on or after 1 July 2018.

Detailed analysis

Primary rule (section FH 8)

New Zealand residents that are related to a foreign hybrid entity or have a foreign branch may fall within the scope of this rule.

The main requirement for the rule to apply is in sections FH 8(1)(a) and FH 8(1)(b) which together require that the relevant foreign country allows losses of the hybrid entity/branch to be offset against income of a person whose income is not taxed in

New Zealand (other than that which is sourced in New Zealand). This is often referred to (though not in the legislation) as non-dual inclusion income.

Section FH 8(2) provides that a New Zealand person to which section FH 8 applies has a mismatch amount for the expenditure it incurs through the hybrid entity or branch. This amount of expenditure is denied a deduction under section FH 8(3). The mismatch amount can then be offset against surplus assessable income under proposed section FH 12.

Example 1

The Globe group consists of Prospero Co., Falstaff Co. and Mercutio Co. Prospero Co., a company resident in New Zealand, owns 75 percent of Falstaff Co., a hybrid entity resident in Titania (a foreign country). Falstaff Co. is treated as a company in Titania, but is treated for New Zealand tax purposes as a partnership. Its income and expenditure is thus attributed to its owners (Prospero Co. and the 25 percent minority owner). Falstaff Co. owns 100 percent of Mercutio Co., a company resident in Titania, and the two entities are consolidated. The consolidation regime of Titania allows the losses of one entity to be offset against the income of the other. Mercutio Co. is treated for New Zealand tax purposes as a company, and undertakes an active business in Titania, such that its income is not attributed to Prospero Co. under the CFC regime.

Falstaff Co. performs a financing function for the Globe Group, which means that it regularly makes tax losses in Titania due to the deductibility of its financing costs. The financing expenditure is also attributed to Prospero Co. under New Zealand law, and Prospero Co. claims deductions for its 75 percent share of that expenditure. Because Falstaff Co. borrows in Titanian dollars, fluctuations in the NZ\$/T\$ exchange rate mean the amount of its deductions attributed to Prospero Co. under New Zealand tax rules can be much larger or smaller than the amount calculated for Titanian tax purposes.

Prospero Co. satisfies section FH 8(1) due to the ability of its related hybrid entity Falstaff Co. to offset its losses against the income of Mercutio Co., which is not generally assessable in New Zealand. Under section FH 8(2), Prospero Co. has a mismatch amount equal to its expenditure from Falstaff Co. There is no need to compare the amount of this expenditure with the amount of expenditure Falstaff Co. calculates for Titanian tax purposes.

A person that is outside the scope of section FH 8(1) because its foreign hybrid or branch is not able to set off expenditure or loss against another person's non-dual inclusion income and then falls within the scope of the subsection due to a change of group structure (for example, the acquisition of a new non-hybrid entity in the same country as the hybrid entity) is subject to the rule on a prospective basis and also must consider the proposed subsection (4) and (5) of section FH 8. These provisions function as a transitional rule for persons in such a situation to reverse their historic foreign hybrid or branch losses if they become usable in the other country in a way that would defeat the integrity of the primary rule.

This transitional rule only applies if:

- the person was related to a foreign hybrid entity or had a foreign branch prior to subsection (1) applying to the person; and
- the laws of the relevant foreign country allow accumulated losses of the hybrid entity or branch to be set off against income that is not assessable in New Zealand under the new structure.

To the extent those requirements are met, proposed section FH 8(5) treats the net loss of the hybrid entity or branch as assessable income and a mismatch amount.

Example 2

Drake Co., a company resident in New Zealand, has for many years sold guitars in Pink Moon Country (a foreign country) through a branch. In the last two years trading conditions have been poor in Pink Moon Country and the branch has made losses. These accumulate in Pink Moon Country and can also be offset against Drake Co.'s assessable income from other activities. Drake Co. has had no other activities or interests in Pink Moon Country.

Drake Co. does not satisfy the section FH 8(1)(a) and section FH 8(1)(b) requirements because the branch losses cannot be offset against the income of an entity that is not taxable in New Zealand.

However, Drake Co. has now decided to expand its operations in Pink Moon Country by acquiring Bryter Co. - a company resident in Pink Moon Country that sells pianos and has a very solid profit history. Bryter Co. is treated as a company for New Zealand tax purposes.

The tax laws of Pink Moon Country allow Drake Co. to group its Pink Moon branch operations with Bryter Co. profit such that its future branch losses can be offset against the income of Bryter Co. Drake Co. must now apply section FH 8 to any future branch losses; they will become non-deductible mismatch amounts under section FH 8(2).

The laws of Pink Moon Country have no rules preventing the branch losses of Drake Co. accumulated before the Bryter Co. acquisition to be carried forward and offset against Bryter Co. income post-acquisition. Drake Co. must thus apply section FH 8(5) and will have to include as assessable income the accumulated Pink Moon Country branch losses, as calculated for New Zealand tax purposes, in its New Zealand income in the income year of the Bryter Co. acquisition.

Defensive rule (section FH 9)

The defensive rule mirrors the primary rule. It is applied by a foreign resident operating in New Zealand through a branch or a New Zealand hybrid entity in the same control group as a foreign resident. The defensive rule does not apply where the country of that foreign resident has enacted the primary rule.

The rule applies when expenditure of the hybrid entity/branch is deductible in New Zealand and the country of the foreign resident also allows that expenditure as a deduction for the foreign resident.

Proposed section FH 9(2) provides that the hybrid entity or foreign resident through its branch has a mismatch amount for the expenditure it incurs in New Zealand. A deduction is denied for this mismatch amount unless and until it is set off against surplus assessable income under proposed section FH 12.

Example 3

Jefferson Co., a foreign company resident in Washington Country (a foreign jurisdiction) owns 100 percent of Hamilton Co., an unlimited liability company resident in New Zealand. Hamilton Co. is a hybrid entity (see below for commentary as to the definition of this term).

Hamilton Co. incurs various expenses in carrying out its business. These expenses are deductible in New Zealand and are treated as deductible against the income of Jefferson Co. under the tax laws of Washington Country. Washington Country has not enacted hybrid rules.

Under section FH 9(2), Hamilton Co. has a mismatch amount for its incurred expenditure. This expenditure will be non-deductible, except as provided for in section FH 12. This denial is intended to ensure that the expenses incurred by Hamilton Co. cannot be used to offset income which is taxable in New Zealand but is not taxable to Jefferson Co. in Washington Country.

DUAL RESIDENT PAYER RULE

(Clause 30, section FH 10)

Summary of proposed amendments

Proposed section FH 10 implements recommendation 7 of the OECD Hybrid Report. It is a rule designed to deal with companies that are resident in two countries and which produce double deduction (DD) outcomes.

New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group, which are two ways that dual resident company losses can be offset against income that is not taxed in both countries. This rule will more thoroughly prevent this outcome by removing the ability of a dual resident company to offset its expenditure against income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership.

Application date

The rules will apply to income years beginning on or after 1 July 2018.

Detailed analysis

Proposed section FH 10(1) provides that the rule applies to a company that is a New Zealand resident and is liable to tax in another jurisdiction due to its domicile, residence or place of incorporation.

Proposed section FH 10(2) states that a company meeting the requirements of subsection (1) has a mismatch amount for all of its expenditure. A deduction is denied for the expenditure under section FH 10(3). Such a company must then apply section FH 12 to determine whether the denial can be reversed. Generally, the two sections will interact by allowing the expenditure to be offset against the income of the company, less any income that is not and will not be included in the other jurisdiction that the company is resident in.

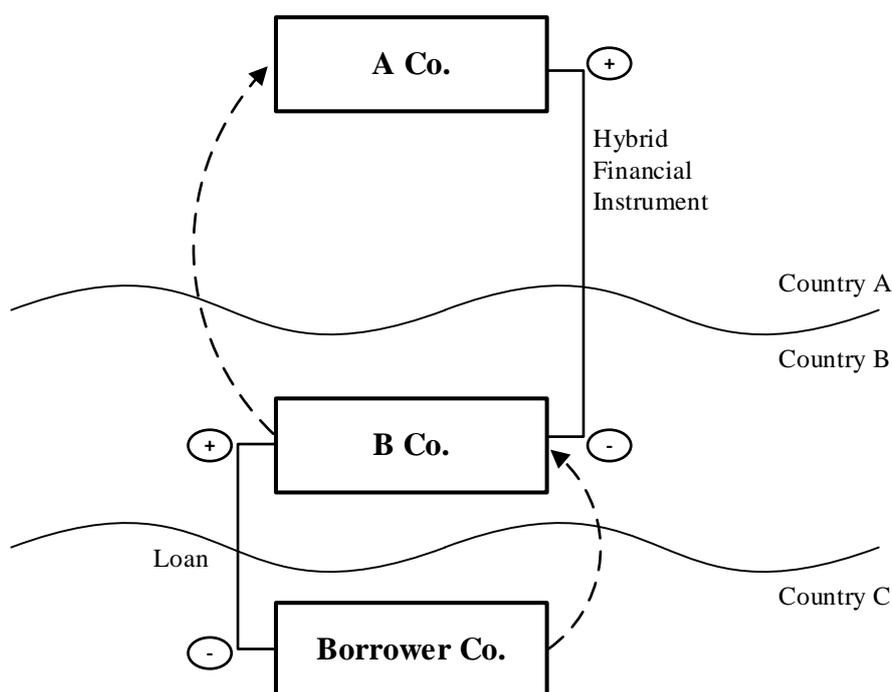
IMPORTED MISMATCH RULE

(Clause 30(1), section FH 11, and clause 30(4))

Background

An imported mismatch occurs when a payment that does not directly result in a hybrid mismatch outcome funds another payment that creates a hybrid mismatch outcome. Figure 7 is an example of an imported mismatch.

Figure 7



The imported mismatch here occurs between B Co. and Borrower Co. Borrower Co. gets a deduction for its payment and B Co. includes that payment as taxable income, meaning there is no direct hybrid mismatch on that payment. However, that payment is used to fund the payment on a hybrid financial instrument from B Co. to A Co. This payment results in a deduction for B Co., but no corresponding income inclusion for A Co. The loan between Borrower Co. and B Co. then 'imports' the hybrid mismatch back to Country C, where there is a resulting indirect deduction/no inclusion hybrid mismatch.

Summary of proposed amendments

This section denies a deduction for a payment (the imported mismatch payment) which does not itself give rise to a hybrid or branch mismatch, but which is treated as funding such a payment (the funded payment). Imported mismatch payments are split into payments where the imported mismatch payment and the funded payment are part of an arrangement (a structured arrangement) and those where they are not.

Application date

Section FH 11(3), which denies a deduction for an imported mismatch payment which is part of a structured arrangement, applies for income years beginning on or after 1 July 2018. Deductions for other imported mismatch payments are not denied until income years beginning on or after 1 January 2020.

Detailed analysis

For purposes of section FH 11, the person who makes the deductible payment is referred to as the funder. Subsection (1) provides that the section applies to a payment which is made by the funder to a person in a country which does not have hybrid mismatch rules and which:

- directly or indirectly funds a hybrid mismatch payment. In order for the funded payment to be a hybrid mismatch payment, it must be between two persons who do not have hybrid mismatch rules that counteract the mismatch (paragraphs (a), (d) and (e));
- is otherwise deductible to the funder (paragraph (b)); and
- is:
 - made under a structured arrangement; or
 - funds a hybrid mismatch between two persons (the payer and the payee) who are in the same control group as the funder (paragraph (c)).

The amount of the deduction denied to the funder depends on whether the payment is made under a structured arrangement or not. The definition of a structured arrangement is the definition used for the hybrid rules generally. A structured arrangement can exist between control group members. For example if funds are provided by a foreign parent to a New Zealand borrower via a series of consecutive intra-group funding transactions, and a transaction in that series gives rise to a hybrid mismatch, it is highly likely that the loan to the New Zealand borrower is part of a structured arrangement.

If the payment is under a structured arrangement, the amount of the denial is given by subsection (3). It is the amount of the deduction, limited to the amount of the funded payment for which a deduction would be disallowed to the payer of the hybrid mismatch payment if hybrid mismatch legislation applied to that person.

If the payment is not under a structured arrangement, the amount denied is the amount that can fairly and reasonably be treated as providing funds for the portion of the funded payment giving rise to a hybrid mismatch. Subsection (5) provides that this portion should be determined consistently with the approach used in chapter 8 of the OECD Final Report.

SURPLUS ASSESSABLE INCOME

(Clause 30, section FH 12)

Summary of proposed amendments

Section FH 12 allows a deduction for hybrid mismatch amounts to the extent that the person paying or deriving the amounts has income which is taxable in New Zealand and can be expected to also be taxed in the other country giving rise to the hybrid mismatch. This income can arise in a different income year from the year the hybrid mismatch amount is disallowed.

Application date

Section FH 12 applies to income years beginning on or after 1 July 2018.

Key features

Section FH 12 applies separately to each mismatch situation to which a person is party, but it applies to all mismatch amounts with respect to that situation.

A key feature of the section is the definition of surplus assessable income. Generally, this is surplus assessable income from earlier years which has not been offset by deductions for mismatch amounts, plus assessable income arising during the year from the structure which can be expected to be taxed in the other country also. Exempt dividends can also be included in some cases.

The carry forward of surplus assessable income and hybrid mismatch amounts is subject to the usual 49 percent ownership continuity test that applies to tax losses.

Background

Deduction/no inclusion of taxable income (D/NI) payments give rise to double non-taxation where the deduction is used against income which is taxed only in the payer country. In that case the effect of the D/NI payment is to reduce payer country tax without increasing payee country tax. To the extent that the entity or branch earns income which is taxable in both countries (referred to by the OECD reports as dual inclusion income, and in the Bill as surplus assessable income), the D/NI payment will still reduce payer country tax, but it will increase payee country tax. That is because the payee country income calculation will not give a deduction for the D/NI payment. So, any tax reduction as a result of that payment in the payer country will simply reduce the amount of tax for which a credit can be claimed in the payee country.

The same result holds for double deductible payments. If a double deductible payment by a hybrid payer is used against non-dual inclusion income, that can produce double non-taxation. However, if the hybrid is profitable in both the hybrid

and owner countries, all of the double deduction expenditure will, broadly speaking, be deducted against dual inclusion income, and there is no mischief.

The purpose of section FH 12 is to reverse the denial of deductions (or inclusion of income, in the case of section FH 6) that arises under sections FH 5, FH 6 and FH 8–FH 10 where there is dual inclusion income.

Detailed analysis

Section FH 12(1) applies when a person has a hybrid mismatch amount for a mismatch situation. A person can have more than one mismatch situation.

Example 1

Burr Ltd, a New Zealand resident company, owns 99.9 percent of Philip LP, a limited partnership formed under the laws of, and operating in, Country A (the remaining 0.1 percent is held by another group company). Philip LP is a hybrid entity, because it is taxed as a company in Country A and a partnership in New Zealand. It has a branch in Country B. Income and expenditure of the branch is not taxed in Country A because of an exemption for active branch income. Burr Ltd also owns 100 percent of Mercer Ltd, a company incorporated and tax resident in Country A, which is in a tax consolidated group with Phillip Partnership for Country A tax purposes.

Payments by Philip LP that relate to its Country A activities are deductible in New Zealand (to Burr Ltd) and Country A (to Philip LP).

Payments by Philip LP that relate to its Country B activities are not deductible in Country A but are deductible in New Zealand and the US.

In this case, Burr Ltd is party to two mismatch situations, one with respect to its interest in Philip LP and one with respect to its interest in Phillip LP's Country B branch. It will have a different mismatch amount for each one.

Subsection (2) requires a person's mismatch amounts from a mismatch situation to be set off against the person's surplus assessable income from the situation. Surplus assessable income is the total of:

- surplus assessable income not offset by mismatch amounts in previous years (subject to a reduction also for foreign tax credits in the other country, discussed below); plus
- assessable income derived from the situation during the year; plus
- if the person is a New Zealand resident hybrid entity, exempt New Zealand source dividends derived during the year if these are taxable to the foreign owner with no tax credit other than for withholding tax; less
- unrecognised amounts. These are assessable income which is not subject to tax in the other country because of the residence of the person who earns the income, or the source of the income; less
- the amount of assessable income earned by the entity which is protected from New Zealand tax by a foreign tax credit; less

- deductions incurred in earning assessable income which do not give rise to mismatch amounts.

Example 2

In the example, above, suppose the following amounts of income and expenditure during the year. The tax rate in all three countries is 25%.

Burr Ltd, before applying subpart FH

	New Zealand only	Country A only	Country B only	Total
Assessable income	300	200	100	600
Expenses	150	210	40	400
New Zealand taxable income	150	(10)	60	200

For the Country A mismatch situation, Burr Ltd has:

- a double deduction amount of \$210; and
- surplus assessable income of \$200, being:
 - \$300 (the amount of assessable income earned through Phillip LP including through the Country B branch); less
 - \$100 (the amount not recognised in Country A because it is from an active business in Country B); less
 - assuming no tax is paid in Country A, no credit protected amount; less
 - deductions incurred in deriving assessable income other than hybrid deductions. This should be zero in this case.

Accordingly, the deduction denied to Burr Ltd under section FH 8 for the \$210 which is a mismatch amount is allowed under section FH 12 as to \$200, and Burr Ltd has \$10 of denied deduction to carry forward to the next year.

For the Country B mismatch situation, Burr Ltd has:

- a double deduction amount of \$40; and
- surplus assessable income of \$100, being the \$100 assessable income earned through the US branch. The other amounts in the calculation of surplus assessable income are zero.

So all of the \$40 deduction denied under section FH 8 for the Country B mismatch situation is allowed under section FH 12. For the Country B situation, Burr Ltd also has \$60 surplus assessable income which it can carry forward to the next year under subsection (6). This surplus assessable income cannot be used to claim a deduction for the \$10 of denied deduction for Phillip LP's Country A double deductions.

Carry forward of a mismatch amount or surplus assessable income not offset in a year is provided for in subsection (6). Carry forward is subject to subsection (7), which imposes the same 49 percent continuity of ownership test as applies to tax losses.

Example 3

In year 2, Phillip LP (excluding Country B) has \$30 of double deductions and \$50 of surplus assessable income. The \$10 mismatch amount for which a deduction was not allowed in year 1 can prima facie be deducted against the \$20 of surplus assessable income. However, the group that includes Burr Ltd, Phillip LP and Mercer Pty Ltd is sold to a new owner at the beginning of year 2. This sale will terminate the carry forward of the \$10 denied deduction with respect to the Country A mismatch situation. So that amount cannot be deducted in year 2.

Subsection (8) provides for a situation where an amount for which a deduction is denied under section FH 8 (a double deduction amount) ceases to be a mismatch amount because the person treated as having the loss in the other country ceases to exist before the loss is used in the other country. This means the loss is no longer able to be used in that other country. This is referred to in the OECD hybrid report as a “stranded loss”.

The section applies where:

- a New Zealand person has a mismatch amount arising under section FH 8 available to be carried forward at the end of a year;
- the person who incurred the loss under the other country’s rules (which may be the New Zealand person or a hybrid entity) ceases to exist; and
- under the law of the other country, in the year in which the mismatch arose or any later year, the person has not offset a loss against income which is not assessable in New Zealand.

If these requirements are met, the mismatch amount will be:

- in the case of a loss incurred by a foreign branch of a New Zealand person, treated as a tax loss component in the year the entity with the branch ceases to exist, in which case it can be offset against another group company’s income in that year; or
- in the case of a loss incurred by a hybrid entity, treated as an ordinary tax loss of the owner.

DIVIDEND ELECTION

(Clause 30, section FH 13)

Summary of proposed amendments

Section FH 13 allows a person who pays interest which is non-deductible by reason of section FH 3 to choose to treat the hybrid financial instrument on which the interest is paid as a share, and the payment as a dividend, for all tax purposes.

Application date

This election is available in income years beginning on or after 1 July 2018.

Key features

This election must be notified to the Commissioner before it takes effect, specifying the date on which it takes effect. On the effective date, the amount owing under the loan is treated as fully repaid by the person (which may trigger an NRWT obligation) and subscribed for an issue of shares having the same terms as the loan.

An election ceases to have effect if the interest payments are no longer subject to deduction denial under section FH 3. At that time the deemed shares are treated as cancelled for an amount equal to the amount payable under the loan, and that amount is treated as re-subscribed for the loan.

Background

If a deduction is denied for an interest payment under section FH 3 and the payment is also subject to NRWT at 10% or 15%, there is an element of double taxation. People can generally avoid this by entering into non-hybrid loans, and so the election under section FH 13 is not strictly necessary to avoid double taxation. However, the election is proposed in order to ensure that the hybrid rules do not give rise to double taxation even if a person has entered into a hybrid loan.

The election will allow a payment which is non-deductible under section FH 3 to be made free of NRWT if the payer either attaches imputation credits to the dividend or is entitled to a zero percent NRWT rate under an applicable treaty. The section treats the instrument on which a payment is made as a share for all circumstances in order to avoid any inconsistencies arising as a result of its being treated differently for different purposes.

Detailed analysis

Subsection (1) states who can make the election – a borrower who would be denied a deduction of interest under section FH 3.

Subsection (2) states the broad result of the election, that is, that while the person is eligible to make it, the financial arrangement giving rise to the payment is treated as a share for all purposes of the Act. Since there will be no voting rights attached to the financial arrangement, it will generally have the same tax effect as a non-voting redeemable share. Payments on it will be subject to the benchmark dividend rule in section OB 61.

Subsection (3) requires the election to be notified to the Commissioner specifying an elective date which must be on or after the date of the notice.

Subsections (4) and (5) spell out in more detail the effect of an existing financial arrangement being subject to an election (the election can also be made for a financial arrangement yet to be entered into), and also the effect of it ceasing to be subject to the election.

On the effective date for the election the borrower is treated as paying all amounts owing under the financial arrangement. If this includes unpaid interest, this interest will give rise to an NRWT or AIL obligation as appropriate. The amount so repaid, less any NRWT, is then treated as subscribed for the share.

Once the interest payments on the instrument are no longer subject to section FH 3, the election becomes ineffective. The deemed shares are then treated as redeemed for the amount owing (which will include any accrued “dividend”) and that amount, against less any NRWT, is treated as re-subscribed for the shares.

OPAQUE ELECTION

(Clause 30, section FH 14)

Summary of proposed amendments

This section allows a New Zealand resident who has a wholly owned foreign hybrid entity when the Bill is introduced to elect to treat it as a company for New Zealand tax purposes. It is intended to simplify compliance for people who set up foreign hybrid vehicles before the hybrid rules were introduced.

Application date

The election applies for income years beginning on or after 1 July 2018. It must be made before the due date for the return of income for the first year in which the hybrid mismatch rules apply to the person.

Key features

The section applies to a New Zealand resident who has, or is a member of a wholly owned group that has, a wholly owned hybrid entity. By making the election such a person can treat the entity as a company for New Zealand tax purposes. This will avoid the person having to apply many of the hybrid rules in relation to the entity. Of course, it will also mean that the entity's income is separate from the owner's income, so that, for example, losses from the entity do not reduce the owner's taxable income.

Background

The hybrid rules impose a compliance burden on a person who is subject to New Zealand tax and has an interest in a foreign entity which is fiscally opaque for purposes of the foreign country but transparent for New Zealand tax purposes. The person has to determine whether there are any deductions claimed by the entity in the other country for payments which are disregarded in New Zealand. If section FH 6 applies, the person will also have to determine the expenditure attributable to the foreign entity and treat it as ring-fenced expenditure, only able to be deducted against income from the entity.

These rules target avoidance of double non-taxation due to different rules relating to the tax classification of entities. The same result can be achieved by ensuring that New Zealand classifies the relevant entity in the same way as the other country. While that is not the approach recommended by the OECD, and it would undoubtedly raise issues which would need to be carefully thought through, adopting it in the very limited circumstances proposed here does not seem problematic.

Detailed analysis

The election can be made by a person who, on the date of introduction of the Bill, owns, or is a member of a wholly owned group that owns, all the ownership interests in a hybrid entity (subsection (1)). Under subsection (3) the owner must notify the election to the Commissioner on or before the due date for the person's tax return for the first income year in which the hybrid rules apply to the person. The election will be effective from the first day of the year (subsection 4) and will determine the New Zealand tax treatment of the entity for the remainder of its existence, regardless of who owns it in the future (subsection (7)).

The effect of the election is that the owners of the entity (the actual owners that is, who may or may not include the person making the election) are treated as selling, on the first day of the income year, the hybrid's undertaking to a new company in return for shares. The sale will in most cases trigger some taxable gain or loss, after which point the hybrid entity's undertaking will no longer be in the New Zealand tax base. The available subscribed capital of the deemed new company will equal the net value of the undertaking it is deemed to acquire (subsection (6)).

The owners of the hybrid entity will have to apply the FIF or CFC rules to it as appropriate, and will have to treat all distributions from it as dividends for tax purposes.

HYBRID RULE DEFINITIONS

(Clause 30, Section FH 15)

Act together

This definition is relevant for determining whether two persons are in a control group or are related persons by virtue of paragraphs (g) or (h) of the control group and related person definitions. Paragraphs (g) and (h) include two persons in a control group if one effectively controls the other or the same group of persons effectively controls both. In both cases, interests held by persons who are related or who act together are aggregated.

The definition of “act together” is intended to be highly fact dependent. For instance, two persons will act together if one “typically” acts in accordance with the wishes of the other, or if their actions are typically controlled by a third person (unless that third person is excluded by section FH 15(2)).

Control group

Many of the hybrid provisions only apply to payments between members of a control group (unless there is a structured arrangement). The control group definition is generally intended to include persons who are commonly controlled or meet a 50 percent common ownership threshold. For companies and partnerships (whether formed under New Zealand or foreign law) these tests are well established for other purposes, and the definition used in the hybrid rules incorporates these other definitions. For trusts, it is more difficult to determine ownership (whether by reason of control or economic interests), and accordingly the legislation uses the same tests that apply to determine whether or not parties are associated.

Financial instrument

This definition is most relevant for sections FH 3 and FH 4. It is intended to encompass all forms of debt and equity. It builds on the financial arrangement definition, which is deliberately very broad. Additions to that definition are then made, including for:

- shares: this inclusion may be of less significance given the deductible foreign equity dividend rule, but it would be odd to leave shares out of the definition;
- annuities: which are only excluded from the financial arrangement rules because they are taxed under their own regime;
- share lending arrangements: share repurchase agreements (share repos), and share lending arrangements which do not meet the statutory definition, are all financial arrangements. Share lending arrangements which do meet the statutory definition are excluded from the financial arrangement definition, and need to be brought back in for purposes of the hybrid rules, as they may be hybrid financial transfers, subject to either sections FH 3 or FH 4.

Hybrid entity

No entity is inherently a hybrid entity. Hybridity exists only as a result of the inconsistent tax classification of the entity by two countries' tax systems. A hybrid entity is defined as one which is recognised as a person subject to tax (that is, taxed like a company) in a country that treats it as a tax resident, and not recognised as a person that is subject to tax (that is, taxed like a partnership) in another country. The hybrid entity definition is used in sections FH 8 and FH 9 to help to define when those rules (OECD recommendation 6 primary and defensive rules applying to amounts which are deductible twice) apply. It is used in section FH 14 to define the kind of entity in respect of which an opaque election can be made. It is also used in section FH 12

Hybrid mismatch

This definition is used in section FH 11, the imported hybrid mismatch section. A payment is only subject to deduction denial under section FH 11 if it funds in some way a hybrid mismatch.

Hybrid mismatch legislation means subpart FH and corresponding legislation in other countries. Another country's legislation will be "corresponding" if it is enacted in accordance with the OECD's Action 2 recommendation, with or without the addition of branch mismatches. It is not to be expected that another country's legislation will be exactly the same as New Zealand's. This means that the amount that New Zealand might counteract, in a given situation, is different from that which would be counteracted by another country's rules in exactly the same situation. This should not prevent that other country's rules qualifying as hybrid mismatch legislation.

Mismatch situation

This means a situation giving rise to denial of a deduction, or assessable income, under sections FH 5, FH 6, or FH 8 to FH 10. A person can be involved in more than one mismatch situation. Also, a single mismatch situation can give rise to more than one kind of mismatch. For instance, a New Zealand resident hybrid entity can make payments which are subject to both section FH 5 (because they are made to a foreign owner who disregards the entity) and section FH 9 (because they are deductible in New Zealand and the foreign country).

Related

This definition is important for sections FH 3 and FH 4. It is closely based on the associated person definition, except that:

- for two companies, it imposes a 25 percent common ownership test;
- it applies the same 25 percent rule to a general partnership as for a limited partnership; and
- there is a common control test, which also aggregates interests of persons who act together, also as defined in section FH 15.

Structured arrangement

This definition is used for defining the situations where a hybrid mismatch between persons who are not related or in a control group is nevertheless subject to the hybrid rules. It follows the definition in chapter 10 of the OECD Hybrids Report, by having two (potentially overlapping) limbs, the first of which includes an arrangement where the pricing is based on the existence of a hybrid mismatch, and the second of which includes an arrangement whose terms are intended to produce a hybrid mismatch. The test of “intention” is an objective one, to be applied by looking at the facts and circumstances of the whole arrangement. An arrangement can be intended to produce a hybrid mismatch even if it is also intended to produce significant commercial outcomes.

Section FH 15(2) provides that a person will not be treated as acting together with another person on the grounds that both persons’ interests in an entity are managed by the same person if the interests are held through investment funds that do not act together in relation to those interests.

FIF RULE CHANGES RELATING TO HYBRID RULES

(Clauses 12–16)

Summary of proposed amendments

The Bill contains some amendments to the foreign investment fund (FIF) regime designed to ensure that a person holding a FIF interest must use the comparative value (CV) method to calculate FIF income from the interest if a distribution on the interest might otherwise be subject to hybrid rules counteraction. The amendments also turn off the ability for to a share supplier of a FIF interest under a returning share transfer to use the fair dividend rate (FDR) method in relation to an arrangement within the scope of the hybrid rules.

Application date

The changes apply for income years beginning on or after 1 July 2018.

Key features

The key features of these clauses is that they require a person to use the CV method in relation to a FIF interest if:

- the FIF is entitled to a deduction or equivalent tax relief in relation to the distribution (subject to certain additional requirements);
- the person holds the shares as a share user under a returning share transfer which is within the scope of the hybrid rules.

They also turn off the ability of a share supplier in a returning share transfer to use the FDR method in relation to FIF interests which are within the scope of the hybrid rules.

Background

A straightforward situation where the hybrid rules could apply to a person holding a FIF interest is where the arrangement is within the scope of the hybrid rules and the FIF is entitled to a deduction or equivalent tax relief for a distribution in its country. If the person is applying the FDR method:

- technically, the dividend is exempt income (section CW 9(1));
- the distribution may be greater than the amount recognized under the FDR method.

This may make it difficult to determine whether and to what extent the hybrid rules should apply to the deductible dividend.

A more complex scenario arises in relation to a FIF interest held by a share user pursuant to a returning share transfer. The hybrid rules apply to hybrid transfers giving rise to a deductible/non-includible result. One way this can occur is if a New Zealand person lends money to a foreign related party by way of a returning share transfer which is a share repo arrangement. In a share repo arrangement, the loan takes the form of an initial sale of shares by the borrower to the lender, followed by a sale back of equivalent shares. The lender may make a financing return by:

- receiving and retaining the dividend on the shares;
- receiving a greater amount for the sale back of the shares than it paid to acquire them.

In some countries, the borrower in a share repo arrangement is treated for tax purposes as continuing to own the shares, which it has provided as security for a loan. In this case, the tax law applying to the borrower will usually treat any dividend paid on the shares and retained by the lender as if it were a deductible payment by the borrower to the lender. If the lender is a New Zealand person and exempt from tax on the dividend, this payment is deductible (to the borrower (share supplier))/non-includible (to the lender/share user).

Application of the FDR regime, which taxes a deemed 5% return, complicates the picture, and would make it difficult to know whether or how to apply the hybrid rules to such a payment. In order to avoid these complications, the legislation provides that the New Zealand lender (the share user) in such situations has to use the CV method to determine its income from the share. This ensures that the dividend is taxable to the lender, and the hybrid rules do not need to apply. It is analogous to the taxation of a deductible foreign equity distribution.

A third scenario arises when a person supplies FIF interests under a returning share transfer which is a share loan. Under current law the person can continue to apply the FDR method as if they still held the shares. If the person is a share lender and receives a substitute payment which is deductible, this can give rise to a hybrid mismatch. In order to prevent this possibility, the changes prevent such a person from applying the FDR method if the counterparty is related to the person, or the returning share transfer is a structured arrangement.

Detailed analysis

Clause 13(2) deals with the more straightforward case of a person holding a share which is a FIF interest in respect of which a dividend is deductible or entitles the payer to equivalent tax relief. The clause inserts a new section EX 46(10)(db) which provides that in such a case the share is a non-ordinary share, which means income from it must be determined using the CV method. This method includes dividends in the calculation of the income, so there can be no hybrid mismatch arising from the payment.

New paragraph (db) only applies if:

- the arrangement is within the scope of the hybrid rules, because the parties are related or it is a structured arrangement;

- the non-resident is not a foreign PIE equivalent. In many countries, widely investment funds are entitled to a deduction or equivalent tax relief for distributions, designed to ensure that their investors, rather than the fund, are subject to tax on underlying income from the fund's investments. An example is an Australian unit trust (AUT), where income to which unit holders are presently entitled is taxed to them rather than the trust. This change is not intended to remove the ability for a New Zealand taxpayer to use the FDR method in relation to an AUT undertaking portfolio investment

Clauses 12, 13(1) and 14 relate to the returning share transfer scenario. Clause 12(1) adds new section EX 47B to the list of provisions which limit a person's choice of FIF income calculation methods. Clause 13(1) amends section EX 46(6)(d) so that a person who holds a FIF interest as a share user in a returning share transfer can use the comparative value method to calculate FIF income from that interest if section EX 47B applies to the person. The Bill is also broadening the definition of a returning share transfer so it does not require that the transfer shares are listed. Clause 14(1) adds new section EX 47B, which requires a person to use the comparative value method to calculate their FIF income or loss from a FIF interest subject to a returning share transfer if:

- the share supplier is resident outside New Zealand;
- the person is related to the share supplier, or the returning share transfer is or is part of a structured arrangement;
- the share supplier is treated as the owner of the shares for purposes of its tax rules.

Clauses 15 and 16 replace subsections EX 52(14C) and EX 53(16C) respectively. Currently these subsections allow a person who holds a FIF interest and calculates income from that interest under the FDR method to continue to apply that method even if the person has disposed of the shares under a returning share transfer. In practice, this seems to mean that replacement payments paid by the share user are treated as exempt (as dividends would be), and the share supplier continues to pay tax only on the "fair dividend". In order to avoid the potential for a hybrid mismatch counteraction in such a case, clauses 15(1) and 16(1) respectively amend these subsections by denying the ability take this approach if the share user is related to the share supplier, or the returning share transfer is part of a structured arrangement. This means the share supplier has to apply the financial arrangement rules to the returning share transfer. The financial arrangement rules are comprehensive, and will ensure that replacement payments are taxable.

NRWT CHANGES CONSEQUENT ON HYBRID RULES

(Clause 41)

Summary of proposed amendments

This clause amends the formula for determining whether a financial arrangement gives rise to non-resident financial arrangement income (NRFAI). It is intended to ensure that expenditure for which a deduction is denied or deferred under the hybrid rules is not taken into account in determining whether a loan gives rise to non-resident financial arrangement income.

Application date

The amendment applies for income years beginning on or after 1 July 2018.

Background

The purpose of the NRFAI definition is to identify situations where there is a sufficient degree of deferral between:

- deductions; and
- payments

under a financial arrangement between associated parties that NRWT should be imposed on an accrual basis, rather than the usual payments basis. The purpose is to ensure that in such cases, there is a better matching between deductions for the borrower and the imposition of NRWT on the lender.

However, the NRFAI definition looks at when expenditure is incurred, rather when it is deductible. This means that where a deduction for expenditure is denied or deferred under the hybrid rules, that denial or deferral is not taken into account, for purposes of the NRFAI definition, because it does not affect the time when the expenditure is incurred. This is not appropriate. For example, if a deduction for interest expense is deferred under section FH 5 there can be no deferral between deduction and NRWT until the deduction is allowed.

Detailed analysis

Clause 42 reduces the amount of the denominator in the formula used to determine whether a loan gives rise to NRFAI. The denominator is intended to be reduced by the amount of deductions which have been denied or deferred under the hybrid rules. Once the deductions are denied, they are intended to be included in the denominator.

THIN CAPITALISATION CHANGES CONSEQUENT UPON HYBRID RULES

(Clauses 19(1)–(3) and 26)

Summary of proposed amendments

The amendment is intended to ensure that interest for which deductions permanently denied under the hybrid rules do not give rise to additional income under the thin capitalisation rules, and that the debt associated with such interest is not treated as debt under those rules.

Application date

The amendment applies for income years beginning on or after 1 July 2018.

Background

The thin capitalisation rules prevent a multinational group taking deductions for interest expense in New Zealand to the extent that it is excessively highly leveraged. Leverage is determined by comparing debt with assets (less, if the Bill is enacted, non-debt liabilities).

If a deduction is permanently denied for interest under the hybrid rules, it is not appropriate for that amount to be treated as interest under the thin capitalisation rules. Such treatment could result in that amount being subject (effectively) to an additional denial of deduction. It is also not appropriate for the debt giving rise to that interest to be treated as interest-bearing debt. It should be treated as either equity or a non-debt liability.

If a deduction is deferred under the hybrid rules, there is a possibility that that interest will subsequently be allowed, by reason of being offset against surplus assessable income. Deductibility of such interest should depend on the position of the New Zealand borrower and its worldwide group at the time the interest is incurred. Accordingly, no amendment to the current thin capitalisation rules is required in respect of such interest.

Detailed analysis

Section FE 6(3) provides that an entity subject to the thin capitalisation regime has income equal to, broadly speaking, that portion of its interest deductions that is equal to the extent to which its New Zealand debt/assets percentage exceeds the greater of 60 percent and 110 percent of its worldwide debt/assets percentage.

Clause 19 is intended to amend subsection (3) so that it does not include in the amount of interest which can give rise to such income the amount of interest for which a deduction is permanently denied under the hybrid rules.

Clause 26 is intended to exclude from the definition of total group debt the amount of financial arrangements that give rise to interest for which a deduction is permanently denied under the hybrid rules.

NRWT ON HYBRID ARRANGEMENTS: TREATY ISSUE

(Clauses 4 and 42)

Summary of proposed amendment

Proposed new section RF 11C inserts a new hybrid mismatch rule allowing New Zealand to charge NRWT on payments under certain cross border hybrid financing instruments if New Zealand treats the payment as interest. This rule would override our double tax agreements (DTAs).

Application date

The proposed rule would apply retrospectively from 1 April 2008. Where taxpayers have already adopted the position that NRWT or AIL is not payable in respect of such cross border interest payments made prior to the introduction of the Bill, a savings provision will be available.

Background

The Government has identified a further hybrid mismatch issue that arises in the following circumstances.

The New Zealand PE of a non-resident company borrows money from another non-resident in the same overseas jurisdiction as the corporate headquarters of the PE. This occurs under a hybrid instrument which New Zealand treats as debt but the other country treats as shares.

Under our DTAs, New Zealand is able to charge NRWT on interest payments made by a non-resident's New Zealand PE to another non-resident. However, New Zealand is not able to charge NRWT on dividends paid by one non-resident company to another (regardless of whether the dividends are connected with a PE in New Zealand). This means that whether New Zealand can charge NRWT on payments under a hybrid financial instrument in these circumstances depends on whether the payments are classified as interest or dividends for DTA purposes.

Inland Revenue's view has been that New Zealand can charge NRWT on the payments. This is on the basis that the source state's (that is, New Zealand's) classification of the payment determines its tax treatment under the DTA. However, a question has recently been raised as to whether this view is correct.

If this view is not correct, then the PE would be entitled to an interest deduction in New Zealand for the payments (as the payments are characterised as "interest" under New Zealand domestic law), but the payments would not be subject to NRWT (as the payments are characterised as "dividends" under the DTA). This is contrary to the intent of the relevant DTA provisions, as outbound interest, which is deductible in determining the profits of a PE, should always have NRWT withheld unless there is a

specific exemption providing otherwise (For example, some of our DTAs provide specific exemptions to the sovereign wealth funds of the other treaty party).

The hybrid mismatch measures already proposed would ensure that payments made under such hybrids could not be both deductible in New Zealand and non-assessable overseas. This would remove the incentive to use these types of hybrids in most, but not all cases. In particular the existing hybrid measures would still permit payments under a hybrid financial instrument to be deductible in New Zealand, but not subject to NRWT in some cases. This tax treatment differs from that applying to either ordinary interest (which is deductible and subject to NRWT) or dividends (which are non-deductible), and could be attractive to some taxpayers.

Australia already has a rule effectively providing that outgoing payments are not dividends for DTA purposes (and so are subject to Australian NRWT) if they are treated as interest under Australia's domestic law.⁵

Analysis

The Bill proposes inserting a new section RF 11C to clarify this issue. Under proposed section RF 11C(1), the rule applies to a payment of interest (as defined in section YA 1) by a company that is resident outside New Zealand under an applicable DTA to another person who is also resident outside New Zealand under that DTA. Section RF 11C(2) then provides that, for the purposes of the NRWT rules, the payment is treated as interest, notwithstanding anything in the DTA. Section BH 1(4) is also being amended to make it clear that section RF 11C overrides the applicable DTA.

The combined effect of the legislation is that New Zealand may withhold NRWT from a cross border payment that is interest under section YA 1, regardless of whether it is treated as a dividend under the applicable DTA.

⁵ Section 3(2A) of Australia's International Tax Agreements Act 1953

Other policy matters

INCREASING INLAND REVENUE'S ABILITY TO OBTAIN INFORMATION FROM OFFSHORE GROUP MEMBERS

(Clauses 50, 51 and 53 to 55)

Summary of proposed amendments

In order to improve Inland Revenue's ability to investigate multinationals, the Bill proposes amendments to allow the Commissioner to request offshore information that is held by large multinational groups. The proposals in the Bill are based on some existing powers that the Commissioner already has in sections 17 and 21 of the Tax Administration Act 1994.

The Bill also proposes a new civil penalty so the Commissioner can impose a fine of up to \$100,000 on a large multinational group member who has failed to comply with a request for information.

Application date

The proposed changes would apply from the date that the Bill is enacted. This means that these new powers can be used by Inland Revenue after the date of enactment when pursuing current or new investigations, even if those investigations cover income years prior to the date of enactment.

Key features

The proposed new rules only apply to members of large multinational groups. A large multinational group is defined in section YA 1 of the Bill to include multinational groups that exceed the revenue threshold of EUR €750m of consolidated global turnover described in paragraph 5.53 of the OECD transfer pricing guidelines. This revenue threshold was agreed by the OECD as a way to define large multinational groups for the purpose of filing Country-by-Country reports.

The Commissioner has an existing power under section 17 of the Tax Administration Act 1994 to request specific information or documents from New Zealand residents as part of a tax investigation. New section 17(1C) proposes expanding the scope of the existing section 17 power by allowing it to also be used to request information or documents that are held by any member of a large multinational group. This includes members that are non-residents, such as a parent or a sister company.

New section 21BA is designed to incentivise large multinational groups to comply with a request for information under section 17 by setting out some specific consequences that can be applied if the multinational fails to provide an adequate response within a reasonable timeframe. These consequences will enable Inland Revenue to make a tax assessment based on the (limited) information it has available and to prevent the requested information from being admitted as evidence in a dispute or court proceeding.

Background

It can be difficult and resource intensive for Inland Revenue to investigate multinationals with complex tax structures. Inland Revenue is at a significant evidential disadvantage, as the multinational possesses the information required to prove Inland Revenue's case. Further, some of the information may be held by the non-resident offshore, making it difficult or impossible for Inland Revenue to obtain it. This can allow a multinational to stymie an Inland Revenue investigation through non-cooperation, particularly through withholding the information required by Inland Revenue to perform the investigation.

Inland Revenue's existing powers for requesting information in section 17 and section 21 of the Tax Administration Act 1994 are inadequate in respect of offshore information.

Under section 17 of the Tax Administration Act 1994, the Commissioner can request any information or documents that she considers necessary to administer or enforce Inland Revenue's functions. Section 17 is typically used to access information and documents held by a New Zealand resident. However, in many investigations of multinationals, the relevant information is held by an offshore group member.

Section 17 only applies when the information is within the knowledge, possession, or control of a New Zealand resident. When the relevant information is held by a non-resident, section 17 only applies if that non-resident is controlled by the New Zealand resident (such as a Controlled Foreign Company). Section 17 does not currently apply to a non-resident that is the parent or sister company of a New Zealand resident or to a non-resident that is taxable in New Zealand (for example, because it has a PE in New Zealand).

Under Section 21 of the Tax Administration Act 1994, the Commissioner is able to deny a deduction for taxpayers who fail to adequately respond to information requests regarding payments by them to an offshore entity (section 21(1)). A failure to provide the requested information to Inland Revenue can also prevent the information from being subsequently admitted as evidence in court proceedings (section 21(2)).

Section 21 is currently limited to deductible payments. In many BEPS arrangements the New Zealand entity does not make a deductible payment but instead the arrangement results in income being allocated to an offshore group member when the income was actually generated as a result of economic activity carried out by a New Zealand company or PE.

Detailed analysis

Section 17(1CB): Allowing Inland Revenue to request information held by non-resident members of large multinational groups

New section 17(1CB) allows the Commissioner to apply section 17(1) to request information or documents that are in the knowledge, possession, or control of a member of a large multinational group, including members that are non-resident.

In practice, it is anticipated that the Commissioner would request the information from the group member who is resident or potentially subject to tax in New Zealand. This group member would then source the required information from non-resident members of their group. The information would be passed on to the relevant New Zealand taxpayer who would then supply this information to the Commissioner.

For example, the Commissioner could ask a New Zealand subsidiary of a multinational corporation to provide transfer pricing documentation that was held by their offshore parent. The New Zealand subsidiary would ask their parent to provide this documentation to them, and they would then supply it to the Commissioner.

Section 21BA: Consequences from failure to provide information

New section 21BA applies if the Commissioner requests, under section 17, information from a large multinational group member and that group member fails to provide a response, or provides a misleading, incomplete or otherwise inadequate response within three months of the request.

The Commissioner must then provide a further notice to the member with a one month deadline. If the member still fails to provide a sufficient response within one month of the further notice they will be subject to the following consequences:

- the Commissioner can make a tax assessment based on the (limited) information it has available; and
- the requested information will not be allowed as evidence in a dispute with Inland Revenue or in a court proceeding (unless a court or authority determines that the information request was unreasonable and admitting the evidence is necessary to avoid manifest injustice).

Section 21BA(1) outlines the scenarios where section 21BA can be applied. Subparagraph 21BA(1)(a) deals with the case where no response is provided within three months.

Subparagraph (b) deals with cases where a response is provided but the Commissioner considers the response to be misleading, including due to the fact that relevant information has been omitted from the response.

Subparagraph (c) deals with cases where the response omits the information that the Commissioner requires to check compliance with the transfer pricing rules or attributing income to a PE. Subparagraph (c) can apply regardless of whether or not the relevant information is in the knowledge, possession, or control of the member. This ensures the consequences under section 21 can still be applied where the information does not exist because the multinational group has not prepared transfer pricing documentation or has not attempted to calculate the profits attributable to a PE.

Subparagraph (d) deals with any other case where a response has been provided but the Commissioner does not consider the response fulfils the requirement of the section 17 request.

Penalties for failure to provide the requested information

Currently, there are criminal penalties for not complying with a request for information under section 17. These penalties include fines of up to \$4,000 (for a first offence of simply not providing the requested information) or a fine of up to \$25,000 (for a first offence of knowingly not providing the information or knowingly supplying false or misleading information).

The Bill extends the existing criminal penalties for failing to respond to a section 17 request so that the penalties can also be applied to a large multinational group member that fails to provide information or documents that are in the possession or control of another member of the multinational group. This is achieved through the proposed amendments to sections 143 and 143A(2) of the Tax Administration Act.

Because the existing penalties for section 17 offences are criminal penalties, Inland Revenue must take court proceedings against the taxpayer which is resource-intensive. In addition, the modest size of the current criminal penalties may be an insufficient deterrent for large multinationals.

The Bill therefore proposes providing Inland Revenue with the ability to impose a fine of up to \$100,000 as a civil penalty on large multinational groups which fail to comply with a section 17 request for information or documents. The proposed civil penalty in new section 139AB will provide an alternative to applying the criminal penalties.

COLLECTION OF TAX FROM LOCAL SUBSIDIARY OF MULTINATIONAL GROUP MEMBER

(Clause 38)

Summary of proposed amendment

It is currently difficult for Inland Revenue to collect tax from large multinationals that have no direct presence in New Zealand. The Bill therefore proposes to introduce new section HD 30 into the Income Tax Act 2007. This provision will allow Inland Revenue to collect tax owed by a member of a large multinational group from any wholly-owned (local) group member. In the event that a non-resident company fails to pay its tax, this provision will allow Inland Revenue to collect the tax owed from any wholly-owned (local) member of the multinational group.

Application date

The new rule will apply from income years starting on or after 1 July 2018.

Key features

The proposed new rule only applies to members of large multinational groups. New section HD 30 will allow Inland Revenue to collect tax owed by a member of a large multinational group from any wholly-owned (local) group member. The rule does this by treating the wholly-owned (local) group member of the large multinational group as an agent for the non-resident member that owes the tax.

The rule will apply only if:

- the non-resident and the New Zealand entity are part of the same wholly-owned group;
- the non-resident fails to pay the tax itself; and
- the Commissioner has notified the New Zealand entity of its obligations as agent.

A large multinational group will be defined in section YA 1 to include multinational groups that exceed the revenue threshold of EUR €750m of consolidated global turnover described in paragraph 5.53 of the OECD transfer pricing guidelines. This revenue threshold was agreed by the OECD as a way to define large multinational groups for the purpose of filing Country-by-Country reports.

Background

It is currently difficult for Inland Revenue to collect tax from large multinationals that have no direct presence in New Zealand. The new rule is therefore necessary to allow Inland Revenue to collect tax owed by a member of a large multinational group from

any wholly-owned (local) group member, because the non-resident and the subsidiary are part of the same wholly-owned group and therefore part of a single economic entity, the tax owned can be collected from the New Zealand subsidiary.

DEEMED SOURCE RULE

(Clause 44)

Summary of proposed amendment

The Bill proposes inserting a new subsection into section YD 4 of the Income Tax Act 2007. The new subsection will deem an item of income to have a New Zealand source under our domestic legislation if New Zealand has a right to tax that item of income under a DTA. The new rules aim to both simplify the test for determining whether an item of income has a source in New Zealand, and ensure that all items of income New Zealand is entitled to tax under a DTA will be taxable under domestic law.

Application date

The proposed application date for this amendment is income years starting on or after 1 July 2018.

Key features

Section YD 4 of the Income Tax Act 2007 contains a list of the types of income that are treated as having a source in New Zealand for income tax purposes.

The Bill proposes inserting new subsection (17D) into section YD 4. The subsection will deem an item of income to have a source in New Zealand if we have a right to tax the item of income under a DTA. Subsection (17D) is intended to ensure that if a DTA applies in respect of an item of income, that item of income will automatically have a New Zealand source.

Currently, the Income Tax Act 2007 requires the domestic law provision relating to the particular item of income (section YD 4) to be applied. Following this, the relevant DTA articles are applied to determine whether the domestic law assessment requires amending.

New subsection (17D) will simplify this two-stage inquiry by deeming an item of income to have a source in New Zealand if New Zealand has a right to tax the item of income under a DTA. The new rule will also address the situation whereby New Zealand is permitted to tax an item of income under a DTA, but is unable to do so under domestic law. This could potentially arise in the context of the permanent establishment article and would undermine New Zealand's negotiated taxing rights under our DTAs.

Background

Multinationals are currently able to structure their affairs so that their sales income does not have a source in New Zealand, even if they have a New Zealand-resident

subsidiary that is carrying out significant sales activities here. Under our current source rules, in order for New Zealand to tax a non-resident on all or part of its sales income here:

- the sales income must have a New Zealand source under our domestic legislation; and
- New Zealand must not be prevented from taxing the sales income under any applicable DTA.

Domestic law

Whether the sales income has a New Zealand source under our domestic legislation depends on the extent of the business activities carried on in New Zealand by the non-resident. In particular, a non-resident's sales income will have a New Zealand source if:

- the non-resident's business is wholly or partly carried on in New Zealand; or
- the non-resident's sales contracts are either concluded wholly or partly performed in New Zealand.

Because of this, a non-resident's sales income will arguably only have a New Zealand source if their New Zealand-resident subsidiary is acting as an agent for the non-resident. Where the subsidiary is just contracting to provide sales activities for its non-resident parent, the sales activities might not be attributable to the non-resident. If this is the case then the non-resident would not be treated as carrying on any business activity in New Zealand, and therefore its sales income would not generally have a New Zealand source under our domestic law. This is an inappropriate result as the New Zealand-resident subsidiary is part of the same economic entity as the non-resident multinational and is effectively under its control.

DTAs

Under New Zealand's DTAs, there is no requirement for the New Zealand-resident subsidiary to be an agent for the non-resident to carry on its business in order to determine whether a PE exists – a representative of the multinational only needs to play a principal role leading to the conclusion of contracts in order to give rise to a PE.

Deemed source rule

There is therefore an inconsistency between New Zealand's domestic law rules and those found in our DTAs. This inconsistency raises the possibility that New Zealand may be able to tax a non-resident on its sales income under the PE article of a DTA, but be prevented from doing so under our domestic law. Proposed section YD 4 (17D) will therefore bring domestic law into alignment with our DTAs and prevent any argument that New Zealand is unable to tax an item of income.

LIFE REINSURANCE

(Clause 9)

Summary of proposed amendment

The Bill proposes an amendment to section DR 3 of the Income Tax Act 2007 to ensure that no deductions for the reinsurance of life insurance policies are available if the premium income on that policy is not taxable in New Zealand. The amendment will ensure that section DR 3 applies as intended, and that life insurance businesses operating out of Canada, Russia, Switzerland, and Singapore will no longer benefit from more favourable tax treatment compared with those operating in New Zealand or other countries.

Application date

The application date for this amendment is income years starting on or after 1 July 2018.

Key features

The amendment to section DR 3 denies a deduction for a life reinsurance premium paid to a non-resident life reinsurer if the premium is not taxable in New Zealand, including under a DTA.

Background

Life reinsurance premiums are currently deductible and therefore can be used to shift profits out of New Zealand. For this reason, section DR 3 of the Income Tax Act 2007 denies a deduction for life reinsurance premiums when the corresponding premium income is not taxable in New Zealand. Section DR 3 achieves this result by providing that no deduction is available for the reinsurance of a policy unless the policy is offered or entered into in New Zealand.

Under Article 7 of our DTAs, New Zealand is prevented from taxing business profits earned by a non-resident unless they are attributable to a PE of the non-resident in New Zealand. To ensure that the life insurance rules can continue to operate for non-resident life insurers without a New Zealand PE, New Zealand typically excludes insurance income from the scope of the business profits exemption in Article 7 of our DTAs. However, New Zealand's DTAs with Canada, Russia, Switzerland, and Singapore include life insurance income in Article 7. Under these DTAs, New Zealand is unable to tax a non-resident life insurer on its New Zealand sourced premium income unless that premium income is attributable to a PE of the non-resident in New Zealand.

The amendment to section DR 3 is therefore necessary to ensure that section DR 3 applies as intended, and that life insurance businesses operating out of Canada,

Russia, Switzerland, and Singapore will no longer benefit from more favourable tax treatment compared with those operating in New Zealand or other countries.