

BEPS – Transfer pricing and permanent establishment avoidance

A Government discussion document

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue



First published in March 2017 by Policy and Strategy, Inland Revenue, PO Box 2198,
Wellington 6140.

BEPS – Transfer pricing and permanent establishment avoidance: a Government discussion document.
ISBN 978-0-478-42442-3

CONTENTS

CHAPTER 1	Summary	1
	Introduction	1
	Background	2
	Summary of proposed rules	3
	Submissions	5
CHAPTER 2	Background	7
	New Zealand's current tax rules	7
	The problem	7
	The international response to the issue	8
	Diverted profits taxes	9
	The New Zealand response	9
	New Zealand's international tax framework	10
CHAPTER 3	Permanent establishment avoidance	11
	Background	11
	The problem	12
	The overseas response	13
	The proposed solution for New Zealand	13
CHAPTER 4	Amendments to the source rules	20
	Background	20
	The problem	21
	Permanent establishment source rule	22
	Anti-avoidance source rule	23
	Life insurance source rule	24
	Royalty substitution rule	25
CHAPTER 5	Strengthening the transfer pricing rules	26
	What is transfer pricing?	26
	Transfer pricing is becoming increasingly important	27
	New Zealand's transfer pricing rules need to be updated	27
	Including an explicit reference to the OECD transfer pricing guidelines	28
	Aligning the transfer pricing rules with economic substance	29
	Reconstruction of transactions	30
	Arm's length conditions	31
	Burden of proof	32
	Transfer pricing documentation	33
	Large multinationals are already required to do country-by-country reporting	33
	Master file and local file documentation	34
	General requirements to document transfer pricing practices	35
	Penalties for lack of transfer pricing documentation	35
	Time bar for transfer pricing tax positions	36
	Applying the transfer pricing rules to investors acting in concert	37

CHAPTER 6	Administrative measures	39
	Background	39
	Proposed rules for New Zealand	40
	Non-cooperation	41
	Assessments	42
	Payment of tax in dispute	42
	Collection of tax	43
	Collection of information	43
	Penalties for not providing information	45
APPENDIX	Taxation of structures multinationals use in New Zealand	46

CHAPTER 1

Summary

Introduction

- 1.1 There are international concerns about multinationals not paying their fair share of tax. This is because some multinationals use base erosion and profit shifting (BEPS) strategies to report low taxable profits in New Zealand and other countries in which they operate. These BEPS strategies include arrangements between related parties which shift profits out of New Zealand (usually into a lower taxed jurisdiction). They also include arrangements which are designed to ensure New Zealand is not able to tax any income from sales here despite there being a physical presence in New Zealand in relation to the sales. These particular BEPS strategies are known as transfer pricing and permanent establishment avoidance (TP and PE avoidance).
- 1.2 This discussion document seeks submissions on a package of proposed measures to counter certain base erosion and profit shifting (BEPS) activities by large multinationals in New Zealand. The package is focussed on BEPS activities which involve transfer pricing and permanent establishment (PE) avoidance. The package complements other BEPS related measures which the Government is progressing.
- 1.3 The proposed measures seek to counter BEPS activities by strengthening the existing rules in the Income Tax Act 2007. They focus on improving the transfer pricing rules and the source rules, while preventing the abuse of double tax agreements (DTA) to avoid New Zealand tax. The proposals also include some new administrative rules to make it easier to assess and collect tax from uncooperative multinationals in practice.
- 1.4 The proposed measures are intended to prevent the existing tax rules from being avoided or circumvented by multinationals. They are not intended to make any fundamental changes to the current international tax framework. Therefore multinationals whose legal arrangements match the economic substance of their activities and who cooperate with Inland Revenue should not generally be affected by the new measures.
- 1.5 Multinationals provide many benefits for the New Zealand economy, and the Government is committed to making New Zealand an attractive place for them to do business. However, this does not mean rewarding firms that are aggressive in attempting to flout the current rules. It is important to enforce the integrity and efficiency of the tax system in designing tax policy so that there is a level playing field. Multinational enterprises that set out to circumvent the current tax rules should not be allowed to outcompete more compliant multinational enterprises or domestic firms.
- 1.6 In this regard, the package contains base maintenance measures that are intended to ensure that the intended level of tax is borne by all non-residents carrying on business in New Zealand. Neutral taxation of different investors

into New Zealand is consistent with New Zealand's taxation framework for in-bound investment and is in New Zealand's best economic interest.

- 1.7 Addressing transfer pricing and PE avoidance is also an important revenue integrity measure. For New Zealanders to have confidence in their tax system, it is important that everyone is seen to pay their fair share of tax, including multinationals.

Background

- 1.8 While the majority of multinationals operating here are tax compliant, there is a minority that engage in aggressive tax practices. This kind of aggressive tax planning may increase if it is left unchecked. In addition, incentives to engage in these practices could increase as we address other profit shifting techniques through other BEPS measures (such as hybrid mismatch arrangements and excessive interest deductions).
- 1.9 It can also be difficult and resource intensive for Inland Revenue to investigate and assess multinationals that are suspected of engaging in TP and PE avoidance. This is due to the highly fact dependant nature of the cases, combined with the fact that the multinationals possess all the information needed by Inland Revenue to prove its case. Getting this information can also be difficult when it is held offshore by non-residents, even when they are in the same group as a New Zealand taxpayer.
- 1.10 The OECD has recommended various courses of action to address general BEPS strategies in its BEPS Action Plan. Along with other OECD countries, New Zealand is implementing a number of these OECD recommendations. However we consider that the OECD BEPS actions will not completely address the issue of TP and PE avoidance. Accordingly, the Government would like to explore additional measures to address this issue.
- 1.11 One overseas response to the issue has been to impose a separate tax on the diverted profits that arise from TP and PE avoidance. This is known as a diverted profits tax (DPT), and has been proposed by Australia and adopted by the UK. France is also considering adopting a DPT. A DPT is levied at a penal rate compared to income tax and has greatly enhanced assessment and collection powers. A DPT is intended to incentivise multinationals to pay the correct amount of income tax under the normal rules rather than to raise revenue by itself.
- 1.12 While the Government has not ruled out the adoption of a DPT, it would like to investigate an alternative approach.¹ This is to take certain features of a DPT and combine them with the OECD's BEPS measures and some domestic law amendments to produce a package of measures that is tailored for the New Zealand environment. The intention is that this approach would be as effective as a DPT in addressing TP and PE avoidance in New Zealand,

¹ See the Cabinet paper published in November 2016, *Measures to strengthen transfer pricing rules and prevent permanent establishment avoidance – a Government discussion document*, <http://taxpolicy.ird.govt.nz/publications/2016-other-cabinet-paper-transfer-pricing/overview>.

but it would do so within our current frameworks and with fewer drawbacks. This discussion document sets out these alternative measures.

1.13 These measures are in addition to a number of other measures to address BEPS and related issues which the Government has been progressing. In particular:

- A bill has recently been reported back from select committee which would strengthen non-resident withholding tax rules, limit the use of look-through companies as conduit vehicles, and clarify that New Zealand's general anti-avoidance rule overrides tax treaties.
- A bill has recently been enacted to strengthen the foreign trust disclosure rules and implement automatic exchange of information with other tax authorities.
- GST now applies to cross border services – including e-books, music, videos and software purchased from overseas websites.
- The Government has released a discussion document on addressing hybrid mismatch arrangements. These proposals are designed to prevent taxpayers reducing their tax liability by exploiting technical differences in countries' tax.²
- The *BEPS – Strengthening our interest limitation rules* discussion document outlines some proposed law changes that will limit the ability of multinationals to use interest payments to shift their New Zealand profits offshore.
- New Zealand intends to sign the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (also known as the multilateral instrument or MLI). An officials' issues paper has been released to consult on implementation issues associated with New Zealand signing the MLI.

Summary of proposed rules

Source and permanent establishment avoidance

1. A new anti-avoidance rule will be introduced that will apply to large multinationals (with over EUR €750m³ of consolidated global turnover) that structure to avoid having a permanent establishment (taxable presence) in New Zealand. The proposed rule would deem a non-resident entity to have a permanent establishment in New Zealand if a related entity carries out sales related activities for it here. This permanent establishment will be deemed to exist for the purpose of any applicable double tax agreement (DTA).

² *Addressing hybrid mismatch arrangements – a Government discussion document*, September 2016, <http://taxpolicy.ird.govt.nz/publications/2016-dd-hybrids-mismatch/overview>.

³ The EUR €750m threshold has been chosen to align application of the proposed rule with the OECD's threshold for requiring large multinationals to file country-by-country reports.

2. An amount of income will be deemed to have a source in New Zealand if New Zealand has a right to tax that income under the permanent establishment article of any applicable DTA. For non-residents in respect of whom no DTA applies, New Zealand's model treaty permanent establishment article will be incorporated into domestic law to apply as an additional source rule.
3. A non-resident's income will have a source in New Zealand if the income would have a source, treating the non-resident's wholly owned group as a single entity. This complements the existing rule in section CV 1 for income derived by corporate groups.
4. Some potential weaknesses of the life insurance source rules will be addressed by amending section DR 3 to ensure that no deductions are available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand and by amending the definition of a FIF to ensure that New Zealand residents are subject to the FIF rules in respect of any policies that are not subject to New Zealand tax under the life insurance rules.

Transfer pricing rules

5. The transfer pricing rules will be strengthened so they align with the OECD's guidelines and Australia's new transfer pricing rules. This involves amending our transfer pricing rules so that:
 - they disregard legal form if it does not align with the actual economic substance of the transaction;
 - in cases where independent entities would not have entered into the contracted conditions, the transfer pricing rules would allow for those conditions to be replaced by arm's length conditions (or allow the entire arrangement to be eliminated or disregarded);
 - the legislation specifically refers to arm's length conditions and the latest OECD Transfer Pricing guidelines (which incorporate the BEPS actions 8–10 revisions).
6. The burden of proof for demonstrating that the actual conditions align with arm's length conditions will be shifted from the Commissioner of Inland Revenue to the taxpayer (consistent with the burden of proof for other tax matters).
7. The "time bar" for transfer pricing issues will be increased to seven years (in line with Australia).
8. In addition to applying to dealings between associated parties, the transfer pricing rules will be amended to also apply to investors that "act together", such as private equity investors.
9. Inland Revenue will collect the information required by the OECD's country-by-country reporting initiative from multinational groups with over EUR €750m of annual consolidated group revenue (large multinationals). We will not require large multinationals to annually file their master and local files, but we will increase Inland Revenue's powers to access information and documents held by large multinationals offshore.

Administrative rules

11. If the large multinational (over EUR €750m worldwide revenues) does not cooperate with Inland Revenue, then Inland Revenue may more readily issue a notice of proposed adjustment (NOPA) (and any subsequent documents under the disputes process) based on the information available to Inland Revenue at the time.
12. Any disputed tax must be paid by a large multinational earlier in the disputes process. This only applies in respect of disputes over transfer pricing, the amount of New Zealand sourced income, and the application of a DTA.
13. Tax payable by any member of a large multinational can be collected from any wholly owned group member, or the related New Zealand entity in case of the new PE avoidance rule.
14. Inland Revenue will be empowered to collect more information from large multinationals, including information about its various non-resident group members.

Application dates

15. The proposed administrative rules would apply from the date of enactment of the relevant legislation. The proposed rules for addressing the source, permanent establishment and transfer pricing issues would apply to income years beginning on or after the date of enactment.

Submissions

- 1.14 The Government seeks submissions on the proposals set out in this discussion document.
- 1.15 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.16 Submissions should be made by 18 April 2017 and can be emailed to policy.webmaster@ird.govt.nz with “BEPS – Transfer pricing and PE avoidance” in the subject line.
- 1.17 Alternatively, submissions may be addressed to:

BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140
- 1.18 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular

submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

- 1.19 In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document with key interested parties.

CHAPTER 2

Background

New Zealand's current tax rules

2.1 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 (which override our domestic rules). In general, New Zealand can at present only tax a non-resident multinational group on its sales here if both of the following conditions are met:

- The multinational group has a sufficient taxable presence in New Zealand. This means the group must operate in New Zealand either through a New Zealand resident subsidiary (in which case the subsidiary is taxable on its income) or through a PE of a non-resident group member. A PE is basically a place of business of the non-resident, but it also includes an agent acting for the non-resident.
- Where a multinational operates in New Zealand through a PE of a non-resident group member, some of the non-resident's net profits from its sales can be attributed to its taxable presence here. This involves determining:
 - the amount of the non-resident's gross sales income which can be attributed to its PE here; and
 - the amount of the expenses which can be deducted from that income to determine the net taxable profits in New Zealand.

2.2 The non-resident must also have a sufficient taxable presence in New Zealand (if a DTA applies) for New Zealand to charge 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

2.3 It is hard to estimate the overall fiscal cost to New Zealand of TP and PE avoidance. In common with BEPS activities generally (and as noted by the OECD), TP and PE avoidance may not be directly observable in the absence of knowledge of the multinational's global business structure. It is expected that the OECD's country-by-country reporting initiative (which New Zealand intends to join) will assist in estimating the fiscal cost of BEPS related activities.

2.4 However we are aware of problematic structures being used in New Zealand.

- 2.5 Through the use of TP and PE avoidance strategies, some multinationals are able to report low taxable profits in New Zealand despite carrying on significant economic activity here. These avoidance strategies involve:
- **Tax structuring:** Non-residents can structure their affairs to avoid a taxable presence in New Zealand, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).
 - **Creating enforcement barriers:** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.
- 2.6 We set out examples of the more common structures used by multinationals to do business in New Zealand in the appendix, together with a discussion of their current tax treatment. We also discuss how these structures would be taxed under the proposed measures set out in this discussion document.
- 2.7 The revenue at risk from structures Inland Revenue is currently aware of is estimated to be \$100 million per year. Naturally there will be BEPS cases that Inland Revenue is not aware of. In addition, multinationals which use these structures in other jurisdictions typically use them in New Zealand as well. Therefore the total revenue at risk will be greater than this figure.

The international response to the issue

- 2.8 BEPS activities are a global concern (including TP and PE avoidance). The OECD's BEPS Action Plan has been formulated to address these kinds of activities by multinationals. Like many countries, New Zealand is picking up a number of the OECD's recommendations to address BEPS. More information on BEPS generally and New Zealand's response to it is set out in the published Cabinet paper on BEPS.⁴
- 2.9 However adoption of the OECD's BEPS measures is not sufficient on its own for New Zealand to counter all TP and PE avoidance. Many of the OECD's DTA related BEPS measures will only apply if both parties to the DTA so elect – and we expect several of our trading partners not to. The OECD's BEPS measures also do not address issues specific to New Zealand, such as issues with our current source rules. Finally, the OECD's BEPS measures do not generally address the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes). Accordingly, it is sensible for New Zealand to take additional measures to counter TP and PE avoidance.

⁴ *Base erosion and profit shifting (BEPS) – update on the New Zealand work programme*, released June 2016, <http://taxpolicy.ird.govt.nz/publications/2016-other-cabinet-paper-beps-update/overview>.

Diverted profits taxes

- 2.10 Another overseas response to the issue has been to impose a separate tax on the diverted profits that arise from TP and PE avoidance related BEPS activities. This is known as a diverted profits tax (DPT). The UK has adopted a DPT and Australia has introduced draft legislation for its DPT into Parliament. France has also proposed a DPT.
- 2.11 The DPTs that have been proposed in Australia and enacted in the UK tax the diverted profits of large multinationals. Their DPTs are an anti-avoidance measure and are entirely separate taxes levied at a penal rate compared with income tax. DPTs apply to large multinationals that sell goods or services into a country and try to avoid that country's income tax by either:
- using a structure to avoid having a PE in the country, even though they have significant economic activities carried on for them in that country; or
 - shifting profits out of the country to a low tax jurisdiction through arrangements which lack economic substance.
- 2.12 A DPT taxes the profit a multinational has avoided reporting for income tax purposes using these methods. A DPT is thus intended to incentivise large multinationals to pay the correct amount of income tax under the normal rules, rather than to raise revenue by itself.
- 2.13 A DPT has greatly enhanced assessment and collection powers. For example, the DPT must be paid up front, and the taxpayer then has to demonstrate to the revenue authority why its assessment is wrong and by how much (although the assessment can still be challenged in Court after the expiry of a review period).
- 2.14 Importantly, a DPT is an anti-avoidance measure. It does not change the fundamental basis on which non-residents are taxed. For this reason, a DPT would not tax non-resident suppliers without a material physical presence in the country. Such non-resident suppliers include some of the multinationals with a large internet footprint that have been the focus of some public concern in New Zealand and internationally.

The New Zealand response

- 2.15 While the Government has not ruled out the adoption of a DPT at this stage, it wishes to explore the alternative package of measures set out in this discussion document. These measures seek to address TP and PE avoidance within our current tax framework. However the measures do incorporate some elements of the DPTs, such as the PE avoidance measures and milder versions of the DPT's administrative provisions.
- 2.16 The proposals in this discussion document aim to align the tax rules more with the actual economic substance of the multinational group and its intra-group dealings. That is, the proposed rules effectively disregard the legal separation between different group members (such as in relation to related

party payments or the allocation of profits between a New Zealand subsidiary and a non-resident parent) to the extent that the legal form is inconsistent with the actual economic substance. The rules also ensure multinationals cannot avoid having a taxable presence in New Zealand by separating their activities into separate companies. Finally, the proposed rules will disregard artificial arrangements that would not occur between third parties dealing at arm's length.

New Zealand's international tax framework

- 2.17 The measures set out in this discussion document are consistent with New Zealand's international tax framework.
- 2.18 New Zealand has a general broad-base low rate (BBLR) tax framework, which aims to minimise distortions and promote economic efficiency. A robust company tax rate is an important component of this framework. The company tax rate should apply to both residents and non-residents who derive income from New Zealand sources.⁵ It should not favour some taxpayers or some types of economic activity.
- 2.19 TP and PE avoidance essentially exploit deficiencies in the current international tax system (both in New Zealand and abroad) to allow certain non-residents to pay less than the intended amount of tax. This distortion can lead to unfairness and the substitution of low-taxed investors for tax-paying investors. This has the potential to reduce national income while doing little or nothing to reduce the overall pre-tax cost of capital to New Zealand or increase the overall level of investment. It also distorts the allocation of investment by favouring foreign investors who set out to game the system.
- 2.20 The proposed measures protect New Zealand's BBLR tax base from these distortions and ensure the intended level of tax is paid by all taxpayers. They are consistent with New Zealand's general approach to taxing inbound investment.
- 2.21 Further information on New Zealand's international tax framework and the economic impact of such base maintenance measures is set out in the document *New Zealand's taxation framework for inbound investment*, available at <http://taxpolicy.ird.govt.nz/publications/2016-other-nz-framework-inbound-investment/overview>.
- 2.22 Inland Revenue is currently investigating or disputing several BEPS related cases. Nothing in this document is intended to prejudice any of those disputes or investigations. In particular, none of the proposed amendments in this discussion documents should be regarded as evidence that Inland Revenue cannot address the BEPS activities it is currently investigating or disputing under the current law, or that such BEPS activities are within the policy intent of the current law.

⁵ There are a number of reasons for applying the company tax rate to non-residents, such as ensuring that location-specific economic rents are taxed, maintaining current taxation of sunk investments and land, ensuring an equal playing field for local and non-resident competitors, and the availability of tax credits for New Zealand tax in the non-resident's jurisdiction (which effectively reimburses the non-resident for the New Zealand tax charged).

CHAPTER 3

Permanent establishment avoidance

- 3.1 This chapter sets out a proposed rule to prevent multinationals avoiding a PE in New Zealand. The rule broadly applies where a related entity (such as a wholly-owned subsidiary) carries out sales activities for the non-resident in New Zealand under an arrangement which is contrary to the purpose of the PE provisions.
- 3.2 The proposed rule is an anti-avoidance measure. It is intended to apply where the non-resident's economic activities in New Zealand should result in a PE here, but the non-resident has been able to structure its legal arrangements to avoid one arising. The proposed rule is not trying to widen the accepted international definition of a PE in substance. In particular, the rule will not apply where no material economic activities (other than the sale of the goods or services into New Zealand) are carried on in New Zealand by or on behalf of the non-resident.
- 3.3 The proposed rule is very similar to the ones found in the UK DPT and the Australian multinational anti-avoidance law (MAAL).

Background

- 3.4 A long established and widely used concept in tax systems around the world is the concept of permanent establishment or "PE". Historically, taxing rights were based around a taxpayer's PE in a jurisdiction. Where no PE exists, then there are generally no rights to tax business profits. The advent of the internet has made cross-border commercial traffic much easier, with no need for a company to have a PE in a country.
- 3.5 Under New Zealand's 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.
- 3.6 The current definition of a PE varies from DTA to DTA, however a non-resident will generally have a PE in New Zealand if (amongst other things) either:
- the non-resident has a fixed physical place in New Zealand through which it carries on its business (excluding any preparatory or auxiliary activities); or
 - there is a person in New Zealand (other than an independent agent) who has, and habitually exercises, an authority to conclude contracts on behalf of the non-resident. The person in New Zealand is still treated as concluding the contract if they negotiate all the aspects of the contract and the non-resident only formally executes the contract offshore. This is referred to as a "dependent agent PE".

- 3.7 If a DTA applies, the non-resident must also have a PE in New Zealand for us to charge NRWT on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.
- 3.8 Even if a PE exists, not all of the non-resident's sales income will be taxable in New Zealand. Instead the sales income must be apportioned between the PE and the non-resident's offshore operations, based on the contributions of each to the sales income. For example, if goods are manufactured offshore and only sold through a PE in New Zealand, then some of the sales income will need to be apportioned offshore to reflect the profit attributable to the manufacturing activity.

The problem

- 3.9 Some multinationals are able 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 establishing a New Zealand subsidiary to carry out local sales related activities. The subsidiary operates out of the kind of fixed base that meets the definition of a PE. However because that fixed base is used by a separate legal entity to the non-resident (even though they are part of the same wholly owned group), the fixed base does not give rise to PE for the non-resident. This is despite the fact that the fixed base is used by the subsidiary to affect the non-resident parent's sales into New Zealand.
- 3.10 This kind of structure thus allows a multinational to avoid having a PE in New Zealand (arguably) by splitting its sales activities between wholly owned group members (or other associated entities). While these group members are treated as separate entities for legal purposes, they are part of the same economic entity in substance. Accordingly the avoidance of a PE in these circumstances is contrary to the economic substance of the arrangement.
- 3.11 The same concerns also arise where the non-resident's sales activities are carried out by a New Zealand entity that is not owned by 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). The commercially dependant entity is thus also effectively an agent of the non-resident, and so its activities should be also imputed to the non-resident for the purpose of determining whether a PE exists.
- 3.12 An example of this kind of PE avoidance structure is set out in the appendix (structure 3), together with a more detailed discussion of the current legal issues.
- 3.13 Inland Revenue is also aware of cases where the multinational argues that the related party only carries out general support activities (such as marketing), but in reality they substantially negotiate the sales agreements. In such cases the related party should constitute a dependant agent PE of the non-resident.

However these cases are very resource intensive to prosecute in practice, especially obtaining the requisite evidence to demonstrate the true extent of the related party's activities.

The overseas response

- 3.14 The OECD is concerned about the use of DTAs to facilitate BEPS. The OECD has prepared a multilateral instrument, which will make a number of amendments to the DTAs of participating countries to counter DTA related BEPS activities (Multilateral Instrument). In particular, the Multilateral Instrument contains a widened PE definition to counter the avoidance of PE status.
- 3.15 This widened definition should be effective in addressing some of the PE avoidance we see in New Zealand. However an issue with the widened definition is that it will only be included in a DTA if both parties so elect. Several of New Zealand's trading partners are not expected to elect to include the widened PE definition, including some countries from which significant investment into New Zealand is made. Therefore, the Government expects that the OECD's PE amendments will not be sufficient to address the issue of PE avoidance in New Zealand.
- 3.16 The UK and Australia have adopted specific rules to address PE avoidance in their DPT and MAAL. The Australian and UK rules are very similar, and broadly apply where:
- a non-resident supplies goods or services to local customers;⁶
 - a related local entity undertakes activities in relation to the sales;
 - some or all of the sales income is not attributed to a local PE of the non-resident; and
 - the arrangement is designed to avoid tax.
- 3.17 Where the rules apply, the non-resident's supplies are deemed to be made through a local PE. The usual transfer pricing and profit attribution principles then apply to determine the amount of profits from those supplies which can be taxed in the local jurisdiction. Accordingly not all the profits from the non-resident's local sales will be taxed when a PE is deemed to exist under the UK and Australian rules. The UK and Australian rules override their DTAs.

The proposed solution for New Zealand

- 3.18 The Government proposes adopting a similar rule to that in the UK DPT and the Australian MAAL. The rule would widen the circumstances in which the activities in New Zealand of a related party would give rise to a PE for the non-resident under any applicable DTA.

⁶ The customer must be unrelated to the supplier for Australia's MAAL to apply.

Application of the rule

- 3.19 The proposal would only apply to a non-resident that is part of a multinational group with more than EUR €750m consolidated global turnover. The EUR €750m threshold has been chosen to align application of the proposed rule with the OECD's threshold for requiring large multinationals to file country-by-country reports. The threshold also broadly matches the AU\$1b threshold adopted by Australia for its PE avoidance rule (the MAAL).
- 3.20 The proposed rule would apply to income years beginning on or after the date that the relevant legislation is enacted.
- 3.21 Under the proposed rule, a non-resident will be deemed to have a PE in New Zealand for the purposes of any applicable DTA if there is an arrangement under which:
- a non-resident supplies goods or services to a person in New Zealand;
 - a related entity (either associated or commercially dependant) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about;
 - some or all of the sales income is not attributed to a New Zealand PE of the non-resident; and
 - the arrangement defeats the purpose of the DTA's PE provisions.
- 3.22 It is intended that only activities designed to bring about a particular sale should potentially result in a deemed PE. Therefore general auxiliary or preparatory activities (such as advertising and marketing) would not be sufficient to trigger a possible PE under the rule. This is consistent with the definition of a PE in most DTAs, which prevent the carrying out of auxiliary and preparatory activities from giving rise to a PE. It also reflects the intended scope of the rule, which is to determine whether a particular sale is made through a PE by imputing the related party's activities in relation to that sale to the non-resident.
- 3.23 Any sales-related activity carried on by an unrelated independent agent will also generally not give rise to a PE under the proposed rule (to reflect the current definition of a PE in New Zealand's DTAs).
- 3.24 For the proposed rule to apply, the arrangement under which the non-resident makes its supplies into New Zealand must defeat the purpose of the PE provisions in the applicable DTA. This test is focussed on whether the non-resident's supplies are made through a PE in substance. In determining whether this test is met, the following factors will be relevant:
- the commercial and economic reality of the arrangement;
 - the relationship between the non-resident and the related entity in New Zealand;
 - the nature of the services carried out by the related entity;

- whether the non-resident would have a PE in New Zealand if it and the related entity were treated as a single company; and
- whether the arrangement has any of the indicators of PE avoidance, such as the involvement of a low tax jurisdiction, specialised services, or a related entity which is allocated a low amount of profit on the basis it is carrying out low value activities while having a number of well paid employees.

3.25 The legislation enacting the proposed rule (if it is adopted) may specify some of these features.

3.26 This test should also ensure that the rule will only deem a PE to exist if the non-resident would have had a PE but for its arrangement with the related party. 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.

Example

A non-resident located in a low-tax jurisdiction sells computer equipment to New Zealand customers. The non-resident does not itself have a presence in New Zealand. However the non-resident has a wholly owned subsidiary which undertakes significant sales activity in New Zealand for the non-resident from a fixed place of business in New Zealand. The subsidiary locates customers, promotes the non-resident's products to them, discusses their needs and tailors equipment packages for them. It also indicates likely pricing and delivery dates as well as other key terms. These terms are subject to the non-resident's approval, although in practice approval is rarely withheld. The actual contract however is signed overseas by the non-resident, and includes some material terms that were not discussed by the subsidiary.

Under the current rules, the non-resident arguably would not have a PE in New Zealand, as it does not have a presence in New Zealand and the subsidiary did not execute the contract or negotiate all of its material terms in New Zealand. Under the proposed rule however, the non-resident would have a PE in New Zealand for the following reasons:

- The non-resident supplies goods or services to a customer in New Zealand.
- The subsidiary (who is a related entity of the non-resident) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about.
- Some or all of the non-resident's sales income is not derived through a New Zealand PE of the non-resident.
- The arrangement defeats the purpose of the PE provisions in the applicable DTA. This is because the subsidiary is in substance an agent or instrument of the non-resident and carries out the non-resident's business in New Zealand (although it is not legally an agent). In this regard:
 - the subsidiary carries out nearly all of the important sales activity in New Zealand through a fixed place of business, with the non-resident only approving its activities and signing the relevant contract (to ensure no dependant agent PE arises under the DTA);
 - the non-resident would have a PE in New Zealand if it and the subsidiary were treated as a single entity; and
 - the non-resident's location in a low tax jurisdiction is a strong indication of PE avoidance.

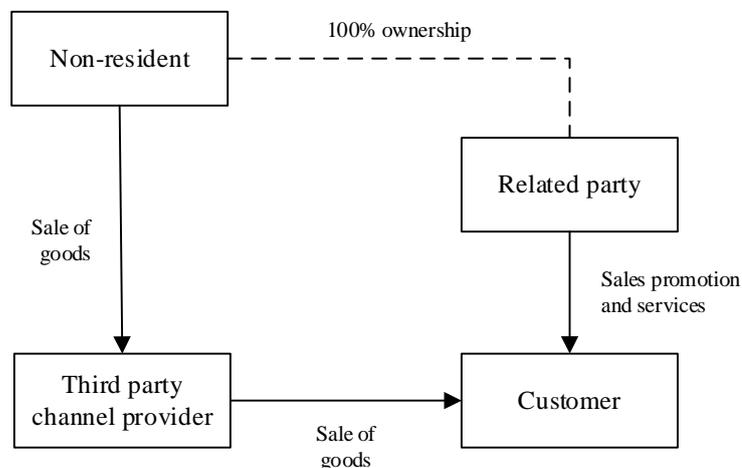
Therefore while the arrangement also has a significant commercial purpose of selling goods into New Zealand, the way the arrangement was implemented defeats the purpose of the PE provisions by preventing a PE from arising at law when one exists in substance.

Arrangements involving third party channel providers

3.27 The proposed rule is also intended to apply where an independent third party is interposed between the non-resident and the New Zealand customer as part of the arrangement. Accordingly the rule will also apply where:

- a non-resident supplies goods or services in New Zealand;
- under an arrangement in which those goods or services are to be on-sold to customers in New Zealand by a third party (whether related or not);
- a related entity to the non-resident carries out an activity in New Zealand in relation to the sale by the third party to the customers for the purpose of bringing that sale about;
- the sales are not otherwise treated as being made through a PE of the non-resident in New Zealand; and
- the arrangement defeats the purpose of the PE provisions.

3.28 This addresses current third party channel provider arrangements, where the sale by the non-resident to the third party is part of a single arrangement in which those same goods or services are to be on-sold by the third party to a particular customer and the non-resident's subsidiary deals with the end-customers to bring the particular sale about. See the following diagram illustrating this kind of arrangement.



3.29 There can be good commercial reasons for third party channel provider arrangements, and the Government does not want to penalise them or prevent them from occurring. However they should also give rise to a PE for the non-resident in respect of its sale to the third party. 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 related party'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 related party acts for the non-resident, not the third party). Therefore the

activities of the related party should be attributed to the non-resident for the purpose of determining whether it has a PE in respect of its New Zealand sales.

- 3.30 This additional rule will only apply in respect of the non-resident that makes the relevant sale into New Zealand. Therefore it will not apply in respect of any sales wholly outside New Zealand.
- 3.31 The rule also will not apply to a standard distributor type arrangement, under which the third party purchases goods from the non-resident and independently sells them to customers in New Zealand. This is because, in such a case, the third party would be carrying out all the particular sales activities (rather than the related party). This would be the case even if the related entity undertook general marketing and advertising activities in New Zealand in respect of the products (or after sale support).

Consequences of application

- 3.32 If the rule applies, then a PE is deemed to exist and the non-resident's supplies in New Zealand are treated as being made through that PE.
- 3.33 Only the non-resident's supplies that are within the ambit of the rule would be treated as made through the deemed PE. 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 a deemed 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 those supplies, then those other supplies would not be treated as being made through the deemed PE.
- 3.34 The PE will be treated as existing for the purpose of any DTA. So the non-resident will not be able to argue the PE article of an applicable DTA prevents New Zealand from taxing the supplies where the proposed rule applies. This matches the position under the Australian MAAL and the UK DPT.
- 3.35 However the other provisions of a DTA in relation to the taxation of profits of a PE will still apply. Therefore if the rule applies, New Zealand will only tax the portion of the sales income that is attributable to the deemed PE. This will be determined by the application of the normal profit attribution principles.
- 3.36 We expect that the application of these principles will result in a fairly significant amount of the sales income being attributable to the deemed PE in most cases. We also expect a material amount of net taxable profit to remain in the PE after the deduction of related expenses. In this regard, we note that New Zealand, like many countries, has not adopted the OECD's revised methodology for attributing profits to a PE.⁷ The OECD's revised

⁷ One reason for this is that the OECD's latest approach, referred to as the Authorised OECD Approach or AOA, allows a deduction to be taken by the PE for a notional royalty paid to the head office, but does not allow withholding tax to be charged on that notional royalty (unlike a real royalty).

methodology is also not currently reflected in many DTAs. New Zealand instead applies the earlier version of the OECD's methodology.

- 3.37 If the proposed rule applies, then the PE will be treated as existing for the purpose of all the provisions in the DTA. So for example where the rule applies, New Zealand would be able to impose withholding tax on any royalty paid by the non-resident in respect of the supplies made through the PE (for example, in the New Zealand/Australia context, under article 12(5) of the NZ Australian DTA).
- 3.38 The current 100% penalty for taking an abusive tax position (under section 141D of the Tax Administration Act 1994) will also apply for the purposes of the proposed PE avoidance rule.
- 3.39 We note that the ultimate objective of the proposed rule is to discourage non-residents from entering into PE avoidance structures in the first place. This reflects the current policy emphasis on voluntary compliance within the Tax Acts.

Interaction with New Zealand's double tax agreements

- 3.40 The proposed rule should not conflict with New Zealand's DTAs in the vast majority of cases.
- 3.41 New Zealand's DTAs are based on the OECD's Model Tax Convention. The OECD's Commentary to the Model Tax Convention (the Commentary) is an important part of the context in which these DTAs are internationally understood.
- 3.42 The proposed rule is an anti-avoidance provision. It will only apply to an arrangement which defeats the purpose of the DTA's PE provisions. The 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 jurisdictions are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that this should not be lightly assumed).
- 3.43 The OECD's 2015 report on BEPS Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"), which will update the Commentary in light of the OECD's BEPS project, has also confirmed this position.
- 3.44 The proposed rule is also consistent with the OECD's recommended measures to prevent the artificial avoidance of PE status, set out in its report on Action 7. In particular, the OECD recommends a measure to widen the circumstances in which the sales activities of a related party can give rise to a PE for the non-resident. This new measure will be incorporated into a DTA where both parties agree pursuant to the Multilateral Instrument, which will amend the DTAs of participating countries to implement a number of the OECD's DTA related BEPS measures.

3.45 We propose providing that our PE avoidance rule would apply 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 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.

CHAPTER 4

Amendments to the source rules

- 4.1 This chapter sets out some proposed amendments to the source rules in the Income Tax Act 2007. These amendments are designed to fix current deficiencies with the source rules and to ensure they cannot be circumvented. The proposed amendments are not intended to fundamentally widen the scope of the source rules.
- 4.2 Under the amended rules, income will have a source in New Zealand if it is attributable to a PE in New Zealand. There will also be a rule to ensure that non-residents cannot structure around the new source rules by dividing their activities between group members. Finally amendments will be made to address some technical issues with the source related rules for life insurance.
- 4.3 The amendments proposed in this chapter would apply to income years beginning on or after the date of enactment of the relevant legislation.

Background

- 4.4 In order for New Zealand to tax a non-resident on all or part of its sales income here:
- that sales income must have a New Zealand source under our domestic legislation; and
 - we must not be prevented from taxing the sales income under any applicable DTA.
- 4.5 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 or wholly or partly performed in New Zealand.
- 4.6 In either case the amount of sales income with a New Zealand source will be limited to the amount a separate and independent person would have derived if it carried out the non-resident's activities in New Zealand on an arm's length basis. The non-resident will then be entitled to deduct its expenses from this income in determining the amount of tax payable.
- 4.7 In order for a non-resident's sales to have a New Zealand source under these rules, the non-resident must carry out some business activity in New Zealand. There will not be a New Zealand source where goods are simply shipped to the New Zealand consumer by the non-resident. This reflects a fundamental

distinction in international taxation between trading “with a country” (which is not taxable in that country) and trading “in” a country (which may be taxed in that country).

- 4.8 The Income Tax Act 2007 also has a series of further source rules in respect of specific types of income. For example, royalties paid by non-residents have a source in New Zealand if they are deductible to the non-resident payer.

The problem

- 4.9 Under the current rules, a non-resident’s sales income may not have a New Zealand source even if significant sales activity is carried out for the non-resident by a subsidiary here. This is because the non-resident’s sales income will arguably only have a New Zealand source if the subsidiary is effectively an agent for the non-resident, so that the non-resident can legally be treated as carrying on business in New Zealand through the subsidiary. 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 so its sales income would not generally have a New Zealand source.
- 4.10 The Government considers that this is an inappropriate result. The subsidiary is part of the same economic entity as the non-resident and is effectively under its control. Accordingly, the non-resident is carrying on its business through the subsidiary in substance. The same analysis also applies where the non-resident uses a commercially dependant representative to carry on its sales activity.
- 4.11 In addition, the current DTA approach to PEs differs from this strict approach. Under the Model Commentary, a person does not need to be a legal agent of the non-resident to carry on its business for the purpose of determining whether a PE exists. The PE definition is also being amended under the Multilateral Instrument to widen the circumstances in which a representative can give rise to a PE for the non-resident.⁸ In particular, the representative will only need to play a principal role leading to the conclusion of contracts in order to give rise to a PE under the amendments.
- 4.12 This 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 is prevented from doing so under our domestic law.
- 4.13 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.

⁸ See the officials’ issues paper *New Zealand’s implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, March 2017, <http://taxpolicy.ird.govt.nz/publications/2017-ip-beps-mli-nz/overview>.

- 4.14 In addition, in order to tax a non-resident on its New Zealand sales income, it is currently necessary to show that the income has both a New Zealand source and is attributable to a PE under a DTA. This increases the administrative requirements of assessing multinationals on their sales income here.
- 4.15 There is also a further issue concerning possible future attempts by taxpayers to circumvent the source rules. A consequence of strengthening some rules is that taxpayers may try to circumvent other rules to avoid paying tax. Therefore the Government intends to strengthen our source rules against potential attempts to circumvent them in the future.
- 4.16 Finally, there is an issue with how the source related rules for life insurance interact with a small number of DTAs.
- 4.17 The following proposals are intended to address these issues.

Permanent establishment source rule

- 4.18 A new source rule is proposed under which income will have a New Zealand source if it is attributable to a PE in New Zealand.
- 4.19 If a DTA applies in respect of the income, then the definition of a PE in that particular DTA will be used for this purpose. 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 where a PE is deemed to exist under the proposed new PE avoidance rule (discussed in chapter 3).
- 4.20 This is the same approach Australia currently takes. However Australia deems most of the income it can tax under a DTA to have a source in Australia (for example, including dividends, interest, royalties, etc.). The proposal at this stage is only that income attributable to a PE and royalties that New Zealand can tax under a DTA will automatically have a New Zealand source under the new rule. This is because the Government is only aware of issues with the source of these kinds of income.
- 4.21 If there is no DTA which applies in respect of the income, then the proposed rule will still apply. The Act will be amended to incorporate, for residents of countries with which New Zealand does not have a DTA, the definition of a PE in New Zealand's model PE article. Therefore the income will have a New Zealand source if it is attributable to a PE in New Zealand, as that term is defined in the Act. A similar amendment would also be made in respect of royalties. It is important to include this rule so that residents of countries without a DTA with New Zealand are not in a better position than residents of countries with a DTA.
- 4.22 Whether income is attributable to a PE for the purposes of the new source rules will be determined under the normal PE profit attribution principles (as applied by New Zealand). A deduction would also be permitted for any expenditure incurred in deriving the New Zealand sourced income (subject to

the usual deductibility rules) in determining the non-resident's New Zealand tax liability.

Anti-avoidance source rule

- 4.23 A new rule is proposed stating that a non-resident's income has a source in New Zealand if it would have a source, treating the non-resident's wholly owned group as a single entity. This would prevent non-residents from avoiding having New Zealand sourced income by dividing their activities between wholly owned group members.
- 4.24 It is not appropriate for non-residents to be able to avoid New Zealand sourced income in this way. Given that a wholly owned group is a single economic entity, any income in such a case would have a New Zealand source in substance. Consequently it should also have a New Zealand source under our rules.
- 4.25 The proposed rule is similar to the existing rule contained in section CV 1 of the Income Tax Act 2007. Section CV 1 provides that an amount is income of a member of a wholly owned group if it would be income if the group were a single company.
- 4.26 The proposed rule is also consistent with the OECD's BEPS measures which counter PE avoidance strategies,⁹ in particular the measures aimed at:
- Contract-splitting. This involves a non-resident splitting a single contract into several contracts, each of which is then carried out by a related party. Contract splitting is intended to avoid the application of DTA provisions which deem a non-resident to have a PE in a country if they carry out certain activities (such as mining or construction) in that country for more than a specified period.
 - Fragmentation of activities. This involves a non-resident dividing a single business undertaking between related parties. This is intended to prevent a PE from arising by taking advantage of the exemption for preparatory or auxiliary activities in the PE article of most DTAs. The non-resident argues that each part of the business undertaken by a related party is only preparatory or auxiliary, and so it does not give rise to a PE. This is despite the fact that a PE would arise if all of the related parties' activities were carried on by a single entity.
- 4.27 These BEPS measures will be introduced into New Zealand's existing DTAs (provided the other country agrees) under the OECD's Multilateral Instrument, which New Zealand intends to sign in mid-2017. If New Zealand's domestic law does not include a similar anti-fragmentation rule, then New Zealand may be prevented from taxing a non-resident's income from its New Zealand activities despite having the agreed right to do so under a DTA.

⁹ See the OECD's BEPS report *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report* (published on 5 October 2015).

- 4.28 The proposed new source rule would not apply if the income already has a source under another provision of the Income Tax Act 2007. The rule would also only apply to the non-resident who derived the particular income from New Zealand (so it could not apply to a non-resident higher up the corporate chain).

Life insurance source rule

- 4.29 New Zealand has special rules for taxing life insurance. These include source rules which provide New Zealand with a taxing right on any life insurance contract which is entered into or offered in New Zealand by a non-resident life insurer (sections YD 4(17) and EY 48 of the Income Tax Act 2007).
- 4.30 Because life reinsurance premiums can be used to shift income out of New Zealand, section DR 3 is intended to deny a deduction for life reinsurance premiums when the corresponding premium income is not taxable in New Zealand. This is achieved by providing that no deduction is available under section DR 3 for the reinsurance of a policy unless the policy is offered or entered into in New Zealand.
- 4.31 Life insurance can also be used as a type of investment savings. For this reason, the foreign investment fund (FIF) rules apply to life insurance policies owned by New Zealand residents. However, the FIF rules do not apply if the life insurance is offered or entered into in New Zealand. This is because in these cases New Zealand would typically tax the premium income earned by the non-resident (see section EX 28).
- 4.32 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.
- 4.33 However, New Zealand's DTAs with Canada, Russia 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.
- 4.34 New Zealand's inability to tax life insurance premium income under these DTAs means that the rules denying reinsurance deductions under section DR 3 and the application of the FIF rules may not work as intended when the premium is paid to a non-resident life insurer or reinsurer from these countries. These outcomes are contrary to the policy intent and provide a more favourable tax treatment for life insurance businesses operating out of Canada, Russia and Singapore compared with those operating in New Zealand or other countries.

- 4.35 The Government therefore proposes amending section DR 3 to specifically provide that no deduction is available for the reinsurance of policies if the premium income on that policy is not taxable in New Zealand (including under a DTA). The definition of a FIF in section EX 28 of the FIF rules would also be amended to specifically provide that New Zealand residents are subject to the FIF rules in respect of any policies that are not subject to New Zealand tax under the life insurance rules or any applicable DTA.

Royalty substitution rule

- 4.36 The Government is aware of attempts in Australia to circumvent royalty withholding tax, for example by re-characterising royalties as distribution fees (see the ATO Taxpayer Alert TA 2016/2). An additional anti-avoidance rule for royalties was considered. This would have provided that a royalty includes any amount that it is reasonable to conclude is paid in substitution for a royalty (and is not subject to withholding tax) under an arrangement.
- 4.37 However the Government does not wish to introduce a new rule that would reduce business certainty about the tax treatments of payments unless the rule is necessary. In this regard, the current definition of a royalty in the Income Tax Act 2007 is very broad. In particular, the definition specifically states that it does not matter how a payment is described or computed in determining whether it is a royalty. Royalty substitution schemes also do not seem to be a significant issue in New Zealand at this time.
- 4.38 Accordingly at this stage the Government does not consider that an additional royalty substitution rule is necessary. However we will reconsider this if royalty substitution schemes become a problem in New Zealand in the future.

CHAPTER 5

Strengthening the transfer pricing rules

- 5.1 This chapter proposes strengthening New Zealand's transfer pricing rules so they align with the OECD's latest guidelines and BEPS recommendations and Australia's new transfer pricing rules.
- 5.2 In particular, the proposed new 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.
- 5.3 To encourage better quality documentation by taxpayers and to bolster Inland Revenue's investigative powers, it is proposed that the burden of proof for transfer pricing issues be shifted from Inland Revenue to the taxpayer and that the "time bar" for transfer pricing cases be increased to seven years.
- 5.4 Inland Revenue will collect the information required by the OECD's country-by-country reporting initiative from multinational groups with EUR €750m of annual consolidated group revenue (large multinationals). Although large multinationals would not be required to annually file their master and local files, the Government proposes increasing Inland Revenue's powers to access information and documents held by large multinationals offshore.
- 5.5 Finally, in addition to applying to dealings between associated parties, it is proposed that transfer pricing rules should also apply to investors that "act together", such as private equity investors.
- 5.6 The amendments proposed in this chapter would apply to income years beginning on or after the date of enactment of the relevant legislation.

What is transfer pricing?

- 5.7 Multinationals can use a variety of strategies to shift profits out of New Zealand and reduce their worldwide tax bills. One of the major strategies is "transfer pricing" which involves the use of cross-border payments between associated entities such as a parent and a subsidiary.
- 5.8 Related parties may agree to pay an artificially high or low price for goods, services, funding or intangibles compared to the "arm's length" price or conditions that an unrelated third party would be willing to pay or accept under a similar transaction. By manipulating these transfer prices or conditions, profits can be shifted out of New Zealand and into a lower-taxed country or entity.

- 5.9 Consider, for example, a New Zealand subsidiary that borrows money from its overseas parent. Under the terms of the lending agreement the New Zealand subsidiary pays a 10% interest rate to their parent. However, if the subsidiary had borrowed from an unrelated party, such as a bank, on similar terms, the bank would have only charged a 5% interest rate. The transfer pricing rules require the interest rate to be reduced to 5% to match the arm's length rate.

Transfer pricing is becoming increasingly important

- 5.10 Many of New Zealand's largest businesses are subsidiaries of foreign-owned multinationals. This increases the potential risk of the New Zealand tax base being eroded through aggressive transfer pricing arrangements.
- 5.11 New Zealand has relatively high levels of foreign direct investment. In 2015, FDI into New Zealand represented 39 per cent of New Zealand's GDP, compared with 35 per cent for the OECD as a whole.¹⁰
- 5.12 Some of the largest transfer pricing transactions involve the use of debt or a licence to use intellectual property. In the year ending March 2016, related party debt (\$64b) comprised 25 per cent of all of New Zealand's external debt, while payments for the use of intellectual property (\$1.2b) comprised seven per cent of New Zealand's total services imports.¹¹
- 5.13 Around half of New Zealand's direct investment is from or into Australia (51 per cent of New Zealand's FDI and 46 per cent of ODI in the year ending March 2016).¹² It is important that New Zealand's transfer pricing rules are aligned with Australia's in order to reduce business compliance costs and the risk of double taxation. Furthermore, if Australia's transfer pricing rules are perceived as being more robust than New Zealand's it could lead to a greater share of the profits being allocated to Australia, as taxpayers may perceive there is less risk of a transfer pricing adjustment in New Zealand relative to Australia.

New Zealand's transfer pricing rules need to be updated

- 5.14 New Zealand's transfer pricing legislation was sufficient when it was first introduced, but transfer pricing practices have evolved significantly in the 22 years since then. New Zealand will need to update the rules to reflect the OECD's transfer pricing guidelines and the current tax environment.
- 5.15 New Zealand's current transfer pricing legislation largely focuses on the legal form of the transaction and adjusting the consideration that is paid to an arm's length amount (which can be zero). This means that New Zealand's existing transfer pricing rules may be unable to adequately address some types of profit-shifting.

¹⁰ OECD Data FDI stocks as a percentage of GDP.

¹¹ Statistics New Zealand, Balance of Payments Statistics.

¹² Ibid.

- 5.16 Consider, for example, a subsidiary that distributes products that it buys from an associated offshore company to New Zealand customers. Under the terms of the contract for buying the goods, most of the risk is contractually assigned to an associated offshore company. As a consequence, the New Zealand subsidiary pays a relatively high price for the goods, which reduces their sales margin and the profits that they earn in New Zealand. This contract may be commercially unrealistic as, in practice, the New Zealand subsidiary controls and bears the economic risk of supplying the goods to New Zealand customers. If the multinational had engaged a third-party to sell their products in New Zealand, the third-party distributor would typically have assumed both the legal and economic risk of supplying the goods to New Zealand customers. (The described example is further illustrated in example 4 of the appendix.)
- 5.17 Australia's transfer pricing rules and the OECD's new transfer pricing guidelines address this type of profit-shifting by allowing for the conditions of the contract to be adjusted so that it aligns with the economic substance of the transaction.
- 5.18 The Government therefore proposes updating New Zealand's transfer pricing rules to reflect the OECD's BEPS actions (8–10) and recent policy developments in Australia.

Including an explicit reference to the OECD transfer pricing guidelines

- 5.19 Whilst New Zealand has contributed to and applied the OECD Transfer Pricing guidelines since they were first published in 1995, these guidelines were substantially updated in 2010. More recently, some major revisions to the guidelines were approved by the OECD in 2016 as part of their wider project to address BEPS (BEPS actions 8–10).
- 5.20 Australia's transfer pricing rules are designed to align with the OECD's transfer pricing guidelines. In fact, section 815.20 of Australia's Income Tax Assessment Act 1997 explicitly instructs taxpayers to apply the 2010 OECD transfer pricing guidelines (to the extent that they are relevant and not contrary to Australia's transfer pricing rules). In February 2016, Australia announced their intention to update their transfer pricing legislation so it refers to the latest OECD Guidelines (which address BEPS actions 8–10).
- 5.21 A major driver of Australia's law changes was to remedy an adverse decision in *Commissioner of Taxation v SNF (Australia) Pty Ltd [2011] FCAFC 74*, where the Full Federal Court did not accept the Commissioner's position that the OECD's transfer pricing guidelines were relevant to that particular case.

- 5.22 The Government proposes that New Zealand’s transfer pricing legislation should include an explicit reference to the latest OECD Transfer Pricing guidelines (which incorporate the BEPS actions 8–10 revisions) in order to ensure that these guidelines will be given due consideration as relevant guidance material by New Zealand courts when interpreting the transfer pricing rules.
- 5.23 It is important to emphasise that New Zealand already applies the latest version of the OECD’s transfer pricing guidelines to aid with the application and interpretation of our existing transfer pricing rules. As transfer pricing has become more sophisticated the guidelines have evolved and been updated over time to represent international best practice. Inland Revenue and taxpayers routinely apply the latest versions of the guidelines to cases from earlier years, as the guidelines are generally consistent with our existing law. Adding a reference to the OECD guidelines into New Zealand’s transfer pricing legislation will simply clarify our existing practice of using the latest guidelines.

Aligning the transfer pricing rules with economic substance

- 5.24 Australia’s transfer pricing legislation was updated in 2012 and 2013 to focus on the economic substance of the relevant transactions.
- 5.25 Australia’s transfer pricing legislation requires taxpayers to have regard to both the legal form and economic substance of those relations (section 815.130(1) of the Income Tax Assessment Act 1997). It also requires taxpayers to disregard the form of the actual commercial or financial relations to the extent (if any) that it is inconsistent with the substance of those relations (section 815.130(2)).
- 5.26 We propose that New Zealand introduce transfer pricing provisions that have a similar purpose as Australia’s sections 815.130(1) and (2) on requiring transfer pricing practices to align with the economic substance.
- 5.27 The proposed economic substance test is intended to be consistent with conventional transfer pricing practices which involve a functional analysis to identify the economic activities that the related parties perform in relation to the cross-border transaction. As described in the OECD guidelines:
- “this functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide.”*
- 5.28 The use of a functional analysis has underpinned transfer pricing practices since the OECD’s 2010 Guidelines. However, the OECD guidelines are being updated as part of BEPS actions 8–10. The new guidelines will emphasise that multinationals cannot simply rely on legal contracts to shift profits into a lower-taxed entity. The transfer pricing rules will not respect such contracts if the economic ownership, risk or substance is unchanged. Australia’s transfer pricing legislation appears to be a good way to codify this approach into the legislation.

5.29 The recent BEPS-related revisions to the OECD guidelines are designed to ensure the outcomes (that is, allocation of profits) from transfer pricing are aligned with the value created through the underlying economic activities. This includes:

- rules to prevent BEPS whereby multinationals transfer risks among, or allocate excessive capital to, group members. The new guidelines ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. They require alignment of returns with value creation.
- rules to prevent BEPS whereby multinationals engage in transactions which would not, or would only very rarely, occur between third parties. The new guidelines clarify the circumstances in which transactions can be reconstructed or not recognised for tax purposes.

5.30 The new OECD guidelines have a particular focus on funding, intangible assets and legal risk as these factors are particularly mobile – they can be shifted through contracts alone. By contrast, other factors such as the location of tangible assets and key staff cannot be easily shifted without also re-locating the actual economic activity.

5.31 On legal risk the new guidelines state that any:

“risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise control and does have the financial capacity to assume the risks.”

5.32 On intangibles they say:

“For intangibles legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible.”

5.33 On funding arrangements the new guidelines state that if a “capital-rich” group member does not in fact control the financial risks associated with its funding, it will be entitled to no more than a risk-free return.

Reconstruction of transactions

5.34 The OECD guidelines recommend that “non-recognition” or reconstruction of transactions should only be used in exceptional circumstances where the related party dealings would not be commercially rational if they were between unrelated parties. The OECD guidelines state that:

“the key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties.”

- 5.35 The reconstruction should make the related party dealing align with a commercially rational arrangement that would be agreed by independent businesses operating at arm's length. If the commercially rational alternative is that an independent business would not enter into a similar arrangement, it may make sense to disregard (rather than reconstruct) the arrangement for tax purposes.
- 5.36 Australia's reconstruction rules (sections 815.130(3) and (4) of the Income Tax Assessment Act 1997) apply when "independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations."
- 5.37 The ATO have interpreted this requirement as being consistent with the advice in the OECD transfer pricing guidelines that reconstruction should only apply in "exceptional circumstances" where the related party dealings would not be commercially rational if they were between unrelated parties (see paragraph 121 of ATO ruling TR 2014/6).
- 5.38 It is proposed that New Zealand introduce reconstruction rules based on those in Australia's transfer pricing legislation.
- 5.39 Consistent with Australia's rules, the proposed reconstruction rules would not be explicitly limited to "exceptional circumstances". This is because "exceptional circumstances" is a fairly subjective concept with several possible meanings which could lead to disputes. For example, there could be instances where several different multinationals adopt essentially the same type of aggressive related party arrangement. Even though these arrangements would not be "exceptional" in the sense of being unique, it may still be appropriate to reconstruct these arrangements if independent entities dealing wholly independently with one another would not have entered into such arrangements.
- 5.40 The proposed reconstruction rules will reduce certainty for taxpayers, but this should only be the case where the arrangement is aggressive and commercially irrational. Inland Revenue already operates a co-operative approach to transfer pricing compliance, with strong encouragement of taxpayers to seek Advance Pricing Agreements and to raise complex transfer pricing matters with Inland Revenue in a timely and transparent manner in order to increase certainty and compliance.

Arm's length conditions

- 5.41 New Zealand's legislation currently refers to an arm's length amount of "consideration". The transfer pricing rules could be amended to refer to arm's length "conditions" to clarify that the transfer pricing rules require taxpayers, when determining an arm's length price, to take into account the relevant conditions that a third party would be willing to accept. The proposed change would be consistent with the proposed approach of considering the economic substance of the transaction and also consistent with Australia's new transfer pricing rules which refer to arm's length conditions. Australia also defines the term "arm's length conditions" in

section 815.125 of the Income Tax Assessment Act 1997. A similar definition is proposed for New Zealand.

5.42 The Federal Court in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2015] FCA 1092 found that the term “consideration”, which was used in Australia’s transfer pricing rules at the time the disputed transaction took place, had a broader meaning than just the price (interest rate). The Federal Court agreed that the Commissioner could make adjustments to other conditions (security and loan covenants in the Chevron case), that could have an impact on the price. This case is currently under appeal.

Burden of proof

5.43 When New Zealand’s transfer pricing rules were introduced in 1995 they placed the burden of proof on the Commissioner of Inland Revenue. That is, the arm’s length amount of consideration is generally determined by the taxpayer. There are two exceptions to this:

- where the Commissioner is able to demonstrate that another amount is a more reliable measure of the arm’s length amount; and
- where the taxpayer has not co-operated with the Commissioner and this has materially affected the Commissioner’s administration of the transfer pricing rules, the Commissioner is also able to determine the arm’s length amount.

5.44 At that time, there was much closer alignment between multinational behaviour and market behaviour. This made it feasible for Inland Revenue to obtain relevant information and determine an appropriate arm’s length price for most transactions.

5.45 Over the last 22 years, however, multinational structures and transactions have become vastly more complex and are less aligned with typically observed market behaviours. Information asymmetry, whereby the multinational has much better information than Inland Revenue, has increased. Pertinent information is often held outside New Zealand, which can be difficult for the Commissioner to obtain.

5.46 Unlike New Zealand, in the majority of OECD and G20 member countries, the burden of proof for transfer pricing is on the taxpayer. This creates an implicit bias for allocating profits to countries other than New Zealand, as taxpayers may perceive there is less risk of a transfer pricing adjustment in New Zealand relative to another country.

5.47 It is proposed that the burden of proof should be shifted onto the taxpayer rather than the Commissioner of Inland Revenue. This would align the burden of proof in transfer pricing cases with the standard for other tax matters. 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 or any other party.

- 5.48 Multinationals are already required to prepare transfer pricing documentation that satisfies the burden of proof in many other countries. Such compliance efforts are routine for most multinationals and are managed on a global basis. 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 is not expected to be substantial.

Transfer pricing documentation

- 5.49 The proposal to shift the burden of proof to the taxpayer will increase the importance of taxpayers ensuring that they adequately document and explain their transfer pricing practices.
- 5.50 Each taxpayer is responsible for developing their own transfer pricing documentation. This has led to a wide range of different documentation standards depending on the taxpayer's own standards or the standards expected by different tax authorities. It has also resulted in tax authorities having an incomplete view of transfer pricing arrangements, for example they may only see the leg of a transaction that connects to their country and not the other steps in the supply chain.
- 5.51 To address these issues, the OECD has developed a three-tier standardised approach to transfer pricing documentation comprising a master file, local files and country-by-country reporting (BEPS Action 13) as explained below.
- **Master file.** Multinational enterprises will provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations.
 - **Local file.** Detailed transactional transfer pricing documentation will be provided in a "local file" specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.
 - **Country-by-Country reporting.** Large multinationals (with EUR €750m of annual consolidated group revenue) are required to file an annual country-by-country report. For each tax jurisdiction in which they do business the report lists the amount of revenue, profit before income tax and income tax paid and accrued. The country-by-country report will also report on the number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. They will identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities that each entity engages in.

Large multinationals are already required to do country-by-country reporting

- 5.52 Implementing country-by-country reporting is one of the minimum standards for OECD countries and other countries that endorse the BEPS Action Plan.

- 5.53 Accordingly, New Zealand has signed the multilateral competent authority agreement on exchanging country-by-country reports with other tax authorities and Inland Revenue is already requiring New Zealand headquartered multinationals with annual consolidated group revenue of EUR €750m or more in the previous financial year¹³ to file a country-by-country report 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.
- 5.54 A specific legislative provision for country-by-country reporting 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, if necessary. However, it may be useful to codify the country-by-country reporting requirements in legislation to provide a more explicit signal to multinationals and other countries of New Zealand's commitment to country-by-country reporting.

Master file and local file documentation

- 5.55 New Zealand endorses the OECD recommendations on transfer pricing documentation and considers that the master file/local file approach provides a useful platform on which taxpayers with material transfer pricing risks can meaningfully describe their compliance with the arm's length standard.
- 5.56 Some countries such as Australia and Japan are requiring large multinationals to provide a master file and a local file to the national tax authority each year in an approved form. Other countries only require this type of transfer pricing documentation to be provided upon a request or audit by the tax authority.
- 5.57 At this time, it is not considered necessary to require multinationals to routinely provide Inland Revenue with their master file and local file transfer pricing documentation each year. Mandatory requirements for multinationals to update and file their transfer pricing documentation each year could impose undue compliance costs, particularly for lower-risk transactions. Mandatory reporting of New Zealand documentation is also of limited usefulness for Inland Revenue as in many cases the pertinent information is held by an offshore group member (for example, in the local file for an offshore country or the master file of a non-resident head office).
- 5.58 The Government is proposing that New Zealand only require master and local file transfer pricing documentation to be provided upon a request or audit by the tax authority.
- 5.59 Chapter 6 of this discussion document proposes that the Commissioner's powers to request offshore information could be expanded (see paragraphs 6.29 to 6.37 of chapter 6). These proposals will improve Inland Revenue's ability to investigate transactions where the relevant transfer pricing information or documentation is held by a related offshore group member.

¹³ EUR €750m is equivalent to \$1,164.5m New Zealand dollars using the NZD to Euro exchange rate of 31 December 2014.

General requirements to document transfer pricing practices

- 5.60 There is currently no explicit statutory requirement in New Zealand to prepare and maintain transfer pricing documentation. Inland Revenue's *International Questionnaire* of 292 foreign owned groups found that 79 per cent of these groups produced transfer pricing documentation.
- 5.61 In Inland Revenue's experience transfer pricing documentation has been prepared for the arrangements they are interested in investigating, but the quality of the documentation can vary and it can be difficult to access documentation that is held by a related offshore company. Therefore, rather than making it mandatory for all arrangements to be documented, the Government proposes shifting the burden of proof onto the taxpayer to encourage higher quality documentation and empowering Inland Revenue to request information and documents from related overseas entities.
- 5.62 In practice, the actual level of documentation required to demonstrate compliance with the transfer pricing rules should depend on the complexity and risk profile of the relevant transactions. Some transfer pricing practices can be easily shown to align with comparable arm's length arrangements whilst others require more evidence. Inland Revenue expects taxpayers to exercise their own judgement and prepare documentation that manages their associated transfer pricing tax risks.
- 5.63 However, if a company's documentation inadequately explains why its transfer prices are considered to be consistent with the arm's length principle, Inland Revenue is more likely to audit those transfer prices in detail. The lack of adequate documentation may also make it difficult for the company to rebut an alternative arm's length transfer price proposed by Inland Revenue and is likely to result in penalties in the event of an adjustment to taxable income.

Penalties for lack of transfer pricing documentation

- 5.64 Rather than mandating for all taxpayers with cross-border transactions to prepare transfer pricing documentation, Australia uses penalties to encourage contemporaneous transfer pricing documentation. Australian taxpayers must have prepared their transfer pricing documentation by the time their relevant tax return is filed in order to reduce the potential penalty rate from 25% (the standard penalty) to 10% (the penalty for an incorrect, but "reasonably arguable" position, which also requires the taxpayer's position to be "about as likely as not" to be correct).
- 5.65 It should be noted that Inland Revenue would already apply a "lack of reasonable care" penalty to incorrect transfer pricing positions taken by taxpayers who have failed to adequately document their transfer pricing positions at the time those tax positions were taken. Whilst Australia has codified their approach to penalties for undocumented transfer pricing positions in their legislation, we do not consider this approach to be necessary or particularly useful in the New Zealand context. As mentioned above, in Inland Revenue's experience, transfer pricing documentation is

usually available for the arrangements they are interested in investigating, but it can be difficult to get high quality documentation.

- 5.66 Failure by a large multinational to provide Inland Revenue with adequate transfer pricing documentation in response to a request for this documentation, could lead to Inland Revenue applying the proposed new administrative measures for uncooperative taxpayers that are discussed in chapter 6.

Time bar for transfer pricing tax positions

- 5.67 When a taxpayer makes an assessment that is incorrect, Inland Revenue can amend the assessment to increase the amount of tax, but only within the statutory “time bar”. The time bar is currently four years from the end of the tax year in which the relevant tax return was provided to Inland Revenue. The time bar recognises there is a trade-off between allowing Inland Revenue to investigate and challenge incorrect tax positions and providing taxpayers with certainty that their tax is final.
- 5.68 Unlike many other tax disputes, where the facts are often agreed, and the dispute typically centres on differing interpretations of the law, transfer pricing assessments are very dependent on the facts and circumstances of each specific case. 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. Some transfer pricing transactions are difficult to assess as they involve “hard to value” intangibles while others involve arrangements that appear reasonable to begin with but only subsequently result in conditions that are not arm’s length.
- 5.69 For these reasons, it can be difficult for tax authorities to adequately identify the risk, apply the arm’s length principle and amend the relevant tax return within four years.
- 5.70 As shown in the table many other jurisdictions have a longer time-bar for transfer pricing assessments.

Time bars for other jurisdictions

Country	Transfer pricing time bar	Standard time bar for other tax matters
China	10 years	10 years
Australia	7 years	4 years
Canada	7 years for publicly listed or foreign owned firms, 6 years for private Canadian-owned firms	4 years
Malaysia	7 years	5 years
Hong Kong	6 years	6 years
Japan	6 years	5 years
Ireland	4 years	4 years
Germany	4 years	4 years
UK	4 years extended to 6 if the taxpayer has acted carelessly or up to 20 for a deliberate misstatement	4 years extended to 6 if the taxpayer has acted carelessly or up to 20 for a deliberate misstatement
US	3 years extended to 6 for substantial omissions of income	3 years extended to 6 for substantial omissions of income

5.71 In particular, Australia and Canada both have a seven year time bar for transfer pricing, which is three years longer than their four year time bars for other tax matters. The Government proposes increasing New Zealand's time bar for transfer pricing matters to seven years.

5.72 A longer time bar will decrease certainty for taxpayers. However, this can be mitigated by engaging with Inland Revenue. Taxpayers are already encouraged to seek Advance Pricing Agreements and to discuss complex transfer pricing matters with Inland Revenue ahead of committing to the arrangements.

Applying the transfer pricing rules to investors acting in concert

5.73 The existing transfer pricing rules only apply to cross-border transactions between associated persons, for example companies with at least 50 per cent common ownership. However, there is a specific anti-avoidance rule in section GB 2 that applies if an arrangement has a purpose or effect of defeating the intent and application of the transfer pricing rules. That arrangement then becomes subject to the transfer pricing rules.

5.74 Inland Revenue is aware of a number of cross-border investments where two or more non-associated investors, each own less than 50 per cent of a New Zealand company but act in concert to make decisions about the investment collectively. Because none of the investors are associated with the New Zealand company or each other, the transfer pricing rules would not typically

apply to such investment arrangements, even though the economic substance of the investment is that the investors operate in a similar manner as if they were a single owner. This creates opportunities to use aggressive transfer pricing arrangements to shift profits offshore.

- 5.75 The transfer pricing rules are intended to apply in conjunction with the thin capitalisation rules.¹⁴ The transfer pricing rules are designed to address BEPS from cross-border payments between associated entities (including interest payments), whereas the thin-capitalisation rules are designed to prevent BEPS through loading excessively high levels of debt funding into a multinational group member.
- 5.76 The thin capitalisation rules were amended from the 2015–16 income year so that they also apply when non-residents act in concert and collectively own 50 per cent or more of a company. Non-residents are treated as acting in concert if they hold debt in a company in proportion to their equity, have entered into an arrangement setting out how to fund the company with related-party debt, or act on the instructions of another person (such as a private equity manager) in funding the company with related-party debt. Similar amendments are being made to the NRWT rules so that if investors act together they can be treated as receiving “related party” interest payments.
- 5.77 The Government proposes introducing a similar provision to the transfer pricing rules, so that the interests of non-resident investors acting in concert can be aggregated in determining whether they are associated with a company, and so whether the transfer pricing rules would apply. Under the proposed rule, non-resident investors into a New Zealand business would be treated as “acting together” if they hold debt in a company in proportion to their equity, have entered into an agreement that effectively produces a controlled arrangement, or act on the instructions of another person (such as a private equity manager) in a way that would effectively produce a controlled arrangement.

¹⁴ The *BEPS – Strengthening our interest limitation rules* discussion document describes a detailed proposal for a potential interest rate cap on related-party debt, which if implemented, would apply instead of the transfer pricing rules to limit interest rates. The proposed cap would apply to companies that are subject to the thin-cap rules. Although interest payments are one way to shift profits to a group of unrelated offshore investors, other types of payments could also be used such as service fees paid to a private equity manager.

CHAPTER 6

Administrative measures

- 6.1 This chapter sets out some new administrative measures to make it easier to assess uncooperative multinationals in practice. The proposed measures mostly apply only to large multinationals (those with global turnover of more than EUR €750m).
- 6.2 Most of the proposed measures would not apply automatically. Instead they would generally be triggered if the multinational does not cooperate with Inland Revenue. It is not expected that the new measures would be applied often. This is partly because their existence should incentivise cooperation and partly because they require significant and persistent non-cooperation. The measures also would not prevent any multinational from challenging Inland Revenue's assessments in Court. However they do attempt to remove current incentives to delay disputes.
- 6.3 The proposed measures would make it easier for Inland Revenue to collect information from multinationals. Further, Inland Revenue's ability to assess multinationals would not be hampered by their refusal to provide the relevant information.
- 6.4 The amendments proposed in this chapter would apply from the date of enactment of the relevant legislation.

Background

The problem

- 6.5 There are significant problems with the current rules for assessing and collecting tax from large multinationals in New Zealand.
- 6.6 It can be difficult to prove that a non-resident is subject to New Zealand tax as a practical matter. A non-resident that wishes to minimise or eliminate its New Zealand tax liability will typically structure its legal arrangements with a view to achieving this objective. Its internal processes and documentation are often also drafted to support this. Establishing that the non-resident is subject to New Zealand tax therefore often involves demonstrating, as a factual matter, that its legal arrangements do not reflect the reality of its operations and value creation in New Zealand. This is highly resource intensive.
- 6.7 This difficulty is compounded by the fact that Inland Revenue is at a significant evidential disadvantage, as the non-resident possesses all 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 for Inland Revenue to obtain it. In addition, the non-resident is not required to pay any tax while it is in dispute with Inland Revenue. This can incentivise a non-resident to delay the progress of disputes.

International responses

- 6.8 The OECD's BEPS measures generally would not address these issues. The OECD measures do require improved information sharing and reporting by taxpayers. However these are directed more at intelligence gathering than the assessment and collection of tax in relation to particular taxpayers. For example, they will not help Inland Revenue prove that a particular taxpayer's legal arrangements do not reflect its actual operations.
- 6.9 The Australian and UK DPTs contain several measures to address these administrative issues.
- 6.10 The DPTs are significantly easier to assess and collect from multinationals than income tax. In the UK (but not Australia), taxpayers must advise within three months of the end of the accounting year if there is a "significant likelihood" of the DPT applying to them. In both countries, the tax office may raise an initial assessment of DPT, based on its knowledge at the time. Following a short period for limited representations by the taxpayer, the DPT is then formally assessed, and must be paid within 21 days (Australia) or 30 days (UK). There is no right to appeal or postpone payment at this stage.
- 6.11 The UK DPT can be collected from the non-resident, its deemed PE, or a related entity (meaning 51 per cent or more commonly owned).
- 6.12 Following assessment and payment of the DPT, there is a 12 month review period in which the taxpayer has to demonstrate why and by how much its DPT assessment is wrong. Alternatively the taxpayer can elect to return the diverted profits as income under normal income tax rules. The DPT may be appealed in Court, but only after it has been paid and the 12 month review period has ended.

Proposed rules for New Zealand

- 6.13 We do not consider it necessary to go as far as the DPTs in assessing multinationals. In particular, we consider that administrative problems generally only arise when multinationals do not cooperate with Inland Revenue. Consequently the proposed administrative remedies are generally targeted at non-cooperative multinationals. The intention is for cooperative multinationals to be generally unaffected by the new rules.
- 6.14 The proposed rules discussed below will only apply to large multinationals (unless stated otherwise). "Large multinationals" will be defined as multinationals with a greater than EUR €750m consolidated group turnover.
- 6.15 The EUR €750m has been chosen to align application of the new measures with the OECD's threshold for requiring large multinationals to file country-by-country reports. The OECD's measures have been widely adopted and will require multinationals to collect information and report on their global transfer pricing arrangements. Consequently, multinationals to whom the

new measures apply should already possess much of the information that Inland Revenue will request from them.

Non-cooperation

- 6.16 The rules will need to specify when a taxpayer is to be regarded as non-cooperative. It is proposed that non-cooperation include:
- Failure by the taxpayer to provide information within the possession or control of the taxpayer or its associated parties within a statutory time-frame. The taxpayer will also be deemed to be in possession of any information it is required to report under the OECD's country-by-country reporting standards for this purpose.
 - Failure to respond to Inland Revenue correspondence.
 - Failure to comply within a statutory time-frame with Inland Revenue's reasonable requests.
 - The provision of materially misleading information (including where the information is misleading by omission).
 - Failure to provide sufficient information to determine the arm's length amount of a related party transaction, or to determine the amount of profit which should be attributed to a PE. This is to ensure there is no incentive for the taxpayer to fail to adequately document its related party transactions for transfer pricing purposes, or fail to retain the relevant information (or to argue that it does not have such information in its possession).
- 6.17 However the proposed rules are not intended to impose unreasonable demands on multinationals. Accordingly, the threshold at which a multinational is treated as non-cooperative should be set above what could be regarded as reasonable in the circumstances.
- 6.18 In addition, the multinational will be warned that it is being non-cooperative and will be given a further opportunity to co-operate before Inland Revenue applies the new administrative measures. Furthermore, the Government expects that Inland Revenue would put in place internal processes so that a decision to treat a multinational as non-cooperative must be approved at a sufficiently high level within the organisation (similar to how section BG 1 is applied currently). This should give taxpayers assurance and certainty that the proposed administrative measures will not be imposed arbitrarily or inconsistently.

Example

The following sets out an example of the circumstances in which the Government envisages that a taxpayer would be treated as non-cooperative.

Inland Revenue requests information from the local subsidiary of a multinational group in order to help determine the arm's length price for a transaction between the subsidiary and a related non-resident member of the group.

The subsidiary fails to provide the information within the specified period of time. Inland Revenue reminds the non-resident of its information request and again asks for the information to be provided.

When the subsidiary fails to provide the information in response to the reminder, Inland Revenue repeats its request and sets a new date by which the information must be provided (in accordance with the guidance set out in the new legislation). Inland Revenue notes that failure to provide the information within this new period may result in the multinational being regarded as non-cooperative. Inland Revenue also explains the consequences of this (being the application of one or more of the proposed administrative measures discussed below).

When the subsidiary still fails to provide the requested information by the due date, the Inland Revenue investigator escalates the matter internally, and requests approval to treat the taxpayer as non-cooperative.

This request is considered at a senior level within Inland Revenue, with reference to the legislation and all the relevant circumstances (including the reasonableness of the original request). In this case approval is granted and one of the new administrative measures is applied in order to prevent the subsidiary's non-compliance from frustrating the transfer pricing investigation. The taxpayer is then informed of this outcome and its options going forward.

Assessments

- 6.19 If the large multinational does not cooperate with Inland Revenue, it is proposed that Inland Revenue may issue a NOPA or assessment based on the information available to Inland Revenue at the time. This is to ensure that Inland Revenue's investigations are not unduly delayed by a taxpayer's non-cooperation. This would be similar to Inland Revenue's existing power to default assess taxpayers, but would apply in broader circumstances.
- 6.20 Inland Revenue will still be required to make reasonable efforts to obtain the requested information. It is also intended that this rule should only apply for the particular matter in respect of which the taxpayer has not cooperated. For example, if the taxpayer has cooperated for six tax issues but not the seventh, the rule would only apply for the seventh issue.

Payment of tax in dispute

- 6.21 Currently tax that is being disputed by the taxpayer is not payable until the dispute is resolved. This can delay the collection of tax for several years and provide an incentive for multinationals to prolong the dispute.
- 6.22 For large multinationals engaged in particular kinds of dispute, the Government proposes bringing forward the time at which the tax must be

paid. There are two potential payment dates being considered for this purpose:

- within 90 days of Inland Revenue issuing an assessment for the tax (which would only occur at the end of Inland Revenue's current disputes process); or
- within 12 months of Inland Revenue issuing a NOPA in respect of the tax, if Inland Revenue and the taxpayer have not been able to resolve the dispute.

6.23 We consider that either date is a reasonable compromise between tax being payable at the commencement of a dispute and tax not being payable until the very end. Either date would provide a reasonable period of time for Inland Revenue and the multinational to resolve the dispute. Feedback on the appropriate date to be included in legislation is welcomed.

6.24 The proposed rule would only apply for disputed tax in relation to transfer pricing, the amount of income with a NZ source, or the amount of tax payable under a DTA. Purchases from a tax pooling service would not be accepted as the payment of tax for this purpose.

6.25 Inland Revenue would repay the disputed tax if the multinational succeeded in a Court challenge.

6.26 The disputed tax would need to be paid earlier regardless of whether the multinational cooperated with Inland Revenue or not. This is because the rule is intended to remove any incentive for a taxpayer to prolong a dispute with Inland Revenue. In addition, refusing to resolve a dispute with Inland Revenue would not usually be regarded as non-cooperation.

Collection of tax

6.27 It is proposed that any tax payable by a member of a large multinational would be collectible from any wholly owned subsidiary of the multinational in New Zealand. The tax would also be collectible from the related New Zealand entity in a case where the income is attributed to a deemed PE of the non-resident under the proposed PE avoidance rule (discussed in chapter 3).

6.28 This will assist New Zealand in recovering tax payable by non-residents.

Collection of information

6.29 To effectively monitor and enforce New Zealand's international tax rules, Inland Revenue may need to request information from the taxpayer about their functions and the functions of their offshore group members. As the OECD notes in their guidelines on transfer pricing documentation:

“It may often be the case that the documents and other information required for a transfer pricing audit will be in the possession of members of the MNE group other than the local affiliate under examination. Often

the necessary documents will be located outside the country whose tax administration is conducting the audit. It is therefore important that the tax administration is able to obtain directly or through information sharing, such as exchange of information mechanisms, information that extends beyond the country's borders."

- 6.30 In addition to transfer pricing, there are other areas of tax where offshore information may be pertinent, such as the attribution of business profits to a PE.
- 6.31 The Commissioner of Inland Revenue has an existing power under section 17 of the Tax Administration Act 1994 to request any information or documents that the Commissioner 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 entity. However, in many cases, the relevant information is held by an offshore group member. Section 17 can be applied to non-residents that are controlled by a New Zealand resident.¹⁵ However, it does not apply to non-residents that are related to, but not controlled by the New Zealand resident (such as an offshore parent or sister company).
- 6.32 Recent improvements to the exchange of information between tax authorities are making it easier for Inland Revenue to request and exchange information that is held by offshore tax authorities. However, relying on an ability to request information indirectly from other tax authorities is not always adequate. In some cases, the relevant information is not held by the offshore tax authority and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.
- 6.33 For these reasons it is proposed that the Commissioner be provided with a direct power to request information or documents that are held by, or accessible to, a group member that is located outside New Zealand. The proposed rule would only apply in respect of multinational groups with EUR €750m of global revenues and would allow the Commissioner to use her existing power under section 17 of the Tax Administration Act 1994 to request information or documents that are held by or accessible to any offshore group members who are associated with the relevant New Zealand group member or permanent establishment. The information would first be passed on to the relevant New Zealand taxpayer who would then supply this information to the Commissioner.
- 6.34 This change would align New Zealand's offshore information powers with other countries' such as Australia¹⁶ and Canada¹⁷ which have specific provisions that enable their tax authorities to directly request information or documents from offshore.

¹⁵ Under section 17(1) Inland Revenue may require a New Zealand resident to provide information in circumstances where the resident's non-resident employees or agents hold the information/documents for the resident. Section 17(1B) gives Inland Revenue the power to require a New Zealand resident to provide information held by a non-resident entity controlled directly or indirectly by the New Zealand resident.

¹⁶ Section 264A of the Income Tax Assessment Act 1936. Australia issued 79 formal offshore notices in 2014–15.

¹⁷ Section 231.6 of the Income Tax Act.

- 6.35 A consequential change would also be required to amend section 143(2) of the Tax Administration Act 1994, to allow a person to be convicted of an offence if they failed to provide information which was held by an associated offshore group member. Again, this change would only apply in respect of multinational groups with EUR €750m of global revenues.
- 6.36 Currently, section 21 of the Tax Administration Act 1994 allows the Commissioner to deny deductions for taxpayers which fail to adequately respond to information requests regarding payments by them to an offshore entity. Taxpayers who fail to provide, on a timely basis, information about an offshore payment under a section 21 information request are also unable to use any information that is later provided as admissible evidence in any subsequent court case.
- 6.37 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 permanent establishment. It is therefore proposed that section 21 be expanded so that it can also be applied to deem an amount of income to be allocated to a New Zealand group member or permanent establishment of a multinational group with EUR €750m of global revenues in cases where they have failed to adequately respond to an information request in relation to New Zealand-sourced income.

Penalties for not providing information

- 6.38 Currently, there are criminal penalties for not complying with a request for information under section 17 or section 21 of the Tax Administration Act 1994. This means that in order to apply these penalties, Inland Revenue has to take court proceedings against the person. If the person is convicted of an offence of not providing the information they are then liable for a fine of up to \$4,000 (for a first offence), \$8,000 for a second offence, or \$12,000 for three or more offences.
- 6.39 It is resource-intensive to take court proceedings against a person who fails to co-operate with a request for information. It is therefore proposed that the Commissioner be able to impose fines under section 17 and section 21 as civil penalties, rather than as criminal penalties.
- 6.40 In addition, the modest size of the fine may be an insufficient deterrent for large multinationals. A larger fine of up to \$100,000 is therefore proposed for information offences committed by multinational groups with EUR €750m of global revenues where that multinational has failed to comply with information requests made under section 17 or section 21. Australia has announced similar plans to increase their penalties for globally significant multinationals that fail to provide certain information from AU\$4,500 to AU\$450,000.

APPENDIX

Taxation of structures multinationals use in New Zealand

Structures used by non-residents to do business in New Zealand

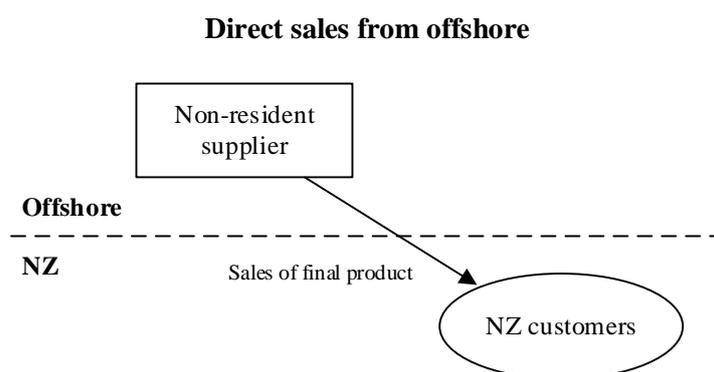
This appendix examines the current tax treatment of four structures that non-residents commonly use to sell goods into the New Zealand market. These are:¹⁸

1. direct sales by a non-resident from offshore;
2. in-market sales by a fully-fledged in-market manufacturer or assembler;
3. in-market support services for direct sales from offshore; and
4. in-market sales through a New Zealand distributor.

This appendix also examines the impact of the OECD's BEPS measures on these structures and impact of the measures proposed in this discussion document. We note that only structures 3 (in-market support services for direct sales from offshore) and 4 (in-market sales through a New Zealand distributor) give rise to potential BEPS concerns at this time. Consequently only these structures could be affected by the measures set out in this discussion document.

1. Direct sales by a non-resident from offshore (direct sales structure)

This structure involves the non-resident having no presence in New Zealand in relation to its sales – either in its own right or through another entity. Instead, the non-resident simply supplies goods or services to New Zealand customers from overseas. This can be by direct sale to consumers or by sale to retailers, who then on-sell the product to consumers. We set out a diagram of this structure below.



No New Zealand income tax is currently payable by the non-resident on its direct sales under domestic law. This is because there is no New Zealand source for income derived by a non-resident from simply selling goods and services into New Zealand.

¹⁸ These structures are simplified versions of the ones used in practice.

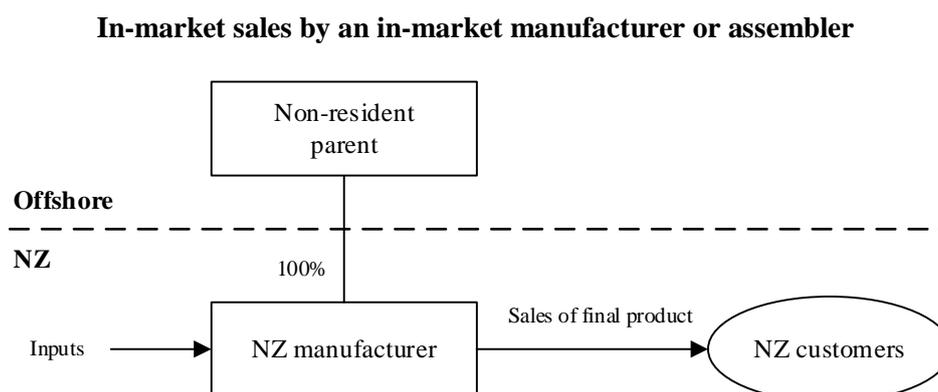
In addition, the non-resident does not have a PE in New Zealand under the direct sales structure because it has no presence here. So even if the non-resident’s income had a New Zealand source, we would be prevented from taxing it under any applicable DTA. The proposed PE avoidance rule would not change this as it does not apply unless there is a related person carrying on sales activities in the local jurisdiction.

From a policy perspective this outcome is entirely in accordance with the current norms of international taxation which New Zealand – as well as other countries – follow. Accordingly the Government is not proposing any measures to address this structure. However the OECD is continuing to monitor this issue with respect to the digital economy and intends to produce a further report in 2020. The Government may reconsider the tax treatment of this structure then.

We note that, following recent amendments, GST will generally be payable by non-residents who supply services to New Zealanders under this structure. GST is also currently applied on the importation of higher value goods into New Zealand.

2. In-market sales by a fully-fledged in-market manufacturer or assembler

We set out a diagram of this structure below.

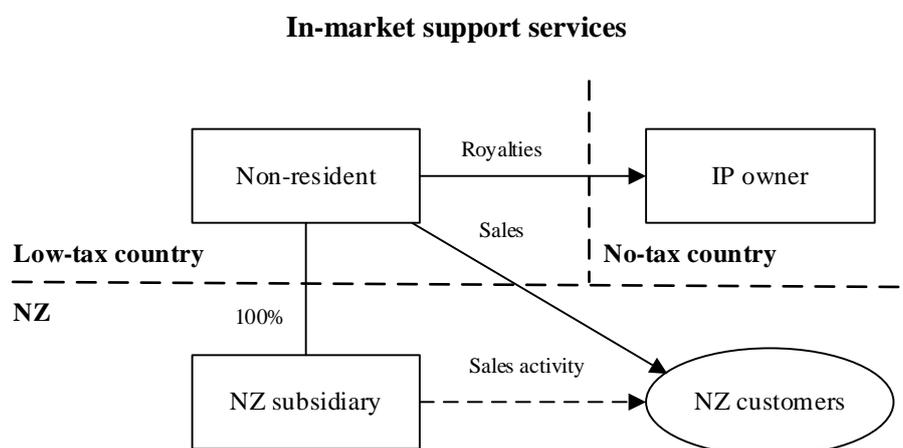


Since everything is happening in-country there are no issues with PE avoidance or transfer pricing. Accordingly this structure does not give rise to any TP or PE avoidance concerns. As a result this structure would not be affected by any of the proposals in this discussion document.

3. Direct sales from offshore with in market sales activities (in-market support structure)

This structure is similar to the direct sale structure discussed in Example 1, except that the non-resident needs to have a sales team in New Zealand to liaise with customers and arrange the sales. Under the problematic variant of this structure, the non-resident would have a PE in New Zealand if it carried out those activities itself, and would be taxable on some of its sales income. To prevent this, the non-resident contracts with a New Zealand subsidiary formed to carry out those activities. We refer to this problematic variant as the “in-market support structure”.

Under the in-market support structure, the New Zealand subsidiary is paid a fee for its services, but this fee generally only exceeds its costs by a small margin. The non-resident also usually pays a significant royalty to another group member (typically in a no tax jurisdiction) for its use of related intellectual property. This ultimately shifts much of the non-resident's profits from its New Zealand sales into a non-tax paying jurisdiction (generally without any New Zealand non-resident withholding tax being payable). We set out a diagram of this structure below.



Problems with the current tax treatment of the in-market support structure

The significance of the sales activities carried out in New Zealand should generate an equally significant amount of New Zealand tax under this structure.¹⁹ However there are several problems with the current tax treatment which prevent this from happening. These are as follows:

- The non-resident's sales income will arguably only have a New Zealand source if the subsidiary is in substance an agent for the non-resident (so that the non-resident can be treated as carrying on business in New Zealand through its subsidiary). Where the subsidiary is just contracting to provide sales related support activities for its non-resident parent, the sales related activities might not be attributable to the non-resident. If this is the case, then the non-resident's income will not have a New Zealand source. This is despite the fact that the subsidiary is part of the same economic entity as the non-resident and is effectively under its control.
- The royalty paid by the non-resident into the low tax jurisdiction for its New Zealand sales will also arguably not have a New Zealand source. As a result, the royalty will not be subject to New Zealand non-resident withholding tax (NRWT) under our domestic law.
- Similarly, New Zealand will be prevented under any applicable DTA from taxing the non-resident's New Zealand sales income or applying NRWT to its royalty payments unless the New Zealand subsidiary is effectively a dependant agent of the non-resident. Non-residents who use the problematic variant of this structure typically attempt to arrange their business activities so their non-

¹⁹ Although New Zealand would never be able to tax all of the sales income. This is because much of the sales income will be attributable to activities carried out overseas, such as the manufacture of goods. New Zealand can only tax the portion of the sales income that is attributable to the activities carried out in New Zealand.

resident subsidiaries are not treated as dependant agents. This can often be achieved, as this currently only requires the sales contracts to be signed and partially negotiated offshore. (Note this will change for some of our DTAs as a result of the BEPS Action Plan as discussed below.)

As a result of these problems, non-residents using this structure may be able to escape tax on their New Zealand sales income. In addition, the non-resident may be able to pay a royalty to shift its profit from its New Zealand sales out of the non-resident's jurisdiction (which has a DTA with New Zealand) and into a low tax jurisdiction (which does not have a DTA with New Zealand) without any New Zealand NRWT being payable.

Even if New Zealand cannot tax the non-resident on its sales income, it is possible to increase the amount of income derived by the New Zealand subsidiary. This is because, if the New Zealand subsidiary is carrying out significant sales activity, it can be treated as receiving a higher fee from the non-resident under our transfer pricing rules.

This does not solve the current problems with taxation of the structure however, as the amount of additional income derived by the New Zealand subsidiary under the transfer pricing rules will usually be less than the amount the non-resident would derive if its sales income was taxable in New Zealand. Effectively, any value attributable to local market factors and intangibles, such as goodwill, would often not be taxed in New Zealand in these circumstances as a practical matter (largely due to a lack of visibility over the value added through the entire supply chain).

Effect of OECD's BEPS measures

The OECD's BEPS PE measures strengthen the definition of a PE by widening the circumstances in which a non-resident's local representative will give rise to a deemed PE for the non-resident. In particular, the measures provide that a person will give rise to a PE for a non-resident if the person habitually plays the principal role leading to the conclusion of contracts by the non-resident and the contracts are not materially modified by the non-resident. This measure should generally result in the non-resident having a PE under the In-Market Support Structure.

However the measures will only apply to a DTA if the other country elects to include them. We expect that several of New Zealand's treaty partners will not elect to include them. Accordingly the BEPS PE measures will not be effective in many cases for New Zealand's purposes.

A general anti-avoidance provision is also being inserted into DTAs (where the countries sign up to the Multilateral Instrument) as part of the OECD BEPS programme. Called the "principal purpose test", it provides that a country does not have to grant a treaty benefit if:

- obtaining the benefit was a principal purpose of the relevant arrangement; and
- granting the benefit in the circumstances is not within the object and purpose of the DTA.

The principal purpose test should help us prevent non-residents from using contrived arrangements to gain protection under a DTA from taxation on their NZ sales income.

However the principal purpose test may not be very helpful in the absence of the widened PE definition.

Effect of the proposals in this discussion document

The PE avoidance rule in this discussion document would address the above problems with taxing this structure. In particular, the rule would:

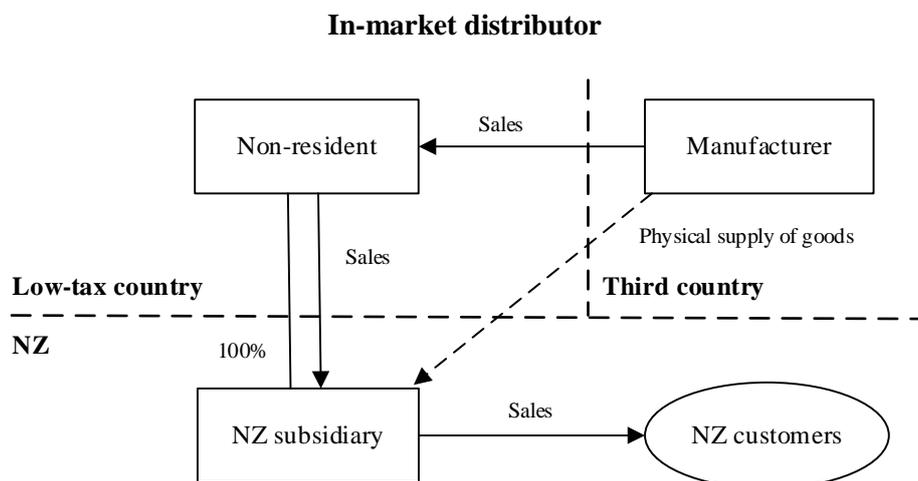
- ensure that the New Zealand subsidiary's sales activity created a PE for the non-resident;
- deem the non-resident to supply its goods or services through the PE;
- ensure the non-resident's sales income had a New Zealand source; and
- allow New Zealand to apply NRWT to the royalty paid by the non-resident to the related entity resident in the no tax jurisdiction under any applicable DTA.

Therefore the PE avoidance rule would allow New Zealand to tax this structure. However, the amount of tax paid would still be determined under the usual PE profit attribution and transfer pricing rules. Accordingly, New Zealand would not be able to tax all of the non-resident's New Zealand sales income. This is appropriate however, given that not all of the value was created by the non-resident in New Zealand.

4. In-market sales through a non-resident owned distributor (in-market distributor structure)

Under this structure, the non-resident actually has its own separate distributor in New Zealand. The distributor is a New Zealand resident subsidiary of the non-resident which buys the products from the non-resident and on-sells them to New Zealand customers. Under the problematic variant of this structure, the distribution terms are arranged so that the non-resident can justify charging a high price for its sale of the goods to the New Zealand subsidiary. The non-resident argues that this leaves only a small profit margin for the subsidiary to be taxed on in New Zealand. We refer to this problematic variant as the "in-market distributor structure".

Under the in-market distributor structure, the non-resident is not usually the manufacturer of the product, but instead operates a "regional procurement hub" in a low tax jurisdiction to centralise procurement, inventory and some distribution activities. The non-resident procurement hub entity typically carries on limited actual activities in relation to its sales to the New Zealand subsidiary. The New Zealand subsidiary manages the risks and is the entrepreneurial entity in reality. We set out a diagram of this structure below.



Problems with the current tax treatment of the in-market distributor structure

In this case the non-resident does not itself carry out any activities in New Zealand. Consequently:

- the non-resident's sales income does not have a source in New Zealand; and
- the non-resident does not have a PE in New Zealand under any applicable DTA.

Therefore it is clear that the non-resident is not subject to income tax on its New Zealand sales income, while the New Zealand subsidiary is fully taxable on its sales income (as a New Zealand resident). The problem with this structure is the low amount of profit attributed to the New Zealand subsidiary compared with the non-resident. Typically the non-resident argues that it legally bears most of the enterprise risk, and so it (the non-resident) should receive most of the profits.

This is a transfer pricing issue rather than an income source or PE issue. New Zealand's current legislation generally allows for a reasonable amount of profit to be attributed to New Zealand in most cases. However it is still possible for non-residents to shift their profits offshore by entering into legal arrangements that lack commercial reality. For example, arrangements can be entered into on terms that are commercially unrealistic, but which legally shift the risk (and thus the profits) to the non-resident. That is, current legislation favours respect for the legal form of the transaction over its economic substance.

Application of the OECD's BEPS measures

The OECD has revised its transfer pricing guidelines as part of its BEPS measures. The guidelines have been amended to price transactions between related parties more on the basis of their commercial and economic reality than their legal form (although the legal form is still relevant). The transfer pricing guidelines are also intended to prevent profits from being allocated to a location where no contributions are made to those profits, with the profits instead being allocated to the locations where the business activities are actually conducted. The guidelines also require arrangements to be re-characterised where they are on non-commercial terms.

The new guidelines should address the in-market distributor structure. This is because under that structure, the non-resident typically carries on no or minimal actual

activities. The New Zealand subsidiary manages the risks and is the entrepreneurial entity in reality. Accordingly the new transfer pricing guidelines should attribute a significant amount of profit to the New Zealand subsidiary.

New Zealand follows the OCED transfer pricing guidelines to the extent permitted by our domestic legislation. However New Zealand will need to amend its domestic transfer pricing legislation before the revised OECD transfer pricing guidelines can be fully applied. This is because the current New Zealand legislation has a more legal focus, and so does not permit the more substance based approach of the OECD guidelines to be applied in all cases.

Application of the transfer pricing measures set out in this discussion document

The transfer pricing measures set out in this document would allow New Zealand to apply the new OECD transfer pricing guidelines. Accordingly, the transfer pricing measures would allow us to appropriately tax the in-market distributor structure.

The proposed PE avoidance rule would not apply to deem the non-resident to have a PE in respect of its sales to the distributor under this arrangement. This is because the distributor's sales activities would be in respect of its own sales to customers, not in respect of the non-resident's sales.