Building a better working world

Ernst & Young Ltd
100 Willis St, Wellington 6011
P O Box 490, Wellington 6140

Tel: +64 4 499 4888
Fax: +64 4 495 7400
ey.com/nz

New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

7 April 2017

Email: policy.webmaster@ird.govt.nz

Dear Sir

Submissions on New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*

We refer to the officials' issues paper, "New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS"*, which was released for consultation on 3 March 2017 ("IP"). We appreciate the opportunity to comment and do so below and, in more detail, in the attached Appendix.

Overall we support the implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* ("MLI") in New Zealand as a relatively simple way to enact various international obligations to which New Zealand has committed. We also agree that the MLI should be implemented as widely as possible, taking up minimum standards and virtually all optional articles, with few reservations.

However, there are issues which Inland Revenue should address in order to ensure the MLI is implemented in an efficient manner with minimal uncertainty and compliance costs. We respond to the specific questions posed for submission below, followed by comments on some other matters we believe require consideration.

All legislative references are to the Income Tax Act 2007 ("ITA"), unless otherwise stated.

Domestic law changes

Various amendments are required to the domestic disputes procedure rules in order for the mutual agreement procedure ("MAP") to work coherently alongside the existing domestic disputes procedure in the Tax Administration Act 1994 ("TAA"). These changes are largely required to ensure it is not necessary to invoke the domestic disputes procedure at the same time as carrying out the MAP:

- The response period in section 89AB of the TAA should either be extended or suspended when the taxpayer requests the Commissioner to invoke MAP.
- MAP could alternatively/additionally be treated as an alternative to the domestic disputes procedure.
- In the event of a taxpayer commencing MAP and a domestic dispute, the existing four year time period in section 89P of the TAA should be suspended.
- Rules regarding Commissioner initiated disputes may need amendment.
- Section 138I of the TAA should be extended to all disputed tax which is subject to MAP.
- The taxpayer right to request to opt-out of the disputes procedure should be extended to include international disputes.

Building a better working world

Implementation

To assist with implementation:

- Inland Revenue should provide guidance on the interaction between "treaty abuse" under the MLI and "tax avoidance"/the general anti-avoidance rule ("GAAR") under section BG 1.
- We note New Zealand's intent to enter a free form reservation with respect to arbitration carve out cases that involve the application of section BG 1. Although arbitration does not have jurisdiction over section BG 1 (being a domestic law matter), it is important for arbitration to be available to resolve disputes about the application of DTAs to the (reconstructed) "facts" arising from a BG 1 / GB 1 assessment.
- DTAs currently being renegotiated should be included as Covered Tax Agreements ("CTAs").

Minimising uncertainty and compliance costs

In relation to practical options for minimising uncertainty and compliance costs:

- We anticipate an increase in the number of DTA disputes and cases of double taxation following the implementation of the MLI. Inland Revenue may need to increase the level of resources available to competent authorities in respect of MAP cases.
- Inland Revenue should consider producing consolidated Double Tax Agreement ("DTA") texts.

Other matters for consideration

- New Zealand's domestic law around the attribution of profits is likely to change as a result of BEPS initiatives. Taxpayers would likely benefit from some Inland Revenue commentary/guidance around New Zealand's approach to profit attribution given the proposed changes to the permanent establishment definition.
- The MLI may have a greater impact on New Zealand outbound investors than it does on inbound investors into New Zealand, where outbound investment is into jurisdictions with less sophisticated domestic law and DTA networks. The Government should not assume any additional net revenue as a result of the MLI.
- Further explanation is required regarding the difference in approach between Australia and New Zealand in respect of third-state permanent establishment rules (Article 10).

We would be happy to discuss any aspect of our submissions with you. Please contact David Snell (david.snell@nz.ey.com) in the first instance in that regard.

Yours faithfully

Aaron Quintal
Partner – Tax Advisory Services
Ernst & Young Limited

Appendix

Amendments to disputes procedure

We submit:

- The response period in section 89AB of the TAA should either be extended or suspended when the taxpayer requests the Commissioner to invoke MAP.
- MAP could alternatively/additionally be treated as an alternative to the domestic disputes procedure.
- In the event of a taxpayer commencing MAP and a domestic dispute, the existing four year time period in section 89P of the TAA should be suspended.
- Rules regarding Commissioner initiated disputes may need amendment.
- Section 138I of the TAA should be extended to all disputed tax which is subject to MAP.
- The taxpayer right to request to opt-out of the disputes procedure should be extended to include international disputes.

Various amendments are required to the domestic disputes procedure rules in order for the MAP to work coherently alongside the existing domestic disputes procedure in the TAA.

The interrelationship between MAP and the domestic disputes procedure will be of concern to taxpayers. For instance, in the event a dispute arises over the interpretation or application of the DTA, should the taxpayer seek to apply domestic procedures or MAP? Currently these procedure are run simultaneously which can be a costly, time consuming and inefficient process for taxpayers. In our experience, this double handling has acted as a disincentive for taxpayers to initiate MAP.

Taxpayer initiated disputes

Current international tax BEPS-related proposals will increase uncertainty, and we anticipate an increase in the number of taxpayer initiated disputes. Taxpayers will be required to issue a Notice of Proposed Adjustment ("NOPA") within the four month response period in section 89AB of the TAA, even when the subject matter of the dispute would better be resolved under the MAP.

We submit the response period in section 89AB of the TAA should either be extended or suspended when the taxpayer requests the Commissioner to invoke MAP. This change would provide sufficient time for MAP to be completed without the taxpayer incurring compliance costs in commencing a (possibly unnecessary) domestic dispute, or forfeiting the right to subsequently commence that dispute if it remains unsatisfied by the outcome of MAP.

MAP could alternatively/additionally be treated as an alternative to the domestic disputes procedure. This change would require an amendment to section 138B of the TAA to permit taxpayers to commence a challenge under Part 8A of the TAA if they have completed either:

- The domestic disputes procedure in Part 4A of the TAA, or
- MAP.

In that event, presumably the Commissioner would be required to issue a "challenge notice" to a taxpayer who had initiated MAP and remained dissatisfied with the outcome.

In the event the taxpayer also commenced a domestic dispute within the existing response period, the existing four year time limit for resolving that dispute under section 89P of the TAA will have to be suspended, as it would be difficult for the parties to have completed both MAP and then the domestic disputes procedure.

Commissioner initiated disputes

Where the Commissioner has commenced a dispute, consideration needs to be given as to:

- Whether the parties will be required to complete that dispute pursuant to s 89N of the TAA, if the dispute is also subject to MAP, or
- Will the resolution of MAP permit the Commissioner to truncate the domestic dispute?

In any of those scenarios under which the domestic disputes procedure is not completed because the MAP has been invoked, consideration will need to be given as to how the exclusion rule in section 138G of the TAA will apply to the subsequent challenge.

Deferred tax

In our view, section 138I of the TAA should be extended to all disputed tax (regardless of which party commences the dispute) where the disputed tax is the subject of MAP. There is an inconsistency in the treatment of "deferred tax" under s 138I of the TAA. That provision suspends the taxpayer's obligation to pay disputed tax until the challenge under Part 8A of the TAA is finally resolved. However, there is no comparable provision within Part 4A of the TAA suspending the obligation to pay disputed tax until the dispute (or subsequent challenge) is resolved. Where the dispute is commenced by the Commissioner, this omission has no practical effect. However, where the dispute is commenced by the taxpayer (whether by proposing an adjustment to its own conservative return or in response to an assessment issued by the Commissioner in reliance on s 89C of the TAA) the disputed tax is immediately payable.

Request to opt-out

An inherent problem with the domestic disputes procedure is the practical inability to resolve disputed facts. MAP suffers from the same failing, with other jurisdictions often having poorer fact finding processes than New Zealand. Neither MAP nor the domestic disputes will resolve a dispute involving questions of both international tax law and contested facts. Some disputes are more efficiently resolved before the courts. Accordingly, in our view, the taxpayer right to request to opt-out of the disputes procedure should be extended to include international disputes.

Interaction between "treaty abuse" under the MLI and "tax avoidance" under section BG 1 of the ITA

We submit that Inland Revenue should provide guidance on the interaction between "treaty abuse" under the MLI and "tax avoidance" / the general anti-avoidance rule ("GAAR") under section BG 1.

The MLI incorporates treaty abuse into New Zealand's DTAs, with New Zealand favouring a "principal purpose test" ("PPT") as our preferred means of meeting the minimum standard. There have also been recent amendments to section BH 1, which grants supremacy to section BG 1 over the application of DTAs.

It is not clear whether a dispute must first be resolved under section BG 1 (which, if applicable, determines the facts to which the DTA and MAP is applied) before MAP can be invoked. If not, then the basis on which the Commissioner seeks to apply MAP to the (presumably still disputed) reconstructed facts is unclear. As the Commissioner cannot unilaterally conduct MAP with the counterparty on the basis of reconstructed facts which remain in dispute, the MAP procedure can presumably either:

- Be conducted on the taxpayer's original facts (regardless of the Commissioner's allegation of avoidance) applying the PPT test, or
- Must be invoked only after the domestic dispute over section BG 1 is resolved (which given the recent amendments to section BG 1 results in the PPT test having little, if any, practical effect).

It is not clear how the different thresholds for PPT and section BG 1 co-exist. Treaty abuse arises when a principal purpose was to secure the benefits of the treaty. By comparison, domestic tax avoidance arises when the taxpayer's purpose or effect is more than merely incidental (being the statutory test) and the tax outcomes are not in accordance with the Parliamentary contemplation test (as outlined in *Ben Nevis*)[1].

[1] Ben Nevis Forestry Ventures Ltd v C of IR (2009) 24 NZTC 23,188

Although the IP states that the PPT is very similar to the domestic GAAR, the thresholds are different and there is a possibility that a taxpayer may have breached section BG1 but not guilty of treaty abuse (much as some taxpayers have been found liable for tax avoidance under section BG 1 but faced no shortfall penalty for adopting an abusive tax position under section 141D of the TAA – see for instance see *Penny & Hooper v CIR*[2] and *Glenharrow Holdings Ltd*[3]). Given the recent amendments to section BH 1, further consideration needs to be given as to whether the treaty abuse provision in the MLI is redundant.

Resourcing issues

Inland Revenue may need to increase the level of resources available to competent authorities in respect of MAP cases.

Implementation of the MLI is likely to result in an increased number of DTA disputes, and we have concerns that Inland Revenue may not have sufficient resources to deal with the increased number of disputes. Consideration should therefore be given the Inland Revenue's resourcing in this area.

Exclusion in the case of renegotiation

We submit that DTAs currently being renegotiated should be included as CTAs.

The IP states that New Zealand's general approach is to include the majority of its DTAs as CTAs. However, DTAs will be omitted where we are currently renegotiating the DTA and the other party agrees that it should not be covered because the provisions are expected to be included in the new DTA.

Given New Zealand's intent to adopt almost all provisions of the MLI across our treaty network, we assume they will represent the Government's model treaty position. Treaty negotiations can be protracted. We see no reason why DTAs currently under renegotiation should not be included as CTAs. While the renegotiated DTA will eventually override the previous DTA (as modified by the MLI), if it is expected that the provisions of the MLI will be included in the new DTA then CTA status will promote greater certainty at an earlier date. It may also allow for smoother ratification of a renegotiated treaty given that there will be fewer policy changes for Parliament to consider.

Consolidated DTA texts

We submit that Inland Revenue should consider producing consolidated DTA texts rather than requiring taxpayers to undertake a comparison with amending protocols or rely on consolidated versions produced by commercial publishers.

The IP states that the Government will not produce consolidated versions of each DTA that has been modified by the MLI (paragraph 4.18). While this approach is consistent with existing practice for amending protocols, reading a DTA that is subject to the MLI is likely to be more difficult than reading a DTA subject to an amending protocol. The IP itself notes that the MLI is of a novel nature (paragraph 1.17).

Accordingly, we believe that production of consolidated DTAs would reduce both uncertainty and compliance costs for taxpayers. While commercial publishers are likely to produce consolidated versions, we believe the significance of the MLI warrants production of authoritative consolidated versions by the Government as opposed to reliance on versions produced by others. We anticipate production will have only a marginal cost to the Government as it will already have analysed the effect of the MLI in deciding on CTA status for each treaty partner.

Effect on outbound investors

We submit that consideration needs to be given to the effect the MLI will have on New Zealand outbound investors.

[2] Penny and Hooper v Commissioner of Inland Revenue (2011) 25 NZTC 24,396 (SC)
[3] Glenharrow Holdings Ltd v Commissioner of Inland Revenue (2009) 24 NZTC 23,236 (SC)

Most of the attention around the effect of the MLI has been focused on inbound investors. We believe it is necessary to consider the impact of entering into CTAs on New Zealand outbound investors, in particular, the provisions regarding third-state permanent establishment rules and rules regarding the artificial avoidance of permanent establishment status.

New Zealand already has robust source taxation rules, strong anti-avoidance law and a comprehensive treaty network. Further changes to our domestic law regarding permanent establishments are proposed. This combination of factors means the New Zealand Government may raise relatively little revenue from inbound investors as a result of the MLI.

Outbound New Zealand investors, however, may face bigger effects. Where investment is into jurisdictions with a lesser degree of focus on permanent establishment or sourcing rules, the effect of the MLI may be to increase the taxing rights of our treaty partners, to the detriment of both outbound investors and the Government.

Anti-Abuse Rule for Permanent Establishments situated in third jurisdictions

We submit that greater explanation is required for New Zealand's decision to adopt Article 10 of the MLI regarding third-state permanent establishment rules.

Australia does not intend to adopt Article 10 pending further analysis of its potential impact in the Australian context.[4] We are not clear on the article's impact in New Zealand and would welcome greater explanation of New Zealand's position and/or an approach comparable to that of Australia.

[4] Australia's adoption of the BEPS Convention (Multilateral Instrument), Australian Government Consultation Paper, December 2016