Base erosion and profit shifting

*A summary of the key policy decisions*

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*Prepared by Policy and Strategy, Inland Revenue, and the Treasury*

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Wellington 6140.

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# Introduction

1. In September 2016 and March 2017 the Government released three discussion documents that proposed a comprehensive package of law changes to combat base erosion and profit shifting (BEPS):
* *BEPS – Strengthening our interest limitation rules*;
* *BEPS – Transfer pricing and permanent establishment avoidance*; and
* *Addressing hybrid mismatch arrangements*.
1. On 3 August 2017, Ministers announced the Government’s policy decisions on the proposed package of BEPS measures. As part of this announcement the Government proactively released the relevant BEPS Cabinet papers, policy reports and public submissions. For more information see the media statement[[1]](#footnote-1) and background documents.[[2]](#footnote-2)
2. This document summarises the Government’s key policy decisions. Note that this is a non-exhaustive list – for the details of all the policy decisions see the relevant Cabinet papers.

# Strengthening our interest limitation rules

The Cabinet paper with the details of all the policy decisions is available at http://taxpolicy.ird.govt.nz/publications/2017-other-beps/15-cabinet-paper-interest

| **Proposal** | **Summary of submissions** | **Final decision** |
| --- | --- | --- |
| **Interest rate cap**To limit the interest rate charged by a foreign parent to its New Zealand subsidiary based on the foreign parent’s own credit rating plus a small margin. | Almost all submitters did not support this proposal. Their key concerns were that it:* + - * could affect the interest rates of companies with low amounts of debt who are not being aggressive;
* could be difficult to apply if the foreign parent has no credit rating; and
* is inconsistent with our Double Tax Agreements (DTA) and will result in double taxation.
 | The Government has agreed to replace the interest rate cap proposal with a *restricted transfer pricing* rule. This approach will usually produce the same result, as it will require the interest rate to:* be in line with the parent’s cost of borrowing on the assumption that the borrower is supported by its foreign parent in the event of a default; and
* be set on the basis that it is “vanilla” – disregarding any features or terms that could push up the interest rate.

However, the restricted transfer pricing rule has more flexibility compared with the interest rate cap, so it produces more appropriate outcomes in exceptional cases. |
| **Thin capitalisation non-debt liability adjustment**The amount of debt allowed under thin capitalisation rules is limited to 60 percent of the taxpayer’s “assets”. The proposal was to reduce the taxpayer’s “assets” by the amount of its non-debt liabilities (that is, its liabilities other than interest bearing debt). | Many submitters accepted that the treatment of non-debt liabilities needs to change.However, nearly all submitters said *deferred tax liabilities* should not be counted as a non-debt liability under this new rule. Australia carves out deferred tax from this adjustment.Some submitters suggested that redeemable preference shares and certain classes of derivatives should also be carved out. | The Government has agreed to this proposal in principle. Officials will consult further on whether certain types of deferred tax liabilities should be excluded under the new rule. |
| **Infrastructure projects**To exempt certain infrastructure projects funded entirely with third-party limited recourse loans from interest limitation rules. This exemption recognises that such funding presents little risk of BEPS. | Submitters strongly supported this proposal and wrote that it would make New Zealand a more attractive place for Public Private Partnership (PPP) investment. Submitters did make several technical submissions, primarily with a focus on ensuring the exemption works with the various commercial structures adopted by PPPs. | The Government has agreed to this proposal in principle. Further consultation with submitters on technical detail is necessary. |
| **Removing the net current valuation method for thin capitalisation**To remove the ability for a company to use a value for an asset for thin capitalisation purposes that is different from what is used for financial reporting purposes, provided the valuation would be allowable under GAAP. | Submitters did not support this change, arguing it would result in high compliance costs. | The Government has agreed to modify this proposal to allow taxpayers to retain the ability to use asset values for thin capitalisation that differ from those reported in their financial accounts, but will develop clearer legislative requirements for when this option is used. |
| **Removing the option to measure debt and assets at year-end for thin capitalisation**To require debt and assets to be valued for thin capitalisation based on average values at the end of every quarter or day. | Submitters did not support this change, arguing it would result in high compliance costs. | This proposal will not proceed. The Government has instead agreed to develop an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year. |

# Transfer pricing and permanent establishment avoidance

The Cabinet paper with the details of all the policy decisions is available at http://taxpolicy.ird.govt.nz/publications/2017-other-beps/17-cabinet-paper-transfer-pricing

| **Proposal** | **Summary of submissions** | **Final decision** |
| --- | --- | --- |
| **Permanent establishment avoidance rule**The discussion document consulted on a proposed PE avoidance rule to prevent non-residents from structuring their affairs to avoid having a taxable presence (a “permanent establishment” or “PE”) in New Zealand where one exists in substance. | The majority of submitters considered that the PE avoidance rule should be more narrowly targeted. They said the rule’s proposed scope:* + - * would widen the PE definition in substance rather than just prevent its abuse. This could breach our DTAs and result in double taxation.
			* would capture ordinary commercial arrangements and discourage foreign investment.
 | The Government has agreed that the rule should be more narrowly targeted at avoidance arrangements. The Government will consult further with submitters on options to achieve this result. |
| **Anti-avoidance source rule**To introduce a rule that would deem a non-resident’s income to have a source in New Zealand (and therefore give us a domestic law taxing right) if it had a New Zealand source, treating the non-resident’s multinational group as a single entity. | Submitters considered that the proposed anti-avoidance source rule was hard to understand, too broad and should be more targeted at the perceived problem. | The Government has agreed that the rule should be more narrowly targeted. The modified rule will broadly provide that, where another group member carries on a non-resident’s business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source. |
| **Life insurance**The discussion document proposed an amendment to the Income Tax Act 2007 to specifically provide that no deduction is available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand (including under a DTA). An amendment to the definition of a FIF was also proposed to specifically provide that New Zealand residents are subject to the FIF rules for any policies that are not subject to New Zealand tax under the life insurance rules or any applicable DTA (currently life policies are not subject to the FIF rules if they are offered or entered into in New Zealand). | Submitters considered that the life insurance proposals represented an unfair and unilateral reconstruction of the tax treatment of life insurance premiums and therefore should not proceed. | The Government considers that the proposed reinsurance amendments are necessary to ensure that the rules apply as intended and to protect the tax base. However, as there is little revenue at risk for the FIF amendments and a significant likelihood of accidental non-compliance, the Government has decided that the FIF-related amendments should not proceed. |
| **Time bar for transfer pricing**To extend the time bar limiting Inland Revenue’s ability to adjust a taxpayer’s transfer pricing position from four years to seven years. | Submitters argued the time bar should remain at four years because:* + - * A longer time bar increases uncertainty for taxpayers and could delay the timely resolution of disputes.
			* Other complex areas of tax have a four year time bar.
			* The taxpayer will be at risk of double tax in jurisdictions where the time bar has already passed.
 | The Government decided that there would be no change to the original proposal. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have a special seven year time bar for transfer pricing) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore). |
| **Burden of proof**To shift the burden of proof onto the taxpayer for transfer pricing matters. | Submitters did not support this proposal and argued that the burden of proof should remain with Inland Revenue. | The Government has decided that the burden of proof will be shifted onto the taxpayer for transfer pricing matters. This is consistent with both international practice and other taxation matters under New Zealand’s tax Acts. |
| **Power of reconstruction**To introduce a rule giving Inland Revenue the power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that would not be agreed to by unrelated parties. This rule was based on Australia’s reconstruction provision. | Submitters argued that the test for reconstructing a transfer pricing arrangement should align with the OECD’s transfer pricing guidelines. | The Government has agreed that the test should be based on the corresponding test in the OECD’s transfer pricing guidelines – rather than on the Australian reconstruction provision. |
| **Paying tax upfront**To require large multinationals to pay disputed tax upfront. | Submitters argued that the proposal was unnecessary and should not proceed. | This proposal will not proceed. Inland Revenue already charges use-of-money interest on tax owing, which provides a sufficient disincentive for multinationals to prolong disputes. |
| **Tax collected from the New Zealand member of a multinational group**To introduce a rule that would require a New Zealand member of a multinational group to pay tax owed by a related non-resident group. | Submitters argued that the proposal should not proceed as it undermines the separate legal identity of corporate subsidiaries and could pose risk assessment and banking covenant issues for lenders. | The Government has decided to proceed with the original proposal. However, it has agreed that the rule should only apply if the non-resident fails to pay the tax itself. Also, the rule should only if the New Zealand member and the non-resident are part of the same wholly owned group. |
| **Information collection**The discussion document proposed extending Inland Revenue’s information collection powers to allow Inland Revenue to request information held offshore by a related group member. The discussion document also proposed imposing a civil penalty of up to $100,000 (replacing the current $12,000 maximum criminal penalty) on taxpayer that failed to provide requested information. | Submitters argued that the information collection proposals should not proceed as the rules were unnecessary in light of enhanced international information sharing protocols (for example, country-by-country reporting), would be unworkable in practice, and would unfairly penalise the New Zealand resident who may not be able to get the information from their multinational group members.Submitters also raised concerns about the new civil penalty, arguing against the increase from $12,000 to $100,000 because the New Zealand subsidiary may not control the relevant information. | The Government considers that the information collection powers are necessary to ensure that the multinational group is required to provide Inland Revenue with the information required to determine its tax obligations. There also needs to be appropriate incentives for the multinational to comply with these requests. Further, the consequences of non-compliance with the proposals will be economically borne by the multinational which controls the relevant information. However, the Government has agreed to allow taxpayers to appeal the penalty. |

# Addressing hybrid mismatch arrangements

The Cabinet paper with the details of all the policy decisions is available at http://taxpolicy.ird.govt.nz/publications/2017-other-beps/19-cabinet-paper-hybrids

| **Proposal** | **Summary of submissions** | **Final decision** |
| --- | --- | --- |
| **Scope of rules**New Zealand will introduce the full suite of OECD recommendations on hybrid and branch mismatches. | Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, but many submitters were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.Submitters also argued that the proposals would be complex and would raise the cost of capital in some instances.Some submitters suggested that the rules should incorporate a *de minimis* to reduce compliance costs. | The Government has decided that the best approach is a comprehensive adoption of the OECD recommendations with suitable modifications for the New Zealand context.The Government does not consider that a general *de minimis* is needed for the hybrid rules. (Although see below as to the specific *de minimis* for foreign trusts and limited partnerships.) |
| **Foreign trusts**Foreign trusts will often be a “reverse hybrid” for the purposes of the hybrids rules and so should be subject to tax in New Zealand in certain circumstances. This would effectively eliminate the current non-taxation of foreign trusts (on foreign sourced income) in most cases. | Submissions argued that foreign trusts are not actually reverse hybrids. It was also argued that the existing tax treatment of foreign trusts is conceptually appropriate and was confirmed to be so by the Shewan Inquiry (*Government Inquiry into Foreign Trust Disclosure Rules*). | The Government has decided that foreign trusts will be included within the scope of the rules where their treatment outside of New Zealand means income of the trust is not taxed anywhere in the world.A specific *de minimis* will be provided such that foreign trusts and limited partnerships are not subject to the rules if their foreign-sourced income does not exceed a certain threshold.The application of this rule will be delayed until 1 April 2019 to allow parties affected by this rule more time to assess their options. |
| **Foreign branches of New Zealand companies**New Zealand companies will not be able to claim deductions for foreign branch losses.Submissions were sought on an active income exemption for branches. | In submissions and at subsequent consultation meetings, submitters were concerned about the proposal due to the relatively common structure of a New Zealand company with a simple foreign branch structure (and no ability to offset foreign losses).Submitters generally supported an active income exemption for branches.Submitters also thought a *de minimis* would be helpful to rule out SMEs with foreign branches. | An active income exemption for branches was decided to be outside the scope of the project. This led to a consideration of alternative options in consultation with submitters.The Government has agreed to vary the OECD-recommended initial proposal so that taxpayers who have simple foreign branch structures that do not present a hybrid mismatch problem are not covered by the rules. |
| **Regulatory capital**No exclusion from the hybrid rules should be made for bank regulatory capital. | Submitters argued that bank regulatory capital should be excluded from the scope of the rules.Submitters also argued that if bank regulatory capital is not excluded from the rules, then there should be grandparented treatment for existing regulatory capital. | The Government has decided that there will be no general exclusion for regulatory capital.The Government has agreed with submissions in favour of grandparented treatment, meaning that for regulatory capital issued before 6 September 2016 (the date of the discussion document release) current tax treatment will continue until the next call date of the issue. |
| **Imported mismatches**To introduce an imported mismatch rule to preserve the integrity of the other hybrid mismatch rules, as recommended by the OECD. | Submissions argued that the imported mismatch rule is complicated, impractical and is an overreach. | The Government has agreed that the imported mismatch rule will be introduced in full, but its application will be deferred for non-structured imported mismatch arrangements until 1 January 2020. |

1. *Govt announces BEPS decisions* (3 August 2017), available at http://taxpolicy.ird.govt.nz/news/2017-08-03-govt-announces-beps-decisions [↑](#footnote-ref-1)
2. *BEPS – Policy reports, Cabinet papers and regulatory impact assessments* (August 2017), available at http://taxpolicy.ird.govt.nz/publications/2017-other-beps/overview [↑](#footnote-ref-2)