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**Private and confidential**
BEPS – PE and transfer pricing strengthening
C/- Deputy Commissioner, Policy and Strategy
PO Box 2198
Wellington 6140

13 April 2017

Dear Madam

We have attached our submissions on the deemed PE and transfer pricing strengthening proposals.

**Fairness**

Our approach has been to consider whether the proposals achieve some measure of making the tax system "fair". We refer to our submissions on the Hybrids consultation where we noted that "fairness" remained undefined. We further noted the apparent reliance on a global consensus for implementing the OECD's hybrids actions.

The current document proposes a number of changes which do not apply the global consensus. It is possible that the proposals will produce an unfair result. In particular, there are opportunities for double taxation and in the context of a global allocation of taxable profits, over-taxation for the economic activity carried out in New Zealand.

**Resource intensive nature of transfer pricing**

We have tried to make sense of the Officials concerns regarding the resourcing requirements of transfer pricing. These are used as justification for reversing the burden of proof and increasing the statute bar period.

The current rules are:

— taxpayers document their transfer pricing in accordance with OECD guidelines and methods. If Inland Revenue disagrees with that result, Inland Revenue must prove the taxpayer is wrong. This creates work (because invariably the taxpayer disagrees).

— taxpayers do not document their transfer pricing. Inland Revenue disagrees. The onus of proof is with the taxpayer who will need to document compliance with OECD guidelines and methods. If Inland Revenue continues to disagree, Inland Revenue must do sufficient work to show the taxpayer is wrong.

The proposals will not in our view change this. If taxpayers have carried out the work, they will consider they have discharged the onus of proof. To show that is not the case, Inland Revenue will need to show why that is wrong. This will require the same work from Inland Revenue as currently. (Inland Revenue will not be able to simply make an assessment as otherwise the taxpayer will have discharged the onus of proof through the work they have done.)

It is difficult to see Inland Revenue's complaint as no more than taxpayers disagree/do not accept Inland Revenue's position.

Our submissions take these two perspectives as starting points.

We would be happy to discuss our submissions.  Please do not hesitate to contact John (on 04 816 4518) or Kim (on 09 363 3532).

Yours sincerely

**John Cantin**
Partner

**Kim Jarrett**
Partner

## Permanent establishment avoidance

### Proposal

Under the proposed rules (for both DTA and non-DTA countries), a non-resident will be deemed to have a PE in New Zealand (among other conditions) if there is an arrangement under which a related entity carries out an activity in connection with the particular sale made by a non-resident to a person in New Zealand for the purpose of bringing it about.

As an indication of a deemed PE under the definition above, the paper provides an example of a non-resident located in a low-tax jurisdiction selling computer equipment to New Zealand customers, with its subsidiary undertaking certain sales related activities. These activities include locating customers, promoting the non-resident's products to them, discussing their needs and tailoring equipment packages for them, and indicating likely pricing/delivery dates and other key terms subject to the non-resident's approval (which is rarely withheld).

### Submission

KPMG considers that the PE avoidance rule should be explicitly limited in legislation to those arrangements which are artificial or contrived.

If Inland Revenue is concerned that tax leakage is occurring in the digital and technology industries (e.g. through their ability to service a New Zealand customer base remotely), we consider that the PE mechanism is not the appropriate way to address this. Rather we suggest Inland Revenue consider refinements to the GST system, or work with the OECD to address taxation of the digital economy.

### Comment

KPMG is concerned that Inland Revenue may not take into account modern commercial practice, particularly for technology based businesses. In our experience these companies often operate sales activities in a highly integrated manner across borders, with New Zealand based employees only performing a part of the sales function with New Zealand customers.

Attribution of all sales revenue to a New Zealand PE, in circumstances where the core value-adding sales functions are performed outside of New Zealand, would not reflect the true economic situation of the arrangement and would likely lead to double taxation. A nuanced and fact-specific approach needs to be taken to all such analyses, ensuring that Inland Revenue does not penalise completely commercial (non-tax driven) transactions.

We are concerned that the example provided in the paper may indicate the Commissioner making assumptions based on incomplete industry knowledge. Specifically we comment as follows:

- 'Well paid employees': In the technology sector it is common to have highly paid employees at multiple points in the supply chain, given the qualifications, scarcity of skill set and industry experience needed. This will not be limited to employees that work to build local demand for products in New Zealand, but will generally be a common feature of employees in technology roles across the organisation as a whole. Looking at the salaries of New Zealand employees in isolation provides a false impression of the level of 'value add' provided in New Zealand.

- Use of third party channel providers: In our experience, third party channel providers will almost always be independent agents, and are fully compensated for their role in the sale of products to New Zealand customers under their commercial arrangements with the supplier. New Zealand income will arise on these transactions, and will be subject to income tax. The use of a third party channel provider, or reseller, should not ordinarily be relevant in considering whether a non-resident has a PE in New Zealand.

- Furthermore, third party channel providers often bundle products from multiple suppliers in order to provide a solution to their New Zealand customer. Again, this is not reflective of an arrangement where a PE could be said to exist for a specific non-resident supplier.
- The term 'specialised services' is not defined or clear.

## The labelling of the proposals for DTA countries does not clearly achieve the desired override

### Submission

The override of DTAs may not be effective and will at best be uncertain and subject to dispute and cross country disputes. The proposal should be deferred until the effect of the MLI is determined.

### Comment

The basis of the DTA anti-PE avoidance proposal is that an anti-avoidance rule is accepted as overriding a DTA. Given that New Zealand and its DTA partners have the opportunity to enter into the MLI and to accept the MLI's proposals to amend the relevant DTAs PE rules:

- It is not clear how the proposed avoidance rule will interact with DTAs which are amended in the same way as the deemed PE rules propose. It would be an odd result if the proposed rule continued to apply despite the DTA allowing New Zealand to tax the profit.
- It is not clear that the substance of the rule is an anti-avoidance rule for those DTAs which are not amended in line with the MLI. Simply, if two countries have not agreed to amend their DTA PE rule, it cannot be contemplated that the structures covered by the deemed PE rule avoid the PE rule in the relevant (un-amended) DTA.
  - We expect this position to be a point of contention between taxpayers, their home jurisdiction and Inland Revenue.
  - This is because the New Zealand proposal is inconsistent with the OECD global proposed approach.
  - The labelling of the proposal as a "deemed PE" rather than a "diverted profits tax" is a mere labelling. It has similar terms to Australia's Multi-National Anti-Avoidance Legislation and parts of the UK diverted profits tax.
  - New Zealand does not follow the OECD authorised approach to attributing profit to a PE.

See our submission on the MLI for further comment and discussion.

## The authorised approach to profit attribution

### Proposal

New Zealand will continue to apply its position that a PE is not a separate entity.

**Submission**

The proposals will put pressure on New Zealand's reservation to the OECD's authorised approach to profit attribution to a PE so that the rules will not apply with certainty

The proposals require further clarification of New Zealand's position.

**Comment 1**

The Issues Paper notes that New Zealand does not accept that a PE should be treated as a separate entity. This means that New Zealand does not accept that a margin can be added to deductible costs of a PE.
This difference is in part the reason why the Issues Paper notes that significant revenue can be expected from the proposals.

A potential outcome of applying the deemed PE proposals to DTAs, which are not amended in accordance with the MLI, is that those countries dispute New Zealand's position on profit attribution. Given the push to have a global consensus, this would put pressure on New Zealand to amend its position.

We acknowledge that this pressure may have been previously successfully resisted by New Zealand in the past. This may have been accepted in part because both parties have the same view of what New Zealand can tax. That constraint would no longer apply under the deemed PE proposal if the DTA is not amended.

Further, if the other party has accepted the MAP, without accepting the PE changes, New Zealand's position will be in the hands of an arbitrator. The status of the reservation in the context of an arbitration is in our view unclear.

**Comment 2**

We note that in practice Inland Revenue has accepted an implied margin for core functions. For example, in attributing income to New Zealand, a reduced amount may be allocated because an offshore manufacturer is entitled to a profit.

The Issus Paper implies that no margin is allowed at all under the proposed rules. This conflicts with past positions that Inland Revenue has allowed.

## Supply chain restructures

**Proposal**

None

**Submission**

That the acceptability of supply chain restructures be explicitly confirmed

**Comment**

The expected reaction to the Australian and UK diverted profits taxes (due to their penal nature) is that taxpayers restructure their agreements and supply chains to create actual PEs or to ensure that their sales are made in either Australia or the UK via buy-sell subsidiaries. This is likely to be a natural reaction to New Zealand's proposals as well. (Particularly as an abusive tax position penalty is proposed).

Such a restructure is likely to have the effect of eliminating:

- The full profit margin from the sale, that would arise in a deemed PE, reducing this to the appropriate transfer pricing margin under transfer pricing rules for the activities actually carried out in New Zealand; and
- Removing the New Zealand source for expenses incurred offshore (as these will be captured in the price of goods sold to New Zealand).

Alternatively, the restructure may move sales to a higher tax jurisdiction (see further below).

As these would have the effect of "avoiding the deemed PE rule", explicit confirmation that these are contemplated results is required to ensure that the desired and expected restructure is not subject to section BG 1.

## Low tax jurisdiction

**Proposal**

That a deemed PE arises if a low tax jurisdiction is involved.

**Submission**

Clarity on what is a low tax jurisdiction is required.

**Comment**

We assume that it is not intended that the statutory tax rate should be used to determine whether a country is a low tax jurisdiction. The BEPS project has shown that the effective tax rate can be lower than the statutory tax rate. We assume that is not the test that will be applied.

Determining the effective tax rate will be a complex matter. As an example we understand that the USA is considering tax reform which, simply, would deny a deduction for expenses paid offshore while exempting foreign sales. Understanding how and whether the particular aspects of such a reformed system applied to New Zealand transactions would not be either simple or clear.

Appropriate and clear rules are required to make this an objective test that can be applied by taxpayers.

## Strengthening the transfer pricing rules

**Proposal # 1**

The Government proposes that New Zealand's transfer pricing legislation should include an explicit reference to the latest OECD Transfer Pricing Guidelines.

**Submission**

KPMG agrees that New Zealand's transfer pricing legislation should include an explicit reference to the OECD Transfer Pricing guidelines.

**Comment**

KPMG considers that an explicit reference to OECD Guidelines will provide better certainty to taxpayers, Inland Revenue and the Courts.

We consider this is required because in our view it is Inland Revenue that does not consistently apply the OECD Guidelines in disputed transactions. Legislating the OECD Guidelines will reconfirm to Inland Revenue the tests that it should be applying.

**Proposal # 2**

It is proposed that New Zealand introduce reconstruction rules based on those in Australia's transfer pricing legislation.

Consistent with Australia's rules, the proposed reconstruction rules would not be explicitly limited to "exceptional circumstances".

**Submission**

An exceptional circumstances clauses should be explicit and included in legislation.

**Comment**

In the revised version of Chapter I of the OECD Guidelines, the OIECD strongly cautions against the hasty application of a reconstruction provision noting that,

"*Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult.*"

The OECD Guidelines state further,

"*Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement.*"

The OECD has clearly stated that recharacterisation should be undertaken in exceptional circumstances only. KPMG considers that this should be explicit in the legislation, to avoid any suggestion that these powers may be used arbitrarily or because pricing a transaction is 'difficult'.

An exceptional circumstances clause could ideally include specificity around what would be considered exceptional circumstances similar to what has been outlined in the OECD Guidelines Chapter I. To address one of the concerns raised by Inland Revenue, the clause could specify that even if the arrangement is not unique, the "exceptional circumstances" test may be satisfied.

However, we note that the Government and Inland Revenue should respect and recognise that just because a transaction is not seen between independent parties does not mean it should be subject to reconstruction. This is outlined in the OECD Guidelines,

*"Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons."*

**Proposal #3**

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.

**Submission**

KPMG acknowledges that the taxpayer bearing the burden of proof is consistent with other jurisdictions globally. However the burden of proof should be with Inland Revenue when the Commissioner uses information that is available to her and not the taxpayer.

If the proposal proceeds, it should be clear that an Inland Revenue proposed transfer pricing assessment meets a threshold level of reasonableness so that arbitrary and unsupportable positions are not taken by the Commissioner.

**Comment**

KPMG submits that, should the change in the burden of proof occur, then there should be legislated limits to the ability of the Inland Revenue to leverage what is referred to as "secret comparables" or information pertaining to other companies that are privately held when determining its transfer pricing position.

This is even more important given the depth of information that will soon be at Inland Revenue's disposal with the Business Transformation project, the automatic sharing of information with treaty partners, Country-by-country reporting and other taxpayer information collection mechanisms. In order to ensure a fair and reasonable determination of transfer prices, the comparable information to be used should be limited to what would reasonably be at the company's disposal whether its internal data or data in the public domain. This requirement is of the utmost importance and therefore should be legislated.

We note that currently the burden of proof is only shifted if the taxpayer has applied a transfer pricing method i.e. undertaken the transfer pricing work necessary in relation to their transactions. We consider that this is an appropriate encouragement, in a self-assessment regime, for taxpayers to do the work necessary in order to take a tax position.

A better solution to Inland Revenue's concerns would be to consider either:

- a requirement to disclose the existence of the work at the time of filing the return; or
- filing of the transfer pricing reports and documentation with the returns

to justify the change in the burden of proof. This should assist Inland Revenue with its risk assessment.

In the alternative, if the burden of proof is changed proposed adjustments by Inland Revenue should be capable of being reasonably arguable. This is to prevent Inland Revenue proposing arbitrary or unreasonable adjustments. (We assume that information requested by Inland Revenue, providing that request is itself reasonable, has been provided to allow the Commissioner to propose a reasonable adjustment.)

**Proposal #4**

There is currently no explicit statutory requirement in New Zealand to prepare and maintain transfer pricing documentation.

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.

**Submission**

While KPMG does not support legislating that taxpayers prepare mandatory contemporaneous transfer pricing documentation, we submit that a general requirement to prepare transfer pricing documentation, appropriate for demonstrating that a taxpayer has complied with its obligations to undertake related party transactions in accordance with the arm's length standard, should be legislated.

We further note that retaining the current burden of proof in these circumstances would encourage that this be done. This would assist Inland Revenue with its risk assessment and therefore with its efficient deployment of resources.

**Comment**

Transfer pricing compliance obligations are increasing in nearly every other jurisdiction around the world, and with the introduction of Country-by-country reporting, multinational groups are needing to allocate their resources amongst these compliance requirements. As a result, KPMG is seeing instances of some multinational groups choosing to only prepare formal transfer pricing documentation for countries with an explicit, legislated, transfer pricing documentation requirement.

The need to prepare documentation is implicit in the current transfer pricing legislation. However KPMG considers that this should be an explicit legislated requirement in order to ensure appropriate documentation standards are met by the taxpayer, providing greater assurance of compliance with transfer pricing rules for Inland Revenue, and better certainty for taxpayers.

The preparation of transfer pricing documentation provides an opportunity to reassess whether the pricing of a group's related party transactions are continuing to meet the requirements of the arm's length standard. KPMG is therefore concerned that continuing to operate under an 'implicit' and somewhat looser documentation standard in New Zealand, which is increasingly out-of-step with other jurisdictions, may result in poorer transfer pricing outcomes for New Zealand.

**Proposal #5**

The Government proposes increasing New Zealand's time bar for transfer pricing matters to seven years.

**Submission**

Increasing the statutory time bar for transfer pricing matters to 7 years is inconsistent with the need to provide certainty to taxpayers on tax positions taken. It is also unnecessary in light of the increasingly timely information gathering mechanisms at the disposal of Inland Revenue, enabling Inland Revenue to undertake transfer pricing risk assessments promptly once a tax position is taken for any given year.

**Comment**

— Providing certainty for taxpayers is one of the primary purposes of the time bar. This purpose is as important and relevant for transfer pricing matters as it is for any other provision in the Income Tax Act. Taxpayers require certainty that, after a reasonable period of time has passed to enable Inland Revenue to audit their related party transactions if considered necessary, no reassessment will be sought by Inland Revenue on transfer pricing matters. We consider the current time bar is fully adequate and sufficient for Inland Revenue to perform any necessary audit procedures and reassessments on transfer pricing matters.

- The rationale provided by Inland Revenue for the extension of the time bar is that it is difficult for tax authorities to adequately identify transfer pricing risk, apply the arm's length principle and amend an assessment within four years, given the need to undertake a detailed analysis of facts and circumstances, comparable data and arm's length arrangements.

- KPMG considers that Inland Revenue now has access to significant amounts of information on the intercompany transactions undertaken by multinationals, and receives this in a very timely manner after the completion of an income tax return for any given income year. Specifically this information includes:
  - Information provided by taxpayers as part of the Basic Compliance Package process
  - Information provided by taxpayers completing the International Tax Questionnaire
  - Information provided by taxpayers who complete transfer pricing questionnaires
    - Information that will begin to be received by Inland Revenue in the short to mid-term through information received from overseas tax jurisdictions through the automatic exchange of Country by Country reporting information and Advance pricing Agreements

  Given this, Inland Revenue is able to perform risk assessment procedures within a very short time of a tax position being taken by a taxpayer.

  Furthermore, given that most, if not all, larger multinationals with a significant level of intercompany transactions, will have already been subject to Inland Revenue risk assessments, reviews and/or audits of their transfer pricing practices, Inland Revenue's focus should be on new or significantly changed transactions. A full reassessment of a taxpayer's transfer prices should not be required every year.

  Given the vast amount of information at Inland Revenue's disposal, and its receipt of that information in short order after a tax position has been taken for a given income year, KPMG considers that it is entirely reasonable for a taxpayer to expect Inland Revenue to have completed any necessary audit procedures and reassessments within 4 years.

- The discussion document references the Australian and Canadian statute bar on transfer pricing matters as support for longer statute bar on transfer pricing matters. Inland Revenue's own data however demonstrates that both the US and UK have 3 or 4 year time bars for both Transfer Pricing and other tax matters. In addition, most of the other jurisdictions listed have the same time bar for both transfer pricing and other income tax matters. This isolated focus on Australia and Canada does not show the broader position.

- The whole focus of Business Transformation is that taxpayers are able to be provided certainty more quickly and more robustly. There is no reason to separate transfer pricing from other matters for which Inland Revenue and taxpayers desire finality.

**General comment on transfer pricing and interest limitation rules**

A number of references are made in the Discussion Document to the demands that transfer pricing matters place on Inland Revenue resources. KPMG considers that this is an area where

Inland Revenue should be looking to increase the level of specialist staff that it employs, in order to address this complex, and globally significant, area of tax law.

We submit that Inland Revenue should consider this as part of its repositioning its workforce, post Business Transformation, into those skill sets that will be most necessary in addressing increasingly complex tax issues arising from commercial changes in global businesses, and an international tax landscape that increasingly complex and prone to double taxation. This is consistent with changes made in other Revenue Authorities, most notably the Australian Tax Office which has publically announced significant recruitment of international tax and transfer pricing specialists.

## Administrative measures

**Proposal #1**

The Government proposes introducing a new administrative measure to address "non-co-operation" by multinationals.

**Submission #1**

If such an administrative practice is considered necessary, then KPMG agrees that it should be explicitly legislated for, without reliance on internal administrative practice within Inland Revenue. This should include legislation explicitly stating when a taxpayer will be considered non-cooperative, the threshold at which this will be found and the process that will be used by Inland Revenue before making such a finding (e.g. notice requirements).

**Comment #1**

The Discussion Draft notes that the non-cooperative administrative measure is not intended to impose unreasonable demands on multinationals. As such, KPMG considers it important that all material aspects of a non-cooperation rule be explicitly legislated for in order to provide certainty, and clear guidance on what is considered by Inland Revenue to be an unacceptable practice or delay, to taxpayers.

**Proposal #2**

The Government proposes bringing forward the time at which tax in dispute 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 dispute 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.

**Submission #1**

KPMG considers that there is no reason to have a different rule for the payment of tax in dispute in a transfer pricing matter than for any other tax matter.

**Comment #1**

The general rules for tax in dispute is that this tax becomes payable on the day of final determination. We see no reason why this should be any different for transfer pricing matters.

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Our ref: BEPS PETPSupplementary

**Private and confidential**
BEPS - PE and transfer pricing strengthening
C/- Deputy Commissioner, Policy and Strategy
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19 April 2017

Dear Madam

## Supplementary submission

We have provided submissions on the deemed PE and transfer pricing strengthening proposals. We have a further submission on the proposals to amend the life insurance rules.

The Document notes that under New Zealand's double taxation agreements ("DTAs") with Russia, Japan, and Canada that New Zealand is unable to tax the life insurance business if a resident of those countries does not have a permanent establishment in New Zealand.

Briefly, New Zealand's framework for taxing insurance business of a non-resident is:

— For life insurance, to tax all business offered or entered into in New Zealand;

— For non-life insurance to tax 10% of the premium income if there is no fixed establishment in New Zealand.

New Zealand's DTAs typically preserve New Zealand's entitlement to tax insurance business in this way whether or not a permanent establishment exists.

The document does not say why these DTAs have not followed this approach.

We have only been able to determine two possibilities:

— New Zealand accepted a proposal by those countries to change its standard approach to taxing insurance business;

— The change in these DTAs was inadvertent, mostly likely due to a change in drafting go the relevant provision.

Neither of these reasons support the proposals. In fact, they indicate that the proposal is unprincipled. The proposals unilaterally alter the basis of taxation. The correct approach would be to renegotiate the relevant provision with the other country.

We do not accept a technical response that the proposals do not tax the non-resident insurer. The denial of the deduction for a premium (albeit offset by not taxing claims received), makes the policyholder a proxy taxpayer for the non-resident insurer. This change is likely to lead the policyholder to try to alter the terms of the agreement so the non-resident insurer is effectively bearing the tax. The substance of the proposal is the non-resident's profit is taxed.

Further, the proposal to amend the FIF rules potentially creates double taxation.

For completeness, we note our objection to the proposals is one of principle. We are not aware of insurers using the relevant DTAs. However, we consider the proposals unprincipled in their unilateral change. As we note in our submissions on Interest Rate Limitations, it is also a worrying trend that the substance of a proposal is not made transparent. In this case, the proposal seems to be directed to correcting an error rather than addressing a matter of principle.

## Further information

Please do not hesitate to contact us – John Cantin, on 04 816 4518, and Nick Hope, on 09 363 3210 – if you would like to discuss our comments in more detail.

Yours sincerely

J+ Cantin

**John Cantin**
Partner

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