Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

# Tax policy report: BEPS Cabinet papers

| | | | |
|---|---|---|---|
| **Date:** | 13 July 2017 | **Priority:** | Medium |
| **Security level:** | In Confidence | **Report no:** | T2017/1901<br>IR2017/429 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| Minister of Finance | **Authorise** the attached Cabinet papers for lodgement with Cabinet Office. | 10am, Thursday 20 July 2017 |
| Minister of Revenue | **Authorise** the attached Cabinet papers for lodgement with Cabinet Office. | 10am, Thursday 20 July 2017 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone |
|---|---|---|
| Steve Mack | Principal Advisor, The Treasury | Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted] |
| Carmel Peters | Policy Manager, Inland Revenue | |
| Paul Kilford | Policy Manager, Inland Revenue | |

13 July 2017

Minister of Finance
Minister of Revenue

# Tax policy report: BEPS Cabinet papers

1. This report recommends that you authorise the 3 attached Cabinet papers for lodgement with the Cabinet Office by 10am Thursday 20 July 2017 for the Cabinet Economic Growth and Infrastructure Committee (EGI) to consider at its meeting on 26 July 2017.

2. The three attached papers are:

- *BEPS – strengthening our interest limitation rules*. This paper contains measures to limit the ability of multinationals to use interest payments to shift their New Zealand profits offshore.
- *BEPS – transfer pricing and permanent establishment avoidance*. This paper contains measures to strengthen our transfer pricing rules, counter permanent establishment avoidance and help Inland Revenue deal with uncooperative multinationals.
- *BEPS – addressing hybrid mismatch arrangements*. This paper proposes measures to remove the tax advantages of hybrid mismatch arrangements.

3. These 3 papers form a comprehensive package of measures to address base erosion and profit shifting (BEPS). We reported to you on these measures on 22 June 2017 (T2017/1576, IR2017/325; T2017/1577, IR 2017/330; T2017/1578, IR2017/329; T2017/1604, IR2017/353).

4. We also reported to you on another related Cabinet paper on Thursday 6 July 2017 (T2017/1847, IR2017/410) called *Tax measures to prevent base erosion and profit shifting*. This covering Cabinet paper summarises the background to the 3 attached papers, highlights the most important aspects of the proposed measures, and discusses matters common to all three papers (including application dates, publicity, and financial implications). We recommend that all four Cabinet papers be lodged together with the Cabinet Office.

### Next steps

5. The following table sets out the next steps for the measures set out in the Cabinet papers.

| Date | Milestone/action |
|---|---|
| 10am, Thursday 20 July | Lodge four BEPS Cabinet papers with Cabinet Office (if you agree with their contents) |
| Wednesday 26 July 2017 | EGI |

| | |
|---|---|
| Monday 31 July 2017 | Cabinet |
| August – October 2017 | Further consultation on the measures |
| 14 December 2017 | BEPS bill containing the measures introduced |
| 30 June 2018 | BEPS bill to be passed by this date |
| 1 July 2018 | Application date for most measures |

## Recommended action

We recommend that you:

(a) **Note** that we reported to you on 6 July 2017 on a covering Cabinet paper called *Tax measures to prevent base erosion and profit shifting* which summarises the background to the 3 attached papers, highlights the most important aspects of the proposed measures, and discusses matters common to all three papers (including application dates, publicity, and financial implications).

Noted                                        Noted

(b) **Authorise** the attached 3 Cabinet papers for lodgement with the Cabinet Office (and their attached regulatory impact assessments), along with the covering Cabinet paper referred to above, by 10am Thursday 20 July 2017 for the Cabinet Economic Growth and Infrastructure Committee to consider at its meeting on 26 July 2017.

Authorised                                        Authorised

Withheld under section 9(2)(a) of the Official Information Act 1982

**Steve Mack**
Principal Advisor
Tax Strategy
The Treasury

**Carmel Peters**
Policy Manager
Policy and Strategy
Inland Revenue

**Steven Joyce**
Minister of Finance

**Hon Judith Collins**
Minister of Revenue

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

# BEPS – strengthening our interest limitation rules

## Proposal

1. This paper seeks Cabinet approval to strengthen New Zealand's rules that prevent excess interest deductions being taken in New Zealand. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

## Executive summary

2. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, have large interest deductions leaving little taxable profit in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

3. We recommend that Cabinet agree in principle to two major reforms to our interest limitation rules:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and

- tightening the rules that set the debt levels allowed in New Zealand for taxpayers with international connections (the thin capitalisation rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

4. We also recommend several minor improvements to the rules to ensure they are robust and fit for purpose.

5. These changes follow the Government discussion document *BEPS – strengthening our interest limitation rules (March 2017).* In general, submitters on the discussion document acknowledged the need to respond to BEPS concerns but most did not agree with the specific proposals put forward.

6. Some of the proposals have been modified in response to these submissions. In particular, the approach for setting the allowable interest rate on related-party loans is different to that proposed in the discussion document. We anticipate that this new approach will address many, but not all, of submitters' concerns.

7. There are some technical elements to these reforms that could benefit from further discussion with stakeholders. We therefore request that authority be delegated to the Minister of Finance and the Minister of Revenue to finalise the reforms.

8. The forecast revenue from implementing these changes is $45m in 2018/19 and $90m per annum from 2019/20. Note, however, that one technical detail to be canvassed in the further discussion with stakeholders could reduce the forecast revenue by up to $10m per annum.

## Background

9. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, are able to take large interest deductions. This results in little taxable profit being left in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

10. Accordingly, in March this year the Government released the discussion document *BEPS – Strengthening our interest limitation rules*. There were two key proposals: one to strengthen how related-party debt is priced, and one tightening the rules governing allowable debt levels.

11. The discussion document also recommended several minor improvements to New Zealand's interest limitation rules to ensure they are robust and fit for purpose.

## Comment

12. The majority of multinationals operating in New Zealand have relatively conservative debt positions, and the Government is committed to making sure New Zealand remains an attractive place for them to do business.

13. However, there are some multinationals that deliberately attempt to minimise their tax payments in New Zealand by engaging in BEPS strategies, such as by having related-party debt with excessive interest rates. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

14. Accordingly, we recommend changes to New Zealand's interest limitation rules, most significantly:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the thin capitalisation rules, which set the debt levels allowed in New Zealand for taxpayers either with foreign parents (the inbound rules) or foreign subsidiaries (the outbound rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

### *Restricted transfer pricing*

15. When borrowing from a third party (such as a bank), commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context, such as when a New Zealand subsidiary borrows from its foreign parent. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

16. Broadly speaking, transfer pricing a loan agreement involves determining (hypothetically) the interest rate a third party lender would be willing to lend at, given the terms and conditions of the related-party loan. It is a fact specific and resource intensive exercise and can be manipulated (for example, by adding terms and conditions to the related-party loan that are not frequently seen between unrelated parties). We note that commentators such as Richard Vann, a professor of tax at the University of Sydney, have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

17. For these reasons, the international consensus is moving away from using ordinary transfer pricing as the primary mechanism to limit the interest rates on related-party debt. The OECD, for example, has recommended that countries adopt a simple formulaic approach for limiting interest deductions, which would largely eliminate the advantage of using related-party debt with excessive interest rates (this approach was raised in consultation but was not supported by submitters as it would make a taxpayer's allowable interest deductions volatile. Instead, as outlined below, we are recommending that the current rules for setting allowable debt levels be buttressed by rules that ensure related-party interest rates are appropriate).

18. Accordingly, we recommend that the allowable interest rate for inbound related-party loans be determined under a *restricted transfer pricing* methodology. Inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have substantial third party debt featuring those terms and conditions.

19. The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

20. This *restricted transfer pricing rule* would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate that is the same as the interest rate facing the borrower's foreign parent would automatically be considered acceptable. This safe harbour would be attractive to many companies as it is both simple and provides certainty.

21. We note that the Australian Taxation Office has recently released administrative guidelines which outline a similar approach for limiting related-party interest rates (albeit Australia is implementing this approach as an operational policy, rather than a law change).

*Private sector consultation*

22. This *restricted transfer pricing rule* is different to the proposal suggested in the March discussion document. The original proposal was a hard rule to cap the interest rate a foreign parent could charge its New Zealand subsidiary based on the foreign parent's credit rating (an "interest rate cap").

23. We consider that the *restricted transfer pricing rule* is a more workable way of achieving essentially the same objective – ensuring the interest rate on related-party debt is in line with what would actually be paid on third party debt. While the methods (restricted

transfer pricing and the interest rate cap) are different in approach, the outcome of both will generally be the same – with differences only at the margin. Accordingly, both approaches have the same revenue impact.

24. Submitters on the March discussion document did not support the original proposal. Many submitters argued that a new approach for pricing related-party debt is unnecessary, noting that the Government proposed to strengthen the transfer pricing rules generally (in the other March discussion document *BEPS – transfer pricing and permanent establishment avoidance*).

25. Some submissions highlighted the consequences of adopting a blunt rule in the nature of the cap. These include concerns that:

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;

- the cap would deny deductions even when the amount of debt in the subsidiary was low;

- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating); and

- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

26. It should be noted that the *restricted transfer pricing rule* we are recommending will address many, but not all, of submitters' concerns because it is still a significant departure from using ordinary transfer pricing. Accordingly, we expect it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and

- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur with any frequency because of the shift in the international consensus on what is acceptable in relation to the pricing of related-party debt.

***Allowable debt levels in the thin capitalisation rules***

27. New Zealand has rules to prevent the excessive use of debt by foreign-owned entities operating in New Zealand (inbound investment) and New Zealand-owned entities with international operations (outbound investment). Interest deductions are denied to the extent that the entity's debt level with reference to its assets is determined to be excessive.

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

29. The core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. Under the current rules, where non-debt liabilities are ignored, companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment of non-debt liabilities also mean the rules apply unevenly across companies: companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

30. In addition, one of the objectives of the thin capitalisation rules (ensuring that a taxpayer is limited to a commercial level of debt) is undermined by the current treatment of non-debt liabilities. A third party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

31. Australia requires this same adjustment for non-debt liabilities.

*Private sector consultation*

32. This proposal was accepted by some submitters but opposed by others who argued, for example, that the proposal amounts to a substantial reduction in the amount of deductible debt allowable under the thin capitalisation rules. Overall, this proposal was much less contentious than the interest rate cap.

33. None of the submissions against the core proposal convinced us that the analysis above, suggesting that the non-debt liability adjustment is appropriate, is incorrect. Accordingly, we recommend that the proposed adjustment to the allowable debt level under the thin capitalisation rule proceed. That is, a taxpayer's allowable debt level under the rules should be set with reference to their assets net of their non-debt liabilities.

34. A near-universal comment from submitters was that certain non-debt liabilities – most significantly *deferred tax liabilities* – should be carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept. Accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. Submitters argued that this is often not the case – deferred tax liabilities are frequently technical accounting entries and do not reflect future tax obligations. Submitters also pointed to the rules in Australia, which do include a carve-out for deferred tax liabilities and assets.

35. We recommend further consultation on whether deferred tax should be carved-out from this non-debt liability adjustment. Many, but not all, deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future. Given the concerns raised by submitters, further consultation on this technical detail would be beneficial.

***Other changes***

36. We recommend five other changes to the thin capitalisation rules:

- a special rule for infrastructure projects (such as public private partnerships) that are controlled by a single non-resident;
- a de minimis for the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;

- removing the ability to use asset valuations for the thin capitalisation rules that differ from those reported in a firm's financial accounts; and

- removing the ability to measure assets and debts on the final day of a firm's income year.

37. These measures were all discussed in the March discussion document. Some were supported by submitters, while others were opposed. Where they were opposed, we are recommending changes to the proposals which will, in general, address submitters' concerns.

*Rule for infrastructure projects*

38. We recommend a special rule that allows all of a taxpayer's third party debt to be deductible even if the debt levels exceed the normal thin capitalisation limits, provided the debt is non-recourse with interest funded solely from project income.

39. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously.

40. This rule was well received by submitters; however, some technical issues have been raised which we will consult further on.

*De minimis for the inbound rules*

41. The thin capitalisation rules that apply to New Zealand-owned taxpayers with foreign operations (the outbound rules) has a de minimis (the rules do not apply if a taxpayer has interest deductions of less than $1 million). The thin capitalisation rules that apply to foreign-owned taxpayers (the inbound rules) do not have a similar de minimis.

42. We recommend the current de minimis in the outbound rules be extended to taxpayers subject to the inbound rules, provided the taxpayer has only third party debt. This proposal is to reduce compliance costs for small foreign-owned entities that have a low risk of BEPS.

43. This proposal was generally supported by submitters.

*Allowable debt levels for companies owned by a group of non-residents*

44. At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level is the greater of:

- 60 percent; and

- 110 percent of its third party debt.

45. However, this means that a taxpayer with high levels of third party debt can be funded with almost no equity. For example, a project funded 90 percent with third party debt could have 9 percent shareholder debt and only 1 percent equity.

46. To address this, we recommend changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. This proposal was generally accepted by submitters.

47. The March discussion document proposed that this change be grandparented, as the rules it relates to (for non-residents acting together) have only just taken effect. We recommend that the precise design of this grandparenting be subject to further consultation with stakeholders, with decisions on its final design being delegated to the Ministers of Finance and Revenue.

*Asset valuations*

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

49. While it is permissible to use an asset's net current value, the thin capitalisation rules set out what is required if taxpayers utilise this option. Accordingly, we recommend that this new net current valuation option be available only if certain criteria are met – such as if the valuation is from an independent expert valuer.

## Agency consultation

50. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

## Financial implications, human rights, administrative impacts, legislative implications, and publicity

51. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

## Impact Analysis Requirements

52. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

53. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

## Recommendations

54. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – strengthening our interest limitation rules* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing their overall effectiveness.

3. **Agree** that the interest rate on inbound related-party loans should be set using a *restricted transfer pricing* rule, whereby the interest rate is set under transfer pricing but ignoring all surrounding circumstances, terms, and conditions that could result in an excessive interest rate unless similar terms apply to significant amounts of third party debt, and with the rebuttable presumption that the borrower would be supported by its foreign parent.

4. **Agree** that a taxpayer's allowable debt level in the thin capitalisation rules should be set with reference to its assets less its non-debt liabilities.

5. **Agree** that the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of $1 million or less, be made available also to foreign-controlled taxpayers provided they have no owner-linked debt.

6. **Agree** that an exemption should be provided from the thin capitalisation rules for certain infrastructure projects funded entirely with third party limited recourse loans.

7. **Agree** that, when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.

8. **Agree** that clear legislative requirements be developed for when taxpayers choose to value their assets for thin capitalisation purposes on a basis other than that used in their financial accounts.

9. **Agree** that an anti-avoidance rule should be inserted into the thin capitalisation rules, to apply when a taxpayer substantially repays a loan just before the end of the year.

10. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

11. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

12. **Authorise** the Minister of Finance and the Minister of Revenue jointly to take final decisions on the extent to which deferred tax liabilities are included in non-debt liabilities, up to a limit of reducing the level of expected revenue increases

anticipated by the BEPS measures as set out in recommendation 7 in the accompanying Cabinet paper *Tax Measures To Prevent Base Erosion And Profit Shifting* by up to $10 million per annum

13. **Agree** that the results of the decisions in recommendations 3-12 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

**Hon Steven Joyce**
Minister of Finance

**Hon Judith Collins**
Minister of Revenue

# Coversheet: BEPS – strengthening our interest limitation rules

| | |
|---|---|
| Advising agencies | *The Treasury and Inland Revenue* |
| Decision sought | *The analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet* |
| Proposing Ministers | *Steven Joyce (Finance) and Hon Judith Collins (Revenue)* |

## Summary: Problem and Proposed Approach

**Problem Definition**
**What problem or opportunity does this proposal seek to address? Why is Government intervention required?**

The problem the proposals discussed in this impact statement seek to address is the use of debt financing by taxpayers to reduce their New Zealand income tax liability significantly.

**Proposed Approach**
**How will Government intervention work to bring about the desired change? How is this the best option?**

The adoption of a restricted transfer pricing rule for determining the allowable interest rate (for tax purposes) on related-party loans from a non-resident to a New Zealand borrower will help ensure interest rates on such loans cannot be excessive.

In addition, changing the way deductible debt levels are calculated under the thin capitalisation rules will ensure that taxpayers with little equity are unable to have large amounts of deductible debt.

These changes will provide a solution that is sustainable, efficient and equitable, while minimising impacts on compliance and administration costs.

## Section B: Summary Impacts: Benefits and costs

**Who are the main expected beneficiaries and what is the nature of the expected benefit?**

The Government will benefit in that the new interest limitation rules are forecast to produce approximately $80–90 million per year on an ongoing basis.

There are also efficiency and fairness benefits to these proposals which cannot be assigned to particular beneficiaries.

| Where do the costs fall? |
| --- |
| The costs primarily fall on foreign-owned taxpayers operating in New Zealand (though there may be some minor impacts on New Zealand-owned taxpayers with international operations). Tax payments for affected parties are forecast to increase by approximately $80–90 million per year on an ongoing basis. |

| What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated? |
| --- |
| As with all tax rules, there is some risk of taxpayer non-compliance. However, this is mitigated as the rules predominately apply to large companies – and the tax affairs of large companies are closely monitored by Inland Revenue. |

| Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'. |
| --- |
| There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'. |

## Section C: Evidence certainty and quality assurance

| Agency rating of evidence certainty? |
| --- |
| There is moderate evidence in relation to the problem of excessive interest rates on related-party debt, and good evidence in relation to allowable debt levels. Inland Revenue has some data on interest rates paid on related-party debts, as well as examples of structures that appear to have the effect of increasing the interest rate on such debt. However, this data is not comprehensive.<br><br>Inland Revenue has data on the debt, asset and equity levels of significant foreign-owned enterprises, which allows an accurate estimation of the impact of the non-debt liability adjustment for those firms. |

*To be completed by quality assurers:*

| Quality Assurance Reviewing Agency: |
| --- |
| Inland Revenue |
| Quality Assurance Assessment: |
| The Quality Assurance reviewer at Inland Revenue has reviewed the *BEPS – strengthening our interest limitation rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the Quality Assurance criteria. |

| Reviewer Comments and Recommendations: |
| --- |
| The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version. |

# Impact Statement: BEPS – strengthening our interest limitation rules

## Section 1: General information

**Purpose**

Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy changes to be taken by or on behalf of Cabinet.

**Key Limitations or Constraints on Analysis**

**Evidence of the problem**

While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire. This dataset includes debt levels, related-party debt levels, and related-party interest payments of large foreign-owned firms.

However, there are still limitations to that data – for example, data on interest rates on related-party debt (and the interest rates facing a New Zealand subsidiary's parent company) is not captured in the Questionnaire. Where possible, this information was obtained from other sources (such as credit ratings of parent companies and disclosed related-party interest rates in financial statements) or estimated (for example, estimating interest rates based on related-party interest payments and related-party debt amounts). However, this other data is less comprehensive and accurate.

**Consultation**

The preferred option in relation to limiting interest rates on related-party interest rates has not been subject to consultation. This was because it was developed in response to submissions on the original proposals. However, it is similar in many respects to the original proposal, which was subject to consultation. In addition, to ensure the rule operates effectively and to mitigate the risk of unintended outcomes, it will be subject to consultation with submitters on the technical detail.

**Responsible Manager (signature and date):**

Carmel Peters

Carmel Peters
Policy Manager, Policy and Strategy
Inland Revenue

13 July 2017

# Section 2: Problem definition and objectives

## 2.1 What is the context within which action is proposed?

### BEPS

BEPS refers to tax planning strategies used by some multinational enterprises (MNEs) to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over MNEs not engaged in BEPS and domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter BEPS.

### BEPS using interest deductions

The use of debt financing is one of the simplest ways of shifting taxable profits from one jurisdiction to another. For example, because interest payments are deductible, a related-party cross-border loan from a parent to a subsidiary can be used to reduce taxes payable in the jurisdiction that the subsidiary is located.

### New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations. This includes developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4).

If no further action is taken, MNEs that currently have high levels of debt in New Zealand, or highly-priced related-party debt, will be able to continue paying little tax in New Zealand. There is also a risk that additional MNEs would adopt similar structures.

## 2.2 What regulatory system, or systems, are already in place?

### New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

New Zealand's tax system has been the subject of numerous broad-based reviews – most recently the Victoria University of Wellington Tax Working Group in 2010. It is well regarded and generally functions well.

No other government agencies have a direct interest in the tax system. However, a good tax system is important for a well-functioning economy – many government agencies therefore have an indirect interest in the tax system.

Foreign investment in New Zealand is generally taxed under our company tax at 28 percent. New Zealand's tax system has rules that limit the deductible debt levels and interest rates for taxpayers with foreign connections. These rules affect only foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

**Thin capitalisation rules**

New Zealand has "thin capitalisation" rules to limit tax deductions for interests that non-residents are allowed. These rules generally require an investment owned by a non-resident to have a debt-to-asset ratio of no more than 60 percent (interest deductions are denied to the extent the allowable debt-to-asset ratio is exceeded).

Thin capitalisation rules also apply to New Zealand-owned firms (frequently referred to as the "outbound thin capitalisation rules"). These rules generally require a debt-to-asset ratio of no more than 75 percent. They are designed to prevent a disproportionate portion of a New Zealand company's debt being placed in New Zealand.

Like the tax system as a whole, we consider that the thin capitalisation rules are serving us well. The rules are well understood and taxpayers subject to the rules generally have conservative debt levels and, for those with related-party debt, the debt is at conservative interest rates – as evidenced by the significant amount of tax paid by foreign-owned firms operating in New Zealand (foreign controlled firms paid 39 percent of company tax in the 2015 tax year).

**Transfer pricing rules**

It is important to limit not just the quantum of debt in New Zealand, but also the interest rate on that debt. For third-party debt, commercial pressures will drive the borrower to obtain as low an interest rate as possible. However, these pressures do not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates. Broadly speaking (and as they apply to related-party debt), these rules seek to ensure that the interest rate on a given loan contract is in line with what would have been agreed between unrelated parties.

**NRWT**

While payments of interest to related parties are deductible, they are subject to non-resident withholding tax (NRWT). NRWT applies at either 15 percent or 10 percent, depending on whether New Zealand has a Double Taxation Treaty with the interest recipient's home jurisdiction. This means that, while the use of debt can reduce tax payable in New Zealand, it does not completely eliminate it.

## 2.3 What is the policy problem or opportunity?

A simple way that non-residents can reduce their New Zealand tax liability significantly is by capitalising a New Zealand investment with debt instead of equity, because they can then take interest deductions in New Zealand. This is shown in the example below.

> ***Example***
> *Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.*
>
> *Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.*

Having a generally well regarded tax system does not mean that tax changes are unnecessary. An on-going policy challenge is to ensure that our tax rules are up to date and ensure that MNEs are paying a fair amount of tax in New Zealand. Base protection measures – such as rules for limiting the amount of debt allowable in New Zealand, and the interest rate on that debt – are therefore important.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

This impact statement considers two related policy opportunities:

- ensuring the rules for setting the allowable interest rates on related-party debt are sufficiently robust; and
- ensuring the basis for setting the allowable debt level in the thin capitalisation rules is appropriate.

### Scale of the problem

The OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan) included developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4). We consider the fact that the OECD has included profit shifting using interest in its BEPS Action Plan as evidence that this is a significant policy issue internationally.

As mentioned above, most MNEs operating here have relatively low levels of debt and do not have interest rates considered to be excessive. However, there are a small number of taxpayers with either debt levels that are too high, or interest rates that are excessive. While small in number, the fiscal impact of these arrangements is significant – we estimate the tax revenue lost is $80–90 million per year.

## 2.4 Are there any constraints on the scope for decision making?

There are no constraints on scope.

## 2.5 What do stakeholders think?

**Stakeholders**

The stakeholders are primarily taxpayers (in particular, MNEs) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules.

**Consultation already undertaken**

In March 2017, the Government released the discussion document *BEPS – strengthening our interest limitation rules*. The discussion document consulted on two key proposals which are considered in this impact statement – new interest limitation rules and a non-debt liabilities adjustment to the thin capitalisation rules.

The Government received 27 submissions on the discussion document. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

In general, submitters acknowledged the need to respond to BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, many submitters did not support the specific proposals put forward.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

***Interest limitation***

The discussion document proposed moving away from a transfer pricing approach for pricing inbound related-party loans. Instead, the allowable interest rate for such a loan would – in most instances – be set with reference to the New Zealand borrower's parent's borrowing costs (referred to as an "interest rate cap").

*General reaction*

Most submitters argued that the interest rate cap proposal was not necessary and should not proceed. They noted that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm's length standard, so would result in double taxation;
- will increase compliance costs;
- will apply to firms with a low BEPS risk; and
- has no international precedent.

Only two submitters wrote in favour of the proposed cap. However, the proposal did attract positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.

Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".

***Allowable debt levels***

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

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

*General reaction*

Several submitters indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

A number of other submitters argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

Stakeholders' views displayed no clear pattern. Two big accounting firms agreed with the proposal while two others disagreed. Similarly, of the three major stakeholder groups who submitted on the proposal, one supported and two opposed the change.

*Deferred tax*

To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future;
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

**Further consultation**

Following Cabinet decisions in July 2017, officials are planning to undertake further public consultation on outstanding policy issues, technical design details and an exposure draft of selected parts of the planned BEPS bill.

# Section 3: Options identification

## 3.1 What options are available to address the problem?

**Related-party interest rates**

We have identified five mutually exclusive options to the address the problem of excessive interest rates on related-party debts.

Option 4 (administrative guidance) is a non-regulatory option. The other options for change involve changing New Zealand's tax legislation.

***Option 1: Interest rate cap (discussion document proposal)***

As described in section 2.5.

***Option 2: Restricted transfer pricing***

Under a restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
    - That the loan has no exotic terms that are generally not seen with third-party lending
    - That the loan is not subordinated
    - That the loan duration is not excessive
    - That the debt level of the borrower is not excessive.

The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

This restricted transfer pricing rule would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable.

This option was developed following consultation to address some of the concerns raised by submitters; however, it has not itself been subject to consultation.

***Option 3: Adopt EBITDA-based rule (OECD recommended approach)***

This option would involve limiting the amount of interest deductions a taxpayer is allowed with reference to their earnings (specifically, their profits before deductions for interest, depreciation and amortisation are taken into account, also known as their EBITDA). This new approach would completely replace the thin capitalisation rules, becoming the new method for limiting interest deductions for taxpayers with international connections.

This approach would constrain the tax effectiveness of highly priced debt, since it directly limits interest deductions rather than limiting the amount of debt; a taxpayer with highly priced debt would be more likely to exceed their EBITDA limit and face interest denial.

Almost all submitters did not support the adoption of an EBITDA-based rule.

***Option 4: Administrative guidance***

This option would involve Inland Revenue issuing administrative guidance on how it will assess the risk of related-party lending transactions – similar to what has recently been released by the Australian Taxation Office (ATO) (discussed below).

Under this option, related-party loans with certain features (such as having an interest rate in line with the interest rate facing the borrower's foreign parent) would be given a low risk rating and be unlikely to be challenged by Inland Revenue. Taxpayers with higher interest rates would be more likely to have their related-party loan investigated.

Several submitters suggested this option be adopted in place of the interest rate cap. They argued that it would provide certainty for taxpayers who desired it, but taxpayers who value certainty less would be free to breach the guidelines.

***Option 5: Status quo (ordinary transfer pricing)***

This option would involve continuing to price related-party debt under the transfer pricing rules. As discussed above, the Government proposed strengthening these rules in the discussion document *BEPS – transfer pricing and permanent establishment avoidance.* Many submitters argued that this should be sufficient to address any concerns over related-party interest rates.

***Relevant experience from other countries***

The ATO has released draft guidelines regarding the interest rates of cross-border related-party loans.[1] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

**Allowable debt levels**

We have identified three mutually exclusive options relating to setting the allowable debt level under the thin capitalisation rules.

The options (other than the status quo) involve changing New Zealand's tax legislation.

***Option 1: Proceed with non-debt liabilities adjustment (as proposed in the discussion document)***

As described in section 2.5.

***Option 2: Proceed with non-debt liabilities proposal excluding deferred tax***

Under this option, a taxpayer's deferred tax would be ignored for the purposes of the non-debt liability adjustment. That is, a taxpayer's allowable debt level would be set with reference to the result of the formula: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Of submitters who supported the proposed non-debt liability adjustment in principle, this was the preferred option.

***Option 3: Status quo (do not proceed with non-debt liabilities adjustment)***

Under this option, maximum deductible debt levels would continue to be calculated under the thin capitalisation rules with reference to assets, ignoring non-debt liabilities.

As mentioned in section 2.5, this was the preferred option of some submitters.

***Relevant experience from other countries***

Australia has thin capitalisation rules that are broadly similar to New Zealand's. Australia's rules currently require a non-debt liability adjustment, but deferred tax is carved-out. That is, Australia's rules are consistent with option 2.

[1] ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions, PCG 2017/D4.

### 3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible;
- *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way;
- *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible;
- *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible; and
- *Sustainability* – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

Efficiency, fairness and sustainability are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these three criteria.

### 3.3 What other options have been ruled out of scope, or not considered, and why?

No options were ruled out of scope.

## Section 4: Impact Analysis

| | Option 1 (interest rate cap) | Option 2 (restricted transfer pricing) | Option 3 (EBITDA-based rule) | Option 4 (administrative guidance) | Status quo |
|---|---|---|---|---|---|
| **Efficiency and neutrality** | + <br>Option 1 will provide a strong limit on related-party interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains.<br>However, for some firms the interest rate allowed under the cap may be too low, which lowers the efficiency benefits. | ++ <br>Option 2 will provide a reasonably strong limit on related-party debt interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains. | **0** <br>Option 3 will provide an effective limit on all interest expenses (including related-party interest expenses).<br>However, it also increases the uncertainty of returns on New Zealand investment, since whether or not interest is deductible turns on a taxpayer's EBITDA, which can be very variable. | + <br>Some taxpayers would benefit from the certainty provided by the administrative safe harbour.<br>However, for taxpayers willing to exceed the safe harbour, this option is no different than the status quo – excessive interest rates on related-party debt would still be possible. | **0** |
| **Fairness and equity** | ++ <br>Option 1 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts. | ++ <br>Option 2 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts. | **0** <br>On the one hand, option 3 would be somewhat effective at preventing excessive interest rates. On the other hand, it could result in interest denial for firms with very conservative interest rates and debt positions (say, for example, if a taxpayer is in loss). | **0** <br>Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. For taxpayers willing to exceed the administrative safe, harbour this option is no different to the status quo. | **0** |
| **Efficiency of compliance** | ++ <br>Option 1 would reduce compliance costs for many taxpayers – the allowable interest rate on related-party debt would be set on a clear objective factor (the credit rating of the foreign parent).<br>However, in some cases – where the non-resident parent has no credit rating – compliance costs will stay the same or could potentially increase. | + <br>Option 2 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour.<br>Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo) | **0** <br>Compliance costs in some instances would reduce under option 3, as there would be fewer transfer pricing disputes about related-party debt.<br>However, an EBITDA-based rule would be a fundamental shift in our interest limitation rules – taxpayers and agents would have to come to grips with an entirely new regime. | + <br>Option 4 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour.<br>Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo). | **0** |

| | | | | | |
|---|---|---|---|---|---|
| **Efficiency of administration** | ++<br><br>Option 1 would avoid the need for potentially complex and expensive disputes over whether the interest rate on related-party debt is set appropriate. | ++<br><br>Option 2 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. For the remaining taxpayers, the restrictions (e.g. striking out exotic terms) would simplify the transfer pricing analysis. | +<br><br>Option 3 would reduce administration costs because there would be less need to review and challenge related-party loans under transfer pricing. | +<br><br>Option 4 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. | **0** |
| **Sustainability** | +<br><br>Option 1 would apply to taxpayers that have structured their affairs to strip the maximum profits out of New Zealand; however, it could also affect the interest rates of less aggressive taxpayers. | ++<br><br>Option 2 should generally only affect taxpayers with more aggressive debt structures. | **0**<br><br>Option 3 could result in interest deduction denial even if a taxpayer has conservative debt levels. | +<br><br>Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. | **0** |
| **Overall assessment** | + | ++ **Recommended option** | **0** | + | **0** |

**Key:**

++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

### Allowable debt levels

| | Option 1 (non-debt liability adjustment) | Option 2 (adjustment with no deferred tax) | Status quo |
|---|---|---|---|
| **Efficiency and neutrality** | + <br><br> Option 1 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. <br> However, submitters have argued that in some instances deferred tax (a type of non-debt liability) does not represent real liabilities; to the extent this is correct, reducing allowable debt levels in relation to these liabilities could hamper efficiency. | + <br><br> Option 2 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. <br> However, this option carves out all types of deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option would allow some taxpayers to have too high a debt level. | **0** |
| **Fairness and equity** | + <br><br> Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. <br> However, submitters have argued that in some instances deferred tax does not represent a real liability. To the extent this is correct, including deferred tax in the non-debt liability adjustment could be seen as unfair. | + <br><br> Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. <br> However, this option excludes all deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option will not treat taxpayers in the same situation the same. | **0** |
| **Efficiency of compliance** | **0** <br><br> Neither option will have a significant impact on compliance costs. The result of both options is just a change to how the existing thin capitalisation calculations are carried out. <br> However, there may be some one-off compliance costs if the changes mean taxpayers breach their thin capitalisation limits and, as a result, decide to restructure their borrowing. | | **0** |
| **Efficiency of administration** | **0** <br><br> Neither option has a significant impact on administrative costs. Thin capitalisation calculations are carried out by taxpayers – this change has no substantive impact on Inland Revenue. | | **0** |
| **Sustainability** | + <br><br> Both options similarly target firms with debt levels that are too high relative to their levels of equity and are therefore well targeted. Firms with low levels of debt, or with reasonable levels of debt relative to equity, will be largely unaffected by either option. | | **0** |
| **Overall assessment** | + | + | **0** |

**Key:** ++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

# Section 5: Conclusions

### 5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

**Interest limitation**

We consider that option 2 – developing a restricted transfer pricing approach – is the best option to limit interest expenses in relation to inbound related-party debt.

Following consultation and further analysis, we consider that if the Government pursued the interest rate cap (option 1), adjustments would be needed to the original discussion document proposal which would make it more complex. For example, to address some of the concerns expressed by submitters, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

The difficulty is, however, that simply relying on transfer pricing, as suggested by some submitters, will not achieve the desired policy outcomes. It is clear that the international consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. In addition, as noted in section 2.5, commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

Accordingly, we consider that the restricted transfer pricing rule is the best approach. Like the interest rate cap, it will ensure the policy objective – ensuring there is a robust mechanism for determining the interest rates for inbound related-party debt; however, since the restricted transfer pricing rule has more flexibility (compared to the interest rate cap – the other option that would most effectively achieve the policy objective) it is both more efficient and fairer.

Owing to the time available (and since it was developed subsequent to the initial consultation), this option has not been subject to consultation with stakeholders. This modification will address many, but not all of, submitters' concerns – it is still a departure from using ordinary transfer pricing. Nevertheless, we expect that it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur frequently because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

**Allowable debt levels**

At this stage, we do not have a preference between option 1 (non-debt liability adjustment as originally proposed) and option 2 (non-debt liability adjustment with deferred tax carve-out). Option 3 (status quo) is not preferred.

Both options 1 and 2 have similar impacts in terms of efficiency and fairness (and have no significant impacts in terms of compliance and administration costs). The non-debt liability adjustment in option 1 is potentially too extensive because of the inclusion of *all* types of deferred tax, but, on the other hand, the adjustment in option 2 is too narrow because of the exclusion of all deferred tax.

We consider that the best approach is to recommend neither options 1 or 2 at this stage, but instead consult further with stakeholders on whether there is another feasible option (since this is a minor technical detail, more consultation on this matter is feasible). For example, it might be possible to identify deferred tax liabilities that are the least likely to result in a future tax payment, and restrict the carve-out of deferred tax to just that identified group.

## 5.2 Summary table of costs and benefits of the preferred approach

### Related-party interest rates

| **Affected parties** *(identify)* | **Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks* | **Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts* | **Evidence certainty** *(High, medium or low)* |
|---|---|---|---|
| **Additional costs of proposed approach, compared to taking no action** | | | |
| Regulated parties | Tax payable: It will result in additional tax paid. | Approximately $40m per year | Medium |
| Regulators | Administration costs: There will be a one-off cost to Inland Revenue in developing guidance on how the new rules will operate. | Low | High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Cost** | Tax payable | Approximately $40m per year | Medium |
| **Non-monetised costs** | Administration costs | Low | High |
| **Expected benefits of proposed approach, compared to taking no action** | | | |
| Regulated parties | Compliance costs: Reduction in compliance costs for firms that utilise safe harbour. | Medium | High |
| Regulators | Revenue: Tax collected will increase.<br><br>Administration costs: Reduction in costs for ensuring related-party interest rates are appropriate. | Approximately $40m per year<br><br>Medium | Medium<br><br>High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Benefit** | Revenue | Approximately $40m per year | Medium |
| **Non-monetised benefits** | Compliance and administration cost reduction | Medium | High |

**Allowable debt levels**

*While a preferred option is not recommended, the costs and benefits of any option that is selected will be similar*

| **Affected parties** *(identify)* | **Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks* | **Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts* | **Evidence certainty** *(High, medium or low)* |
|---|---|---|---|
| **Additional costs of proposed approach, compared to taking no action** | | | |
| Regulated parties | Tax payable: It will result in additional tax paid. | Approximately $40–50m per year (depending on option) | High |
| Regulators | | | |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Cost** | Tax payable | Approximately $40–50m per year | High |
| **Non-monetised costs** | | | |
| **Expected benefits of proposed approach, compared to taking no action** | | | |
| Regulated parties | | | |
| Regulators | Revenue: Tax collected will increase. | Approximately $40–50m per year (depending on option) | High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Benefit** | Revenue | Approximately $40–50m per year | High |
| **Non-monetised benefits** | | | |

### 5.3 What other impacts is this approach likely to have?

As discussed above, allowing BEPS through interest deductions is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take use interest deductions to reduce their New Zealand (and possibly worldwide) tax liability is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders. It is something that is fundamental to the tax system itself, which all of the stakeholders already discussed have an interest in preserving.

### 5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes.

## Section 6: Implementation and operation

### 6.1 How will the new arrangements work in practice?

Implementation of both reforms (relating to related-party interest rates and allowable debt level) will be given effect through a combination of legislation and Inland Revenue administrative guidance. The legislative changes proposed will be progressed (subject to Cabinet approval) as part of a BEPS taxation bill to be introduced in late 2017. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin*.

In relation to the allowable debt level proposal, we will consult further with stakeholders on whether a preferred option can be identified. The Minister of Finance and Minister of Revenue will make the final decision on which option should be progressed (option 1, option 2, or a potential new option) following this consultation.

These reforms are expected to apply from income years beginning on or after 1 July 2018, subject to legislation progressing to enactment before this date.

Some submitters on the discussion document argued that transitional relief or grandparenting should be provided to give taxpayers sufficient lead-in time to restructure their affairs if necessary. We consider that the planned application date of 1 July 2018 is sufficiently prospective because:

- the interest rate proposal applies only to related-party transactions (which are more easily altered compared to transactions with third-parties); and
- in relation to the allowable debt level proposal, debt and asset levels under the thin capitalisation rules can be measured as at the end of the relevant income year, meaning taxpayers would have until at least 30 June 2019 to rearrange their affairs.

In addition, in response to consultation, we propose that advanced pricing agreements

(APAs) existing prior to the application date of these changes will be grandparented.

Once the proposals are implemented, Inland Revenue will be responsible for the ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

### 6.2 What are the implementation risks?

There is the risk that the relevant transfer pricing legislation could contain unintended errors or have unintended consequences. However, this risk can be efficiently managed by way of remedial amendments.

## Section 7: Monitoring, evaluation and review

### 7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. Inland Revenue closely monitors the tax affairs of New Zealand's largest companies (which are, in general, the affected population of these proposals). For example, Inland Revenue currently collects data from these firms on their debt levels (including levels of related-party debt) through its International Questionnaire. This will allow how the proposals have impacted debt levels and related-party interest payments to be analysed.

More generally, Inland Revenue is considering the appropriate level of information that should be collected to support the proposed rules for all the BEPS measures being implemented. Any additional information may be collected via a disclosure statement that must be provided to Inland Revenue or it may be collected using existing information gathering tools.

### 7.2 When and how will the new arrangements be reviewed?

The final step in the GTTP involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, following enactment, any changes identified as necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

## BEPS – transfer pricing and permanent establishment avoidance

### Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to prevent permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue investigate uncooperative multinationals. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

### Executive summary

2. Some large multinationals are currently using tax arrangements which allow them to report low taxable profits in New Zealand despite carrying on significant economic activity here.

3. In March this year, the Government released a discussion document called *BEPS – Transfer pricing and permanent establishment avoidance* to consult on proposals to combat these arrangements. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

4. Submissions and workshops with the private sector were used to refine the proposals and better target them at the BEPS activities we are concerned about, whilst reducing the compliance costs and other unintended impacts on taxpayers engaging in ordinary, commercial dealings.

5. We recommend that nearly all of the proposals in the discussion document proceed, subject to some changes following consultation. The most significant changes made to the original proposals as a result of consultation were:

- The proposed permanent establishment (PE) avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

- Clarification of the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

- The proposal to require disputed tax to be paid earlier should not proceed. This is because we consider it to be unnecessary in light of the current "use of money" interest rate regime.

6. These changes are likely to be welcomed by submitters and do not reduce the overall effectiveness of the proposed reforms.

7. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

8. The forecast tax revenue from implementing the transfer pricing and PE avoidance measures is $25m in 2018/19 and $50m per annum from 2019/20. Some of this revenue has already been included in the Budget 2017 forecasts.

## Background

9. In February this year, Cabinet agreed to release the Government discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (CAB-17-MIN-0041 refers).

10. The discussion document, which was released in March 2017, consulted on proposals to combat aggressive tax strategies which allow some multinationals to report low taxable profits in New Zealand despite carrying on significant economic activity here. These strategies involve:

- ***Tax structuring***: In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (a permanent establishment or "PE") in New Zealand. However, non-residents can structure their affairs to avoid such a taxable presence, 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.

11. The OECD and the G20 are also concerned about these kinds of BEPS strategies, and have recommended measures to address them in their 15 point BEPS Action Plan. These include:

- a widened definition of "permanent establishment" for double tax agreements (DTAs), to counter PE avoidance (however this will only be included in a DTA if both countries agree); and

- updated transfer pricing guidelines, to counter profit shifting.

## Comment

12. We have developed a package of proposed tax law changes to combat transfer pricing and PE avoidance. The main elements of the proposed reform package are:

- The introduction of a new PE avoidance rule that will prevent multinationals from structuring their operations to avoid having a PE in New Zealand where one exists in substance.

- Stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income.

- Stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities. We also propose shifting the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length, and extending the time bar (the period of time which Inland Revenue has to reassess a taxpayer) from four years to seven years for transfer pricing.

- A range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues). These are similar to some of the administrative powers provided under the UK and Australia's Diverted Profit Taxes but New Zealand's administrative measures are more targeted at the practical barriers faced by tax investigators as they will only apply when a multinational does not cooperate with a tax investigation.

13. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment to address issues that Inland Revenue has identified when investigating multinationals.

## Private sector consultation

14. 15 submitters provided written submissions on the discussion document. The Treasury and Inland Revenue also met with six of these submitters to discuss their submissions.

### *General reaction*

15. Overall, most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more certain and better targeted.

16. Two of the 15 submitters welcomed the proposals as a positive step by the Government to ensure that all large multinationals are paying their fair share of tax.

17. The other 13 submitters were tax advisors or represent multinationals that could be negatively affected by the proposals. Their submissions were critical of some of the measures.

18. Some submitters argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. As noted in the accompanying covering Cabinet Paper (*Tax measures to prevent base erosion and profit shifting*), there will be additional tax and compliance costs for some investors but these additional costs will mostly be borne by taxpayers engaging in BEPS activities and the overall benefits to New Zealand of addressing BEPS outweigh these costs.

19. As expected, most of the submitters opposed the administrative proposals to increase Inland Revenue's powers to investigate multinationals. However, we consider these new powers are necessary to ensure Inland Revenue can effectively enforce the new rules. These new powers include:

- Expanding Inland Revenue's ability to request information that is held by a related group member offshore. Submitters considered this proposal could unfairly penalise a New Zealand entity that may not be able to get the information from their multinational group members. However, we consider it is unacceptable for Inland Revenue's investigations to be frustrated because a multinational group fails to provide information that is under its control.

- Shifting the burden of proof for transfer pricing onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length. Submitters considered Inland Revenue had information regarding comparable transactions and should bear the burden of proof. However, shifting the burden of proof is consistent with the fact that the taxpayer holds the relevant information on their own transfer pricing practices. The burden of proof is already on the taxpayer for other tax matters and is also on the taxpayer for transfer pricing matters in most other OECD and G20 countries, including Australia. Because most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries, the additional compliance costs from this change are not expected to be substantial.

- Extending the time bar (the period of time which Inland Revenue has to adjust a taxpayer's transfer pricing position) from four years to seven years for transfer pricing. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. 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).

***Changes made as a result of consultation***

20. In response to submissions, we have updated the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

21. Many submissions focused on when the PE avoidance rule would apply. Submitters considered the proposal outlined in the discussion document applied too broadly and could have unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

22. We consider the PE avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

23. Submitters also pointed out that the OECD has updated their model DTA to address PE avoidance and New Zealand is currently in the process of adopting this into some of our tax treaties by signing the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* and through negotiating new tax treaties. We agree that the domestic law PE avoidance rule will only be necessary when the relevant tax treaty does not yet include the OECD's new recommendation and propose narrowing the application of rule accordingly.

24. The PE avoidance rule would apply notwithstanding the relevant DTAs (that don't yet include the OECD's new model PE rule). We consider that this is acceptable for two reasons:

- The OECD's commentary to their model DTA contemplates that countries can adopt anti-avoidance rules and states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. An existing example of this is New Zealand's General Anti-Avoidance Rule which explicitly overrides our DTAs to allow New Zealand to combat tax avoidance arrangements. The PE avoidance rule would be a specific anti-avoidance rule, which would also be consistent with the principle in the OECD's commentary.

- The UK and Australia have already implemented similar PE avoidance rules in their domestic laws which override their DTAs and their treaty partners have not challenged this.

25. Another major point raised by submitters was the need to clarify the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

26. Other significant changes made as a result of consultation were:

- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.

- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money" interest rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay tax that is in dispute.

27. The above changes will make the rules more certain and better targeted and are likely to be welcomed by submitters.

28. We also recommend widening the scope of the original proposal to deem an amount of income to have a New Zealand source under our domestic legislation if we have a right to tax the income under a DTA. The rule proposed in the discussion document was limited to income covered by the PE and royalty articles of our DTAs. We should extend the rule to all types of income that we can tax under a DTA – as Australia does. This ensures we can exercise a taxing right that we have negotiated under a DTA. We will consult further on this wider proposal in the next round of consultation.

29. These recommended changes will not affect the originally forecast revenue from implementing the transfer pricing and PE avoidance measures, which is $25m in 2018/19 and $50m per annum from 2019/20 (some of this revenue has already been included in the Budget 2017 forecasts).

30. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

**Agency consultation**

31. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

**Financial implications, human rights, administrative impacts, legislative implications, publicity**

32. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

## Impact Analysis Requirements

33. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

34. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

## Recommendations

35. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing the overall effectiveness of the proposed reforms.

3. **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure their businesses to avoid having a PE (taxable presence) in New Zealand.

4. **Agree** to expand and strengthen the rules for taxing New Zealand-sourced income by:

   - deeming certain amounts of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA;

   - introducing an anti-avoidance source rule which 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; and

   - addressing a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand, including where the income is not subject to New Zealand tax by operation of a DTA.

5. **Agree** to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. This involves amending New Zealand's transfer pricing rules so that:

   - they disregard legal form if it does not align with the actual economic substance of the transaction;

   - they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;

   - the legislation specifically refers to arm's length conditions;

- they refer to the latest OECD transfer pricing guidelines as guidance for how the rules are applied;

- the new legislation codifies the requirement for large multinationals to provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative;

- the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased to seven years (in line with Australia);

- the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters); and

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

6. **Agree** to strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation by amending the Tax Administration Act 1994 to allow Inland Revenue to:

- more readily assess the multinational's tax position based on the information available to Inland Revenue at the time;

- collect any tax owed by a member of a large multinational group from any wholly-owned group member, provided the non-resident fails to pay the tax itself;

- use section 17 of the Tax Administration Act 1994 to request information that is held offshore by another group member of the large multinational group;

- use section 21 of the Tax Administration Act 1994 to deem an amount of income to be allocated to a New Zealand group member or PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand sourced income (currently the existing power only applies in respect of deductible payments); and

- impose a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty).

7. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

8. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

9. **Agree** that the results of the decisions in recommendations 3-6 and 8 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

**Hon Steven Joyce**
Minister of Finance

**Hon Judith Collins**
Minister of Revenue

# Coversheet: BEPS – transfer pricing and permanent establishment avoidance rules

| | |
|---|---|
| Advising agencies | *The Treasury and Inland Revenue* |
| Decision sought | *This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet* |
| Proposing Ministers | *Steven Joyce (Finance) and Hon Judith Collins (Revenue)* |

## Summary: Problem and Proposed Approach

| **Problem Definition**<br><br>**What problem or opportunity does this proposal seek to address? Why is Government intervention required?** |
|---|
| 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 (PE) avoidance. Finally, Inland Revenue faces administrative difficulties in investigating large multinationals. |

| **Proposed Approach**<br><br>**How will Government intervention work to bring about the desired change? How is this the best option?** |
|---|
| The proposed approach is to adopt the package of measures outlined in the Government discussion document *BEPS – transfer pricing and permanent establishment avoidance (March 2017)*, with some changes resulting from consultation, as the measures will:<br><br>• ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;<br>• stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and<br>• make it easier for Inland Revenue to investigate such multinationals. |

## Section B: Summary Impacts: Benefits and costs

| **Who are the main expected beneficiaries and what is the nature of the expected benefit?** |
| --- |
| The Government will benefit by receiving an additional $50 million of revenue per annum. Compliant businesses will benefit because the multinationals involved in transfer pricing and PE avoidance activities will no longer be able to achieve a competitive advantage. Also, the measures will support voluntary compliance by protecting the integrity of the tax system. |

| **Where do the costs fall?** |
| --- |
| Multinationals which currently engage in BEPS activities will face a medium level of compliance costs. These taxpayers may choose to transition into more tax compliant agreements which will require restructuring costs; or they may apply for advance pricing agreements (APAs). However, the majority of multinationals are compliant and should not be materially affected by the proposals. |

| **What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?** |
| --- |
| There is a risk that foreign companies investing in New Zealand will view the proposals as complex and onerous, incentivising them to remove their existing personnel from New Zealand or to cease operating in New Zealand altogether. However, most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether. |

| **Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.** |
| --- |
| There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'. |

## Section C: Evidence certainty and quality assurance

| **Agency rating of evidence certainty?** |
| --- |
| There is limited certainty of evidence in relation to the problem of transfer pricing and PE avoidance arrangements. This is because such activities are often not directly observable in the absence of specific audit activity. However, Inland Revenue is aware of about 16 cases involved in these types of BEPS arrangements which are currently under audit. While there are only 20 New Zealand-owned multinationals that earn over the threshold for some of the main proposals (over EUR €750 million of consolidated global revenue), the European Union (EU) has estimated that there may be up to 6,000 multinationals globally |

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|---|
| that do. However, we do not know how many of these global multinationals operate in New Zealand. |

*To be completed by quality assurers:*

| Quality Assurance Reviewing Agency: |
|---|
| Inland Revenue |
| Quality Assurance Assessment: |
| The Quality Assurance reviewer at Inland Revenue has reviewed *the BEPS – transfer pricing and permanent establishment avoidance rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria. |
| Reviewer Comments and Recommendations: |
| The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version. |

# Impact Statement: BEPS – transfer pricing and permanent establishment avoidance rules

## Section 1: General information

| Purpose |
| --- |
| *Inland Revenue* is solely responsible for the analysis and advice set out in this Regulatory Impact Statement. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet. |

**Key Limitations or Constraints on Analysis**

**Evidence of the problem**

Our analysis has been limited somewhat by our inability to assess the exact size of the transfer pricing and PE avoidance structures in New Zealand. In common with BEPS activities generally, transfer pricing and PE avoidance is difficult to quantify as tax avoidance is often not directly observable. We consider that, while most multinationals are compliant, there is a minority that engage in transfer pricing and PE avoidance. Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not addressed. Furthermore, as New Zealand endorses the Organisation for Economic Co-operation and Development's (OECD) *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan), there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

**Range of options considered**

Our analysis of options has been primarily constrained by New Zealand's double tax agreements (DTAs). Under its DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

**Assumptions underpinning impact analysis**

The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of transfer pricing and PE avoidance arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs, and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

| Responsible Manager (signature and date): |
|---|
| Carmel Peters<br>Carmel Peters<br>Policy Manager, Policy and Strategy<br>Inland Revenue<br><br>13 July 2017 |

# Section 2: Problem definition and objectives

## 2.1 What is the context within which action is proposed?

**BEPS**

BEPS refers to the aggressive tax planning strategies used by some multinationals to pay little or no tax anywhere in the world. This outcome is achieved when multinationals exploit gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In 2013, the OECD published its BEPS Action Plan which identified actions needed to address BEPS (including transfer pricing and PE avoidance), set deadlines to implement these actions, and identified the resources needed and the methodology to implement these actions. In 2015, the OECD released its final package of recommended actions for countries to implement to counter BEPS.

If no action is taken to counter transfer pricing and PE avoidance arrangements, multinationals that are currently engaging in these types of arrangements will be able to continue, and the number of these types of avoidance cases will continue to increase.

**New Zealand's BEPS work**

New Zealand is a supporter of the OECD/G20 BEPS project to address international avoidance and is advancing a number of the OECD/G20 BEPS recommendations.

In September 2016, the Government released the BEPS discussion document *Addressing hybrid mismatch arrangements*. In March 2017, the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*; along with the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*.

The *BEPS – Transfer pricing and permanent establishment avoidance* discussion document consulted on the Government's proposal to introduce a new set of tax rules to counter BEPS activities involving transfer pricing and PE avoidance. Many of the proposals follow the OECD's BEPS Action Plan recommendations (such as updating our transfer pricing legislation to align with the OECD's new transfer pricing guidelines).

## 2.2 What regulatory system, or systems, are already in place?

**New Zealand's tax system**

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework ensures the tax system is not generally used to deliver incentives or encourage particular behaviours.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge is to ensure that our tax rules are up to date and result in multinational firms paying a fair and efficient amount of tax in New Zealand. Base protection measures, such as transfer pricing and PE rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

**New Zealand's PE rules**

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

In general, New Zealand can 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.

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

**New Zealand's transfer pricing rules**

"Transfer pricing" refers to the use of cross-border payments between associated entities such as a parent and a subsidiary. Transfer pricing rules are therefore concerned with determining the conditions, including the price (and therefore the tax liability), for transactions within a multinational group resulting in the allocation of profits to group companies in different jurisdictions.

New Zealand's transfer pricing legislation was first introduced in 1995 and is largely focused on the legal form of the transaction and adjusting the consideration that is paid to an arm's length amount (which can be zero). Due to the increased complexity and tax planning of cross-border intra-group trade over the last 22 years, New Zealand's existing transfer pricing rules are unable to adequately address some types of profit shifting.

**General anti-avoidance rule (GAAR)**

New Zealand also has a general anti-avoidance rule (GAAR) which effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. However, the GAAR is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own.

## 2.3 What is the policy problem or opportunity?

**The problem of transfer pricing and PE avoidance**

Some multinational companies operating in New Zealand exploit deficiencies in the current international tax system (both in New Zealand and abroad) by using transfer pricing and PE avoidance strategies to report low taxable profits in New Zealand despite carrying out significant economic activity here. Transfer pricing and PE avoidance 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.

***Transfer pricing avoidance***

One of the major strategies used by multinationals to shift profits out of New Zealand and reduce their worldwide tax bills is transfer pricing. 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.

***PE avoidance***

Some multinationals reduce their New Zealand tax liability by structuring their affairs to avoid a PE arising, despite carrying on significant activity here.

**Impacted population**

These rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Many of the proposed measures will apply only to multinational groups with over EUR €750 million of consolidated global revenue. While there are only 20 New Zealand-owned multinationals that earn this much, the EU has estimated that there may be up to 6,000 multinationals globally that do. However, we do not know how many of these global multinationals operate in New Zealand.

**Transfer pricing and PE arrangements in New Zealand**

Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not strengthened. Furthermore, as New Zealand endorses the OECD's BEPS Action Plan, there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Inland Revenue's judgement is that the transfer pricing and PE proposals can expect to add $50 million a year of revenue to the forecasts. This $50 million per year estimate relates to the fact that the proposals will make it more difficult to avoid tax under the transfer pricing and PE rules and easier to find and assess any remaining avoidance cases. This should reduce future avoidance arrangements and free up investigator resources. The changes will also result in more revenue being able to be assessed from any multinationals which continue to use transfer pricing or PE avoidance arrangements.

## 2.4 Are there any constraints on the scope for decision making?

Our analysis of options has been primarily constrained by New Zealand's DTAs. Under our DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. The OECD guidance permits departure from this only in respect of tax avoidance. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

## 2.5 What do stakeholders think?

**Submissions on the discussion document**

The Government received 16 submissions on the discussion document from key stakeholders.[1] We also met with six of the main submitters to discuss their submissions in more detail.

Many submitters strongly opposed the proposals that increased Inland Revenue's power to investigate large multinationals. Others argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented.

However, most submitters accepted the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. Some submitters even welcomed the proposals as a positive step by the Government to ensure multinationals pay their fair share of tax.

**Further consultation**

Following Cabinet decisions in July 2017, we are planning to undertake further public

[1] Most of the submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

consultation on outstanding policy issues, technical design details, and an exposure draft of selected parts of the planned BEPS bill.

# Section 3: Options identification

### 3.1 What options are available to address the problem?

Officials have identified four mutually exclusive options to address the problem:

- Option 1 – Status quo
- Option 2 – MLI and the OECD's transfer pricing guidelines
- Option 3 – Diverted profit tax
- Option 4 – Discussion document proposals (as amended through consultation)

Option 1 is the only non-regulatory option. The other options involve implementing an international agreement or changing New Zealand tax legislation.

**Option 1: Status quo**

This option would retain the existing tax rules for multinationals (as described in the sections above). Under this option, Inland Revenue would continue trying to enforce the existing rules and/or apply the GAAR to challenge tax avoidance arrangements.

**Option 2: MLI and the OECD's transfer pricing guidelines**

Option 2 is to rely on the combination of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI)[2] and the OECD's transfer pricing guidelines without amending our domestic law. Under this option, any PE avoidance issues would be addressed under the OECD's new PE definition in the MLI, and any transfer pricing issues would be addressed by applying the OECD's new transfer pricing guidelines.

**Option 3: Diverted profits tax**

Option 3 is to adopt a diverted profits tax (DPT). A DPT is a separate tax on the "diverted profits" that arise from transfer pricing and PE avoidance. It is levied at a penal rate, compared with income tax, and has greatly enhanced assessment and collection powers. Both the UK and Australia have already implemented a DPT to target multinationals engaging in BEPS strategies. DPTs are intended to incentivise taxpayers to pay the correct amount of income tax under the normal rules rather than to raise revenue by themselves.

**Option 4: Discussion document proposals (as amended through consultation)**

This option involves adopting the package of measures proposed in the discussion document, with some changes resulting from consultation. The discussion document proposals have taken certain features of a DPT and combined 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 transfer pricing and PE avoidance in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. Under this option, we would introduce:

- an anti-avoidance rule that will prevent multinationals from structuring their operations

[2] The MLI allows countries to quickly and efficiently implement a number of the OECD's BEPS Action Plan measures that can only be implemented through changes to DTAs, without having to bilaterally renegotiate their existing DTAs.

to avoid having a PE (a taxable presence) in New Zealand where one exists in substance;

- stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities; shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length; and extend the time bar for transfer pricing from four years to seven years;
- stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income; and
- a range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation (such as allowing Inland Revenue to request information that is held by an offshore group member).

**Consultation**

These four options were identified prior to consultation. The discussion document proposed the adoption of a package of reforms combining elements of a DPT with the OECD's recommendations and some domestic law amendments (option 4). The discussion document discussed the status quo (option 1) and the DPT (option 3). Some submitters proposed that the better approach would be to sign the MLI and apply the OECD's transfer pricing guidelines without amending our domestic law (option 2).

In response to consultation we have refined the proposals so they are better targeted at BEPS arrangements with less compliance costs and fewer unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

Significant changes made as a result of consultation were:

- More narrowly targeting the PE avoidance rule at avoidance arrangements (we will consult further on how best to achieve this).
- Clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.
- The PE avoidance rule will only apply where an applicable DTA does not include the OECD's widened PE definition (as in cases where the OECD's new PE definition is included, the proposed PE avoidance rule will be unnecessary).
- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money interest" rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay any tax which has been assessed.

The above changes are likely to be welcomed by submitters.

**Evidence from Australia's reforms**

Australia's recent experience updating their transfer pricing laws (in 2013) and introducing a new Multinational Anti-Avoidance Law (MAAL) demonstrates the effectiveness of tax reforms to address PE avoidance and transfer pricing issues.

Australia's MAAL came into effect on 11 December 2015 and prevents multinationals from structuring their affairs to avoid having a PE in Australia. It is very similar to our proposed PE avoidance rule.

As of 4 June 2017, the Australian Tax Office (ATO) had identified 221 taxpayers they believed to be shifting profits to a non-resident group member resident in a low-tax jurisdiction. Of these 221 taxpayers, the ATO has cleared 102. Furthermore, since the MAAL was introduced, 18 companies with PE avoidance structures have restructured their affairs to bring their sales onshore – and a further 11 are currently working with the ATO to restructure.

According to the ATO, as a result of the introduction of the MAAL, an additional AUS$6.4 billion worth of assessable income will now be reported in Australia. This translates into $100 million a year in additional tax revenue for Australia.

### 3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible;
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible;
- Neutrality – the tax system should bias economic decisions as little as possible;
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way; and
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality, and fairness impacts without some increase in compliance costs and so there are some trade-offs that were, and continue to be, considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

### 3.3 What other options have been ruled out of scope, or not considered, and why?

Two options were ruled out of scope due to their radical nature, namely:

- cancel New Zealand's DTAs; and
- prevent multinationals from selling products in New Zealand if they were suspected of involvement in BEPS activities.

The former would harm New Zealand exporters and outbound investors. The latter would not only harm New Zealand consumers (as they would no longer be able to import certain goods), but it would also violate New Zealand's trade agreements.

## Section 4: Impact Analysis

| | Option 1: Status quo | Option 2: MLI and the OECD's transfer pricing guidelines | Option 3: Diverted profit tax | Option 4: Discussion document proposals (as amended through consultation) |
|---|---|---|---|---|
| **Efficiency of compliance** | 0 | -<br>Option 2 imposes increased compliance costs on taxpayers as a result of applying the MLI and the new transfer pricing guidelines. | - -<br>Option 3 imposes ongoing compliance costs on taxpayers as it requires them to provide information or concede transfer pricing outcomes in transfer pricing audits. | -<br>Option 4 imposes increased compliance costs on taxpayers as they will be required to conform to the additional administrative measures. See below for further details. |
| **Efficiency of administration** | 0 | 0<br>We do not expect there will be increased administrative costs under this option as the reforms largely change the way some taxpayers self-assess the income and deductions they report to Inland Revenue. | -<br>We expect there will be increased administrative costs under this option as a DPT is a separate tax from an income tax. | 0<br>We do not expect there will be increased administrative costs under this option. The proposed administrative measures should also make it easier for Inland Revenue to investigate uncooperative multinationals. See below for further details. |
| **Neutrality** | 0 | +<br>Option 2 will remove some of the tax benefit of currently observed transfer pricing and PE avoidance opportunities in New Zealand. See below for further details. | +<br>Option 3 will remove the tax benefit of currently observed transfer pricing and PE avoidance opportunities involving New Zealand. However, it may have a negative impact on investment certainty for taxpayers. | + +<br>Option 4 will remove the tax benefit of all currently observed transfer pricing and PE avoidance opportunities involving New Zealand. See below for further details. |
| **Fairness and equity** | 0 | +<br>Option 2 has some fairness benefits as it ensures that some taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details. | 0<br>Option 3 has some fairness benefits as it ensures that taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details. | +<br>Option 4 has the most fairness benefits as it ensures that all taxpayers able to use observed transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. |
| **Sustainability** | 0 | +<br>Option 2 will remove some, but not all, of the current transfer pricing and PE establishment opportunities involving New Zealand. | +<br>Option 3 will remove current transfer pricing and PE establishment opportunities involving New Zealand. See below for further details. | + +<br>Option 4 will remove current transfer pricing and PE establishment opportunities involving New Zealand and is well-targeted at the problems that have been observed by Inland Revenue in New Zealand. |
| **Overall assessment** | Not recommended | Not recommended | Not recommended | Recommended |

**Key:**

++ much better than doing nothing/the status quo
\+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
\- worse than doing nothing/the status quo
\- - much worse than doing nothing/the status quo

***Option 2 (MLI and the OECD's transfer pricing guidelines)***

- **Neutrality:** The effect of this option will be limited as the MLI will not cover many of our DTAs and New Zealand's current transfer pricing legislation does not allow us to apply some of the new transfer pricing guidelines.
- **Fairness and equity:** While option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements.

***Option 3 (Diverted profits tax)***

- **Fairness and equity:** While option 2 has some fairness benefits, it also has some significant fairness detriments owing to its penal tax rate, reduced taxpayer rights, and wide scope. Further, a DPT could also impact on the perception of the fairness of New Zealand's tax system for multinationals investing into New Zealand.
- **Sustainability:** Compared to the other options it would provide less certainty for, and impose more compliance costs on, taxpayers.

***Option 4 (Discussion document proposals (as amended through consultation))***

- **Efficiency of compliance:** It is also highly likely that a number of taxpayers will choose to restructure their affairs and/or apply APAs.
- **Efficiency of administration:** The proposals may place a higher demand on Inland Revenue's transfer pricing team and more transfer pricing specialists may be required to deal with this.
- **Neutrality:** This option will ensure multinationals engaged in BEPS activities are not tax-advantaged over more compliant domestic and non-resident businesses. This will provide some efficiency gains.

# Section 5: Conclusions

**5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?**

We consider that option 4 (discussion document proposals (as amended through consultation)) is the best option to combat transfer pricing and PE avoidance.

Option 4 will improve the neutrality of New Zealand's tax system by eliminating the ability for multinationals to engage in aggressive transfer pricing and PE avoidance schemes to receive tax benefits. Option 4 will:

- ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;
- stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and
- make it easier for Inland Revenue to investigate such multinationals.

Option 4 will also improve the equity and fairness of New Zealand's tax system. Multinationals engaging in BEPS activities are currently able to structure their affairs to receive unintended tax benefits placing them at a competitive advantage over more compliant multinationals or domestic companies. As a result, these more compliant multinationals and domestic companies end up suffering a greater tax burden. Option 4 will therefore ensure that the tax burden is shared more equally among taxpayers.

While option 4 will impose additional tax and compliance costs on some taxpayers, it is important to note that some of the measures will only apply to large multinational groups with over EUR €750 million of consolidated group turnover. Submitters on the discussion document argued that the imposition of higher tax payments may make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, as a number of like-minded countries throughout the OECD are undertaking similar BEPS measures, we believe that any impacts on foreign direct investment into New Zealand will not be material and that implementing the proposals in option 4 remains in New Zealand's best economic interests (see further discussion in section 5.3 below).

Option 1 (status quo) was preferred by a number of submitters to the discussion document. However, retaining the current rules would mean that those multinationals engaging in aggressive transfer pricing and PE avoidance structures would be able to continue, and the number of these types of avoidance cases would continue to increase. While New Zealand has a GAAR (see above in section 2.2), it is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own. This is because applying the GAAR often leads to resource-intensive court cases and it may be difficult to show that certain avoidance structures fail the Parliamentary contemplation component of the GAAR.

Option 2 (MLI and the OECD's transfer pricing guidelines) was the option suggested by many submitters. However, we consider that adopting the OECD's recommendations on their own (without corresponding domestic amendments) would not effectively address the issue of transfer pricing and PE avoidance. First, New Zealand's existing transfer pricing legislation does not contemplate an ability to apply some important aspects of the new OECD's transfer pricing guidelines. This means that Inland Revenue would only be able to apply the guidelines to the extent that our current domestic rules allow. Domestic law changes would likely be needed to adequately address the issue. Second, while option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements. This is because the MLI will only apply where both countries choose to adopt it – and many of New Zealand's trading partners do not intend to adopt it. It is therefore important that New Zealand adopt its own PE avoidance measure to supplement the MLI, otherwise there would still be a gap for multinationals to exploit. Third, the OECD's BEPS measures do not address issues specific to New Zealand, such as issues with our current source rules and the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes).

Option 3 (diverted profits tax) is not recommended. This option would provide less certainty for, and impose significant compliance costs on, taxpayers. This is because a DPT is a separate tax at a much higher rate than the standard company tax rate and includes stringent enforcement mechanisms. This means an investor may find themselves being charged a much higher rate of tax (plus interest and penalties) that can be difficult to challenge or credit against prior year losses or taxes charged by other countries. This increased risk and uncertainty may reduce their willingness to invest in New Zealand (compared to more certain investments elsewhere).

## 5.2 Summary table of costs and benefits of the preferred approach

| **Affected parties** *(identify)* | **Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks* | **Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts* | **Evidence certainty** *(High, medium or low)* |
|---|---|---|---|
| **Additional costs of proposed approach, compared to taking no action** | | | |
| Regulated parties | Compliance costs: increased costs understanding the rules and applying them to transactions and structures for multinationals which currently engage in BEPS activities. Such taxpayers may choose to restructure which will involve compliance costs and the demand for APAs may increase. | Medium. However, they should only affect multinationals currently engaged in BEPS activities. | Medium |
| | Revenue | **$50 million per year** | Low* |

| | | | |
|---|---|---|---|
| Regulators | Administrative costs: Inland Revenue staff, particularly investigators and transfer pricing specialists, need to develop their knowledge of the proposals. | Low | High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Cost** | Revenue | **$50 million per year** | Low* |
| **Non-monetised costs** | Compliance costs<br><br>Administrative costs | Medium<br><br>Low | Medium<br><br>High |

| **Expected benefits of proposed approach, compared to taking no action** | | | |
|---|---|---|---|
| Regulated parties | | | |
| Regulators | Tax payable: we are confident of collecting a significant amount of revenue from the proposals.<br><br>Reduced administrative costs: More powers to both request multinationals' offshore information and to investigate uncooperative multinationals should make investigating these types of BEPS arrangements easier. | **$50 million per year**<br><br>Low | Low*<br><br>High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Benefit** | Revenue | **$50 million per year** | Low* |
| **Non-monetised benefits** | Reduced administrative costs<br><br>Improved voluntary compliance by supporting the integrity of the tax system in a high profile area. | Low<br><br>Low | Low<br><br>Low |

*Note that the evidence for the $50 million figure is a conservative estimate made in light of the behavioural uncertainty associated with introducing transfer pricing and PE avoidance rules together with the fact that the full extent of these types of avoidance arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be significantly higher, but this cannot be estimated with confidence.

## 5.3 What other impacts is this approach likely to have?

During consultation on the discussion document, some submitters raised concerns that adopting the proposed measures would have a detrimental impact on New Zealand being an attractive investment destination. In particular, these submitters were concerned that the proposed measures introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, thereby reducing GDP and lowering employment levels.

The higher tax payments and compliance obligations resulting from these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, at the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded countries throughout the OECD. Given this, we believe any impacts on foreign direct investment into New Zealand will not be material and implementing these measures remains in New Zealand's best economic interests. It is also highly unlikely that foreign companies will remove their existing personnel from New Zealand as a result of these proposals. Most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

## 5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 4 (to adopt the package of measures in the discussion document) conforms to Government's 'Expectations for the design of regulatory systems'.

# Section 6: Implementation and operation

## 6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin* (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018.

One exception is a grandparenting rule that exempts from application of the rules all advance pricing agreements (APAs) existing prior to the application date.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider the planned application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

## 6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we plan on meeting with taxpayers and preparing detailed guidance materials.

# Section 7: Monitoring, evaluation and review

### 7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation, and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

When the MAAL was introduced in Australia, 18 companies restructured their affairs to bring their sales onshore (and a further 11 are currently working with the ATO to restructure). We envisage a similar response to our proposals whereby a number of taxpayers will restructure their affairs to report their sales in New Zealand. We also expect more taxpayers to apply for APAs as a result of the new transfer pricing rules. However, it will be difficult to assess the true impact of the transfer pricing proposals.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

### 7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is significantly unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

# BEPS – addressing hybrid mismatch arrangements

## Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to address the problem of hybrid mismatch arrangements. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

## Executive summary

2. Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

3. The OECD, as part of its base erosion and profit shifting (BEPS) Action Plan, published in late 2015 its final report on hybrid mismatch arrangements. This report recommended that countries enact a comprehensive set of rules to neutralise the benefit of hybrid mismatch arrangements affecting their tax base.

4. The UK has legislated the OECD recommendations into their domestic law and Australia is committed to do the same. The EU has also issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

5. The OECD recommendations will not apply to the vast majority of taxpayers. They will not apply to purely domestic firms. They apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of the OECD recommendations is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

6. The Government released a discussion document in September 2016 called *Addressing Hybrid Mismatch Arrangements* which proposed that the OECD recommendations be adopted in New Zealand and asked for feedback on how that should best be done. Since receiving submissions to this document, officials have engaged stakeholders in targeted consultation on specific design issues relating to the proposal. Consultation has resulted in some of the proposals being modified, such as a proposed exclusion from the rules for New Zealand businesses that operate offshore only through a simple branch structure. Nevertheless, many taxpayers affected by these proposals will still oppose them. Some would prefer to see a targeted approach, which would only tackle hybrids that have already been observed in New Zealand.

7. However, in order to send the clear message that using hybrid mismatch arrangements should not produce a tax advantage, we are recommending that Cabinet agree to a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New Zealand context. To do otherwise may simply encourage the ongoing use of hybrids not covered by any targeted proposal. Other issues raised through the consultation process, and which are likely to attract the most comment (such as the application of the rules to foreign trusts) are set out in paragraphs 24-38 of this paper.

8. We are further recommending that hybrids rules be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

## Background

### *BEPS*

9. New Zealand's BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan,. Its final package of reports was released in October 2015. The Action Plan is a multifaceted approach intending to encourage countries to close many (but not all) of the avenues multinational companies currently use to reduce their worldwide tax liability, and to improve the information available to governments when they deal with multinational companies, without changing the fundamental principles for the taxation of international trade and investment.

10. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

### *Hybrid mismatch arrangements*

11. Hybrid mismatch arrangements are a significant base erosion and profit shifting (BEPS) strategy used by some multinational companies to pay little or no tax anywhere in the world on some or all of their income. They are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation.

12. One way in which this double non-taxation can arise is through a payment being deductible for a payer in one country but not included as taxable income for the payee in the other country. Another way double non-taxation can arise is by way of a single payment being deducted against different income streams in two countries.

13. Double non-taxation of this kind is difficult to deal with, because it can be achieved even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues. It is often difficult to determine which of the countries involved has lost tax revenue through the use of a hybrid mismatch arrangement, but there is undoubtedly a reduction of worldwide tax paid.

*The OECD's response*

14. The OECD has made a number of recommendations as to how countries can improve their domestic rules to prevent mismatches arising and neutralise their effect when they do arise. These recommendations relate to Action 2 of the OECD/G20 BEPS Action Plan: Neutralising the Effects of Hybrid Mismatch Arrangements.

15. The OECD recommends two kinds of rules. The first are rules specifically designed to reduce the likelihood of hybrid mismatches arising. The second are "linking rules", which apply to payments that give rise to a deduction in more than one country, or which give rise to a deduction in one country but are not taxed as income in another country due to a hybrid mismatch. These generally only apply to:

- arrangements between related parties (25% or more commonly owned) or control groups (50% or more commonly owned); or
- structured arrangements - generally, arrangements between non-associated parties which intentionally exploit such mismatches.

16. These linking rules are divided into "primary" and "secondary" responses. Primary responses have precedence, with secondary responses being used if the country that has the primary right does not have hybrid rules. This primary/secondary structure is important for ensuring that all hybrids with a connection to New Zealand are effectively countered irrespective of where the counterparty is based.

17. The OECD has also developed an additional BEPS Action 2 report that makes a number of recommendations as to how countries can deal with the problem of branch mismatch arrangements which is closely related to the hybrid mismatches issue.

*Other countries*

18. The UK has introduced into its domestic law rules that reflect a broad adoption of the OECD recommendations. Australia has proposed to do the same and, as part of its 2017 Budget, committed to introduce rules that are effective by 1 January 2018 or six months following Royal assent.[1] The EU has issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules by 1 January 2020. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

*Hybrids discussion document*

19. On 6 September 2016, the Government released a discussion document entitled "Addressing hybrid mismatch arrangements" seeking feedback on proposals to address hybrid mismatch arrangements in line with the OECD recommendations [CAB-16-MIN-0442].

20. 20 submissions were received on the discussion document. Most submitters accepted the need for some hybrid rules, with some submitters expressing support for New Zealand to take action in line with the OECD hybrids package, subject to various provisos, including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. The majority of submissions argued that we should only implement rules to counter hybrid mismatches actually observed in New Zealand, rather than the full suite of OECD recommendations.

[1] As set out in paragraph 59, Australia has indicated that it is unlikely to implement OECD recommendation 5 at this stage, but may do so in the future if integrity concerns arise.

**Comment**

***Implementing the full OECD hybrids package***

21. As set out in the cover Cabinet paper (*Tax measures to counter base erosion and profit shifting*), we are recommending that Cabinet agree to a comprehensive implementation of the OECD's proposed solutions to the hybrid and branch mismatch problem, , even though there was limited evidence of some of the structures being used in New Zealand. We are of the view that the OECD proposals are in New Zealand's best interests, as enacting these recommendations will improve fairness, reduce harmful distortions in investment patterns, increase tax revenue, and will also address the risk of taxpayers using new hybrid mismatch opportunities if only the more common techniques are addressed initially.

22. In making this recommendation, we recognise that these proposals involve considerable complexity, which will not generally be welcomed by those taxpayers affected. However, we are comfortable that there are a number of factors that outweigh these concerns:

- We are proposing to modify the OECD recommendations when it is appropriate to do so for the New Zealand context. Examples are ensuring New Zealand companies with simple foreign branch structures are not caught by the rules (see "application of hybrids rules to foreign branches" below), not applying the rules to purely domestic firms, and not introducing rules when an adequate New Zealand provision already exists.

- We are recommending that officials continue to consult on a few particular issues that have the potential to ease the compliance costs of the proposals before we make a final decision on them under Cabinet delegated authority. These consist of elective options which would in effect allow existing hybrids to be treated as simple equity investments.

- Despite the necessary complexity, the underlying principle is clear – using hybrid mismatches as a tax-efficient means of inbound, outbound or conduit investment is not appropriate.

- We are recommending that relevant parties be consulted on exposure drafts of key aspects of the legislation. This is intended to facilitate workable legislation that is understandable to those applying it.

- In almost all cases, the complexity will be optional. Taxpayers can avoid having to deal with these rules by undertaking simple debt or equity funding.

23. Some of the other more significant issues relating to this proposal are set out below. Those are followed by a brief explanation of each of the OECD recommendations and the principles behind them. The appendix contains a series of detailed aspects of the proposals that we are also seeking Cabinet's agreement to. These details have been consulted on with interested parties, and are consistent with the general recommendations set out below.

**Significant issues**

*Foreign trusts*

24. As set out in the cover Cabinet paper, we are recommending that foreign trusts be included within the scope of these rules in circumstances where their treatment outside of New Zealand means income of the trust is not included in a tax calculation anywhere in the world. This is not because they are foreign trusts, but because in those circumstances they are "reverse hybrids" according to the OECD recommendations (see the discussion on OECD Recommendation 5.2, below). The same rule would equally impose tax on New Zealand limited partnerships that fit within the reverse hybrids definition.

25. We are aware that foreign trusts have recently had a new set of disclosure rules apply to them following the 2016 Government Inquiry into Foreign Trust Disclosure Rules. In this respect, adding another regulatory regime to the industry now is unfortunate timing. To reflect the fact that these trusts have recently undergone significant compliance costs, and to give the foreign trust and limited partnership industries more time to understand the implications of the proposed rules, we are recommending a delayed effective date for New Zealand reverse hybrids of 1 April 2019.

*Application of hybrid rules to foreign branches*

26. The way in which the OECD recommendations are written would in some circumstances deny a New Zealand company the ability to offset a loss from its foreign branch against its New Zealand income. This is an issue that some submitters have been very concerned about.

27. We have made various modifications to the OECD recommendations to address this issue, including clarifying that taxpayers who have simple offshore branch structures do not present a hybrid mismatch problem and so are not covered by the rules.

*Imported mismatches*

28. OECD recommendation 8 suggests countries include an "imported mismatch" rule when implementing hybrid and branch mismatch rules. Imported mismatch rules apply when the New Zealand resident is not directly involved in the hybrid mismatch, but the benefit of a mismatch is "imported". Some submitters on the discussion document viewed this particular recommendation as over-reach, highly complex and impractical.

29. To address these concerns, we recommend that the introduction of the imported mismatch rule be different for "structured" and "unstructured" arrangements. Structured arrangements are deliberately entered into to obtain a tax advantage, so should be implemented at the same time as the rest of the hybrid rules. By contrast, unstructured arrangements are ones where the New Zealand benefit is not the primary reason for entering into the arrangement. We recommend that the unstructured rule has a delayed implementation date of 1 January 2020. By this date, we expect that the EU countries, the UK, and Australia will all have hybrid rules. Delaying the implementation of the unstructured rule until those countries have similar rules will reduce the costs involved in complying with the rule in New Zealand because, by that time, multinationals that are also operating in those countries should already be complying with their equivalent rules, and also because payments

to those countries will not be subject to the imported mismatch rule at all. More details regarding the imported mismatch rule are contained later in this paper.

*Over-taxation by reason of the imposition of NRWT*

30. The OECD recommends that countries apply the hybrid rules without regard to any withholding tax collected on the relevant payments. In situations where New Zealand imposes non-resident withholding tax (NRWT) on an interest payment that is also denied a deduction under the hybrid rules, there may be over-taxation.

31. As far as our officials are aware, Australia is not planning on departing from the OECD approach. An argument for this approach is that in the majority of cases taxpayers can simply switch to simpler structures and arrangements and be subject to only single taxation. The OECD approach is also less complicated. Nevertheless, there has been an argument from some submitters that the hybrid rules should be modified in New Zealand so as to remove this potential over-taxation for taxpayers that choose to remain in hybrid structures.

32. We recommend that in the case of a hybrid financial instrument, there needs to be further consideration of the possibility of letting taxpayers treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We recommend that Cabinet delegate the authority to determine the appropriateness of such an approach to us to decide after receiving further advice. For hybrid arrangements other than financial instruments, we are less concerned about the imposition of NRWT. Although there may be some over-taxation, in many cases this will simply be a timing issue.

*Grandparenting for certain instruments issued by banks to the public*

33. We recommend that there be an exception to the rules for certain hybrid instruments ("hybrid regulatory capital") issued by banks and insurance companies either directly or indirectly to third party investors, in partial satisfaction of the capital requirements imposed on those companies by regulators (such as the Reserve Bank and its Australian equivalent, APRA). We recommend that such instruments issued before the date of the discussion document release (6 September 2016) should not be subject to the hybrid rules until the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

34. This grandparenting date is different to the date proposed in Australia, which is 8 May 2017 (the day before their Federal Budget). We consider differing from Australia is justified in this case. The Australian Government had made public the fact that it was considering how such instruments should be taxed, and did not make an announcement until its 2017 Budget. In New Zealand the hybrids discussion document released on 6 September stated that such instruments would be subject to the hybrid rules. To grandparent instruments issued after the New Zealand discussion document may be seen as encouraging taxpayers to enter into aggressive structures after the government has stated an intention to change the rules but before that change is enacted. We are wary of creating an expectation that such arrangements will be grandparented.

*Opaque election for foreign hybrid entities*

35. The private sector has proposed that a New Zealand investor in a foreign hybrid entity be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand to remove the hybridity and put that entity outside the scope of the rules. Our initial view is that

excluding simple branch structures from the rules, and the ability of hybrid participants to restructure their arrangements, may make such an election redundant. Nevertheless, we have asked officials to continue their consideration of how such an election may work in practice, including whether the costs of administering it for what may be a relatively small group are justified. We recommend that Cabinet delegate to us the authority to decide on the appropriateness of an opaque election.

*Application of rules to branch mismatch arrangements*

36. Consultation on branch mismatches has taken place but has not been as comprehensive as that for the remainder of the hybrid proposals. In part this is because such mismatches are less significant for New Zealand, and in part because the OECD draft report on branches was released at around the same time as the New Zealand discussion document, and the proposal was therefore less well developed. Nevertheless, we recommend that New Zealand implement rules that are consistent with the OECD recommendations on branch mismatches (this is also consistent with the approach that has been taken by the UK and which we understand will be taken by Australia). Branch mismatches arising from foreign branch losses are a double non-taxation risk and to leave them out of these proposals would expose the tax base to future risk. The remainder of the branch mismatch concerns addressed are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

*De minimis rule*

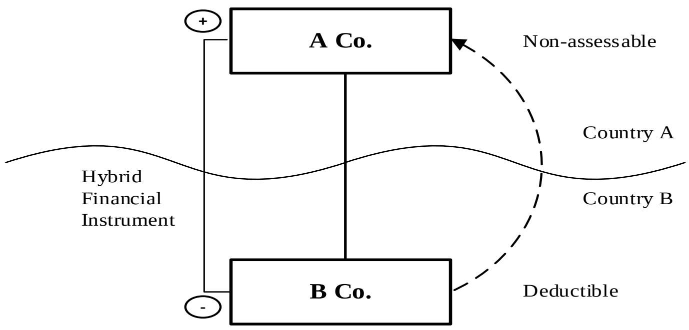
37. We recommend that there be no general de minimis for the hybrid rules. We believe that a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules. This means that any de minimis would likely be ineffective in practice because the other country would still counter the hybrid mismatch using their secondary response right. Also, our proposals will ensure that simple branch structures (the most likely beneficiaries of a de minimis) are not within the scope of the rules.

38. We do however recommend that there should be specific de minimis rules for reverse hybrid entities established in New Zealand (see paragraphs 55-57).

## OECD recommendations

### *Hybrid financial instrument rules (Recommendations 1 and 2)*

39. The following diagram illustrates a typical hybrid financial instrument issued between related parties A Co and B Co.



40. Double non-taxation arises in this situation because the payment on the hybrid financial instrument is deductible (as interest) in Country B but not taxable (because it is treated as an exempt dividend) in Country A.

41. OECD recommendation 2 is a specific recommendation that countries should amend their domestic law so that dividend payments that are deductible to the payer (B Co) should be treated as ordinary income for the payee (A Co).

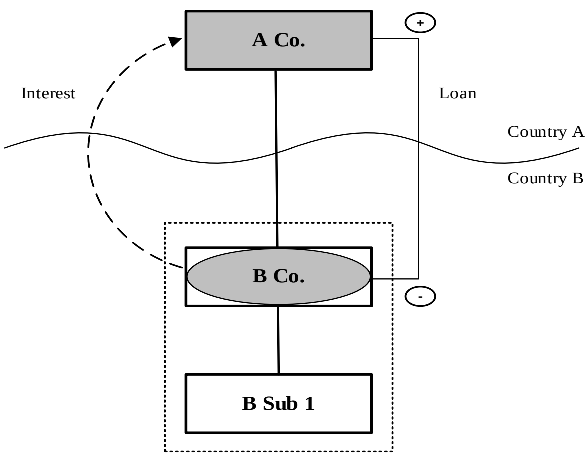
42. New Zealand already has a rule that switches off the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. We recommend that this rule be expanded to also apply if the foreign payer receives tax benefits similar in nature to a deduction.

43. We also recommend introducing rules in line with the general principles of OECD recommendation 1. This means that, in relation to hybrid financial instruments that are structured or between related parties, we should deny a New Zealand payer a deduction for the payment (when New Zealand is Country B) to the extent it is not taxed to a non-resident payee. It is in respect of this aspect of recommendation 1 that we are considering the election to treat interest payments as dividends. In addition, when New Zealand is Country A and Country B does not have hybrid rules, we should tax the New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit.

44. We also recommend that when there is a timing mismatch that allows a deduction to be claimed in one country in a period that is significantly earlier than the period in which income is included in the other country, the rules above should also apply.

***Disregarded hybrid payments rule (Recommendation 3)***

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




46. The interest payment by B Co is deductible in the hybrid entity country (Country B) but disregarded in the investor country (Country A) because Country A sees B Co as being part of A Co and therefore not capable of making a payment to itself. However, as the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can

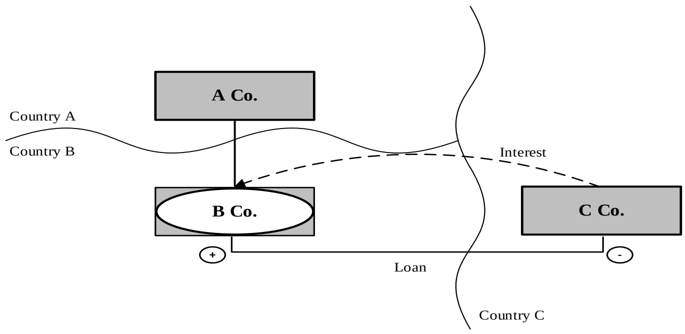
therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

47. We recommend introducing rules in line with the general principles of OECD recommendation 3 in order to prevent double non-taxation arising from a payment by a hybrid entity. We recommend that, when New Zealand is Country B and payments are deductible here but are disregarded for tax purposes in Country A (and the payments are part of a structured arrangement or made to a person in the same control group), we should deny a deduction for the payment. Similarly, if New Zealand is Country A and the non-resident payer in Country B has not been denied a deduction for the payment under similar rules, we should tax the receipt by the New Zealand payee as ordinary income.

48. We recommend that deductions denied and income included by the above rules should be reversible to the extent that the hybrid entity has earned "dual inclusion income", being income taxed in both Country A and Country B. This is because this dual inclusion income is included as income in both countries so the corresponding deduction should also be allowed in both countries. The dual inclusion income can be earned in the same period as the payment is made, in an earlier period, or in a later period.

***Reverse hybrid rules (Recommendations 4 and 5)***

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




50. If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co.

51. We recommend introducing rules in line with the general principles of OECD recommendation 4 to prevent double non-taxation arising from a payment to a reverse hybrid. We recommend that, when New Zealand is Country C, the New Zealand payer be denied a deduction for a payment to a reverse hybrid if the payment would have been taxed if paid directly to the investor (A Co). This rule would only apply when the payer, payee and investor are all in a control group or the payment is part of a structured arrangement.

52. OECD recommendation 5.1 is that countries should change their domestic law so that they tax residents on income not taxed in another country due to its being earned by a reverse hybrid. In other words, when New Zealand is Country A, we should tax A Co on the income of B Co if Country B does not tax it (because it treats B Co as transparent for tax purposes).

53. We recommend that New Zealand should have rules that are in line with the general principles of recommendation 5.1 and other international tax principles. New Zealand already has controlled foreign companies (CFC) rules that in most cases would prevent a reverse hybrid entity mismatch outcome from occurring when a New Zealand resident is the investor (A Co). We recommend that Cabinet delegate authority to us to determine whether our current CFC rules should be enhanced to deal with any forms of reverse hybrid income not currently dealt with, in line with the general principles of recommendation 5.1.

54. OECD recommendation 5.2 is that countries should change their domestic law so that they tax income which is earned by a reverse hybrid entity established in their country. So, when New Zealand is Country B, we recommend introducing rules in line with the general principles of this recommendation. As set out in the cover Cabinet paper and in paragraphs 24-25, this will require amendments to existing law regarding New Zealand limited partnerships and foreign trusts, which can be reverse hybrid entities depending on the tax treatment in the investor country.

55. In regards to limited partnerships, we recommend taxing the partnership income of a non-resident partner if they are in a control group with the partnership and not taxed on their share of the partnership income because their jurisdiction views the income as earned by the partnership as a separate taxpayer from the partner. This rule will only apply if the limited partnership has total foreign-sourced income of greater than $10,000 or 20% of its total income. This de minimis rule, and the corresponding one for foreign trusts in the following paragraphs, is consistent with the recently-enacted de minimis rule for foreign sourced income of look-through companies.

56. In regards to foreign trusts, we recommend taxing the foreign-source trustee income of the trust, provided that the non-resident settlor and trust are all in a control group. Many family trusts would meet this requirement. Foreign source trustee income will only be taxed if the non-resident settlor is not taxed on the trustee income in their residence country simply because the income is earned by the New Zealand trustee rather than the settlor directly. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income.

57. We also recommend taxing the foreign-source beneficiary income of a non-resident beneficiary of a foreign trust if they are not taxed on the income in their residence country because that country views the income as earned by the trustee and not the beneficiary. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income, and the non-resident beneficiary is part of a control group with the trust/trustee. In relation to both beneficiary and trustee income, tax would only be imposed if there was no-one else in the same control group required to include that income in their taxable income.

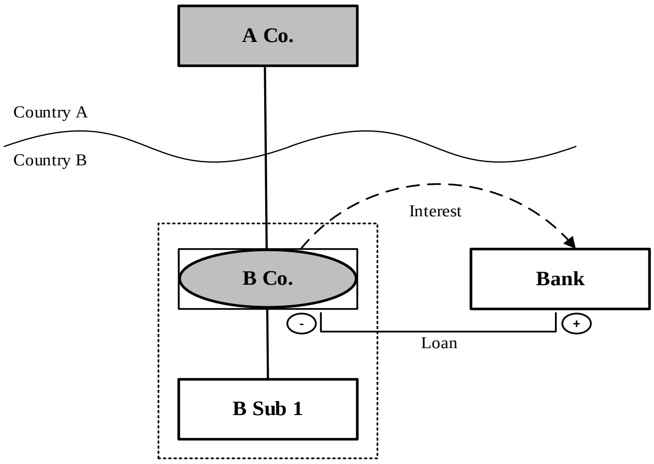
58. OECD recommendation 5.3 is that countries should consider improvements to record keeping and disclosure rules for tax transparent entities established in their country. Following the 2016 Government Inquiry into Foreign Trust Disclosure Rules, the disclosure rules for foreign trusts have been enhanced. New Zealand is regularly reviewed by the OECD to ensure that we are meeting international standards in this area. The Government will

continue to work with the OECD and make improvements to disclosure rules as necessary to ensure compliance with best practice.

59. We note that Australia has indicated that it is unlikely to implement any of recommendation 5 at this point – this is largely because they see their existing rules as adequate. However, they have reserved the right to do so in the future if integrity concerns arise. We are not as confident that our existing rules in relation to reverse hybrids are adequate to prevent mismatches from occurring. As set out above, we are concerned that leaving 'gaps' in our rules exposes our tax base to risks that can be mitigated by following all of the OECD's recommendations.

***Hybrid entities – double deductions (Recommendation 6)***

60. In addition to being capable of generating a deductible/non-inclusion hybrid mismatch, a hybrid entity can also be used to generate a double deduction mismatch. A diagram illustrating this possibility follows, where B Co is the hybrid entity.




61. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment can offset income earned by B Sub 1, which is in a tax consolidated group with B Co. This is a double non-taxation outcome because a single payment has been deducted against different income in two countries.

62. In Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand [CAB-17-MIN-0164]. This means that, when New Zealand is Country A, the deductions in B Co would not flow back to New Zealand if it is possible for that deduction to also offset Country B income that does not flow back to A Co (in this case, the income of B Sub 1).

63. Nothing in this paper is inconsistent with that specific decision. However, as mentioned in paragraph 26-27, we are recommending a slightly narrowed approach to the OECD recommendation 6, whereby simple structures involving a New Zealand company with only an offshore branch would not fall within the scope of the rules.

64. We also recommend implementing a rule that would, when New Zealand is Country B, disallow the losses of a foreign-owned New Zealand hybrid entity or branch when the country of the owner (Country A) has not denied the loss.

65. As with the recommendation 3 rule, denial of a deduction under the recommendation 6 rule should be reversed to the extent that the hybrid entity has dual inclusion income, whether in the current period, an earlier period, or a later period.

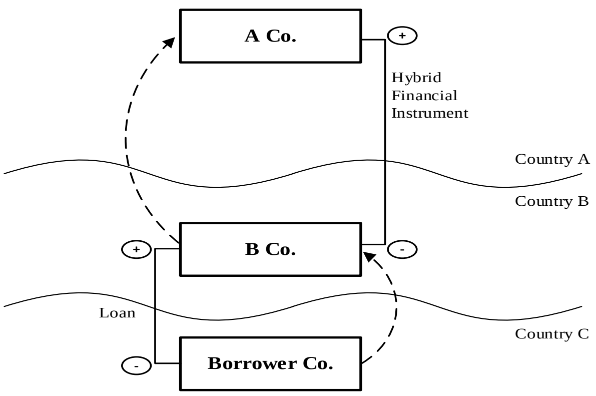
### *Dual resident entities (Recommendation 7)*

66. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. Expenditure incurred by a company that is a resident of two different countries can potentially be used in each country to offset non-dual inclusion income, which is income taxed only in that country. This would achieve the same double deduction outcomes that hybrid entities can produce under recommendation 6 (above).

67. New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

### *Imported mismatches (Recommendation 8)*

68. As set out in paragraphs 28-29, we recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment that funds another payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.




69. In this example, New Zealand is Country C. The loan between A Co and B Co generates a deduction in Country B, with no corresponding income inclusion in Country A. This is a double non-taxation outcome. However, this tax mismatch is not counteracted because neither Country A nor Country B has hybrid rules. The tax benefit of the A/B mismatch helps fund the seemingly benign arrangement between B Co and the New Zealand entity (Borrower Co).

70. The imported mismatch rule would require New Zealand, as Country C, to deny a deduction for interest payments from Borrower Co to B Co to the extend they do not exceed the payments under the hybrid financial instrument between B Co and A Co. This is an integrity measure that prevents New Zealand's other hybrid rules from being circumvented.

Without this rule, businesses in Country A can simply avoid our proposed rules by going from A to C via B.

71. We recommend that the imported mismatch rule applies to both structured arrangements that are designed to produce an imported mismatch outcome, and unstructured arrangements within a control group. However, because unstructured arrangements may not be deliberately contemplated, we are recommending a delayed implementation for those arrangements until more countries, the EU countries in particular, have hybrids rules in place.

**Agency consultation**

72. The consultation on this project has been explained in the cover Cabinet paper. Briefly, there have been two rounds of consultation: one on the proposals in the discussion document; and a further round with selected submitters on branch mismatches and some of the detailed aspects set out in this paper.

**Financial implications**

73. The proposed hybrid rule denying double deductions for foreign hybrid entities is estimated to increase tax revenue by $50 million per year from the 2019-20 year onwards. These amounts are already included in the forecasts as per Budget 2017 (CAB-17-MIN-0164).

74. In addition, the proposed approach to grandparenting certain hybrid instruments as discussed at paragraphs 33-34 is expected to generate a total of $71 million over four years which is not currently included in the forecasts. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

75. The combined revenue impact of all proposals is estimated as:

| $ million – increase / (decrease) | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Vote Revenue** | **2016 /17** | **2017 /18** | **2018 /19** | **2019 /20** | **2020 /21** | **2021 /22** | **2022/23 and out years** |
| Foreign hybrid entity double deductions (already included in forecast) | 0 | 0 | 25 | 50 | 50 | 50 | 50 |
| Hybrid instruments – grandparenting (new adjustment to forecasts) | 0 | 0 | 19 | 19 | 19 | 14 | 0 |
| **Total revenue effect** | **0** | **0** | **44** | **69** | **69** | **64** | **50** |

**Human rights, administrative impacts, legislative implications, publicity**

76. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

## Impact Analysis Requirements

77. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

78. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

## Recommendations

79. We recommend that Cabinet:

1. **Agree** that for payments under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:

    a. to deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (OECD recommendation 1 primary rule); and
    b. if a non-resident payer has not been denied a deduction for the payment under similar rules, to tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (OECD recommendation 1 defensive rule).

2. **Agree** to expand New Zealand's current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (OECD recommendation 2).

3. **Agree** that for payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognised under the tax law in the payee country because the payment is disregarded under that law:

    a. to deny a deduction for the payment if made by a New Zealand payer (OECD recommendation 3 primary rule);
    b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, to include the payment in ordinary income of the New Zealand resident (OECD recommendation 3 defensive rule);
    c. to allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against income that is included as income in both relevant countries ("dual inclusion income").

4. **Agree** to deny a New Zealand payer a deduction in relation to payments made to a reverse hybrid entity in the same control group as the payer or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid entity (OECD recommendation 4).

5. **Agree** that New Zealand should tax the income of a reverse hybrid established in New Zealand (such as a foreign trust or a limited partnership) to the extent that:

   a. the reverse hybrid income is not subject to tax in another jurisdiction (OECD recommendation 5.2); and
   b. the total foreign sourced income of the reverse hybrid exceeds the greater of $10,000 or 20% of the total income of the reverse hybrid.

6. **Agree** to the following in relation to double deduction outcomes produced by branches and hybrid entity structures:

   a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branch if there is another entity in that foreign country whose income is capable of being offset against the losses of the hybrid entity or branch and that income is not taxable in New Zealand (modified OECD recommendation 6 primary);
   b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (OECD recommendation 6 defensive); and
   c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

7. **Agree** to deny a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income (OECD recommendation 7).

8. **Agree** to deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, except to the extent that the payment is made to a country that has hybrid mismatch rules (OECD recommendation 8).

9. **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.

10. **Agree** that the effective date of the rule relating to unstructured imported mismatches (part of recommendation 8 above) should be delayed until 1 January 2020.

11. **Agree** that the application of the rule relating to New Zealand reverse hybrids (recommendation 5 above) should be for income years beginning on or after 1 April 2019.

12. **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:

    a. issued to satisfy the regulatory capital requirements imposed by New Zealand or Australian law;
    b. directly to, or are traceable to, issues to the public; and
    c. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

13. **Note** that the fiscal consequences of agreeing to recommendation 12 above is set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

14. **Agree** to the detailed design proposals set out in the appendix to this paper.

15. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on further detail of these proposals, or to amend the detail in the appendix, provided any such decisions are not contradictory with the principles set out in recommendations 1 to 12, without further reference to Cabinet.

16. **Agree** to delegate authority to the Minister of Finance and the Minister of Revenue to make final policy decisions on the following policy issues without further reference to Cabinet:

    a. whether New Zealand's controlled foreign company (CFC) rules should be modified to include as attributable foreign income all income of a reverse hybrid entity which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is treated as fiscally transparent in that country (OECD recommendation 5.1);
    b. whether New Zealand can and should include a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes; and
    c. whether, the payer under a hybrid financial arrangement for which a deduction is denied, should be allowed to treat the payment as a dividend for purposes of both (but not only one of) the non-resident withholding tax and the imputation credit rules.

17. **Agree** that the results of the decisions in recommendations 1-16 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

**Hon Steven Joyce**
Minister of Finance

**Hon Judith Collins**
Minister of Revenue

## Appendix

### List of detailed design decisions

| | **OECD Recommendations 1 and 2** |
|---|---|
| 1. | A person who receives a payment which is deductible to the payer in another country will not be entitled to the benefit of any imputation credit attached to the payment. |
| 2. | When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency, the deduction denied will take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes, and any net income from the instrument including any foreign currency fluctuations will be non-taxable. |
| 3. | When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the taxpayer will not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method. |
| 4. | To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee entity under another country's controlled foreign company (CFC) regime, the payer will be allowed a deduction for the payment. |
| 5. | If a person holds a FIF interest as part of a share repo arrangement, that person will be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest. |
| 6. | If a person holds New Zealand shares as part of a share repo arrangement, where the borrower is a non-resident, the person is not entitled to the benefit of an imputation credit attached to any dividends on the shares. |
| 7. | OECD recommendation 1 will only apply to timing mismatches if:<br>• the mismatch arises on an instrument with a term of 3 years or more or on an instrument that has been extended to beyond 3 years; and<br>• the lender is not accounting for the payment, for tax purposes, on a reasonable accrual basis; and<br>• it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months |

| | |
|---|---|
| | of the end of the period in which the expenditure is incurred. |
| 8. | Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted. |
| 9. | Interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules. |
| 10. | There will be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016). |

| | |
|---|---|
| | **OECD Recommendation 3** |
| 11. | Any foreign currency fluctuations recognised for tax purposes in relation to a financial arrangement denominated in a foreign currency will be taken into account when denying a deduction to a New Zealand payer. |
| 12. | Dual inclusion income will be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it will not include income which is protected from New Zealand tax by a foreign tax credit. |
| 13. | For the purposes of denying a deduction for a New Zealand payer, full taxation of income under a CFC regime will prevent income being treated as not taxable to a payee and will qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit. |
| 14. | When an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that will be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible. |
| 15. | The ability to claim a deduction in relation to a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company’s ownership since the time the relevant deduction was incurred or deemed expenditure arose. |
| 16. | Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted. |

| | |
|---|---|
| 17. | Denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules. |
| 18. | A deduction would be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs. |
| 19. | Where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income will be reversed in a later year when there is dual inclusion income earned through the hybrid entity. |

| | **OECD Recommendation 4** |
|---|---|
| 20. | Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4. |
| 21. | Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses. |
| 22. | To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed. |
| 23. | Non-resident withholding tax will continue to be applied to payments, despite the denial of the deduction |
| 24. | Interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules. |

| | **OECD Recommendation 5.2** |
|---|---|
| 25. | Tax the partnership income of a non-resident partner of a New Zealand limited partnership if the non-resident partner is in a control group with the partnership and the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not by the partner. |
| 26. | Tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that:<br>• the beneficiary is in the same control group as the trustee; and<br>• the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and<br>• the income is not subject to tax as the income of any person other than |

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| | the trustee (such as the beneficiary or settlor). |
| 27. | Tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that:<br>• the settlor is in the same control group as the trustee;<br>• the settlor would be taxed on the trustee income if it held the trust assets directly; and<br>• the income is not subject to tax as the income of any person other than the trustee. |
| 28. | Include a de minimis so that none of the above recommendation 5.2 rules apply if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust. |

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| | **OECD Recommendation 6** |
| 29. | There will be a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity. |
| 30. | A deduction will be allowed in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country |
| 31. | Income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit. |
| 32. | Double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch will be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income. |
| 33. | The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose. |
| 34. | Amendments will be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are |

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| | deducted. |
| 35. | Denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules. |

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| | **OECD Recommendation 7** |
| 36. | Amend existing consolidation and loss grouping rules for dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid. |
| 37. | Double deduction amounts and dual inclusion income amounts will be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income. |
| 38. | The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred. |
| 39. | Denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules. |

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| | **OECD Recommendation 8** |
| 40. | When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied will ignore any foreign currency fluctuations on the instrument. |
| 41. | Interest that is denied a deduction under recommendation 8 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules |

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| | **General design and definitional matters** |
| 42. | A coordination rule will be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules. |
| 43. | A specific anti-avoidance rule will be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules. |

# Coversheet: BEPS - Hybrid mismatch arrangements

| | |
|---|---|
| Advising agencies | *Inland Revenue, The Treasury* |
| Decision sought | *This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.* |
| Proposing Ministers | *Steven Joyce (Finance) and Hon Judith Collins (Revenue)* |

## Summary: Problem and Proposed Approach

**Problem Definition**

**What problem or opportunity does this proposal seek to address? Why is Government intervention required?**

The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

**Proposed Approach**

**How will Government intervention work to bring about the desired change? How is this the best option?**

A tailored adoption of the OECD's BEPS Action 2 recommendations will comprehensively deal with the problem of hybrid mismatch arrangements while making modifications and variations to take into account what is appropriate for the New Zealand context. This tailored solution is sustainable and achieves gains to efficiency and fairness, while minimising compliance costs where possible. There will be a significant benefit in adopting a solution which is adopted by other countries and which will therefore be easier for multinational businesses to understand and comply with.

## Section B: Summary Impacts: Benefits and costs

**Who are the main expected beneficiaries and what is the nature of the expected benefit?**

The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis.

There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

| Where do the costs fall? |
| --- |
| Taxpayers that use hybrid mismatch arrangements will face a medium level of compliance costs. These may be up-front, in the form of restructuring costs to transition to more straightforward (non-hybrid) arrangements, or they may be ongoing in the case of taxpayers that keep their hybrid mismatch arrangements in place and must apply new tax rules in order to comply with the law. |

| **What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?** |
| --- |
| There is some risk of taxpayer noncompliance with the proposed rules. However, the risk of taxpayers being inadvertently caught by the proposed rules has been minimised due to the design of the preferred regulatory option which seeks to exclude the most simple offshore structures (foreign branches). More generally, the impacts have been reduced through the proposals taking into account the New Zealand context and adjusting the OECD-recommended rules as needed. |

| **Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.** |
| --- |
| There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'. |

## Section C: Evidence certainty and quality assurance

| **Agency rating of evidence certainty?** |
| --- |
| Not every type of hybrid arrangement that would be countered by the proposals has been observed in New Zealand. However, Inland Revenue is aware of some historic and current hybrid arrangements, and there is a very high likelihood there are others that relate to New Zealand and will be affected by this regulatory proposal. |

*To be completed by quality assurers:*

| Quality Assurance Reviewing Agency: |
| --- |
| Inland Revenue |
| Quality Assurance Assessment: |
| The Quality Assurance reviewer at Inland Revenue has reviewed the BEPS – hybrid mismatch arrangements Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria. |
| Reviewer Comments and Recommendations: |
| The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version. |

# Impact Statement: BEPS - Hybrid mismatch arrangements

## Section 1: General information

| Purpose |
|---|
| Inland Revenue is solely responsible for the analysis and advice set out in this Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet. |

**Key Limitations or Constraints on Analysis**

**Evidence of the problem**

Our analysis has been limited somewhat by our inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand. Inland Revenue is aware of some mismatch arrangements, but the full extent of the problem is unknown. This is because evidence of the problem primarily comes from Inland Revenue's investigations staff. Under current law these staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals.

**Range of options considered**

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

**Assumptions underpinning impact analysis**

The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of hybrid mismatch arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

**Responsible Manager (signature and date):**

Paul Kilford
Policy Manager, Policy and Strategy
Inland Revenue

12 July 2017

# Section 2: Problem definition and objectives

## 2.1 What is the context within which action is proposed?

### BEPS

Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinational groups to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter base erosion and profit shifting (BEPS).

### Hybrid mismatch arrangements

Hybrid mismatch arrangements arise when taxpayers exploit inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. The OECD's BEPS package includes Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. Hybrid mismatch arrangements are prevalent worldwide and are an important part of the base erosion and profit shifting strategies used by multinational companies. If no action is taken by the international community to counter these types of arrangements they are likely to continue to be used to avoid worldwide taxation and drive economic inefficiencies and unfairly distributed tax burdens.

### New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations.

In September 2016 the Government released a BEPS discussion document: *Addressing hybrid mismatch arrangements* which proposed adoption of the OECD Action 2 recommendations in New Zealand and sought submissions on how that should be done. In March 2017 the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*.

As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand. This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions.

At the same time, Cabinet noted that the reforms proposed in the BEPS documents would be progressed, subject to modification in consultation, for implementation from 1 July 2018. Cabinet also noted that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later in 2017.

## 2.2 What regulatory system, or systems, are already in place?

**New Zealand's tax system**

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

**Company tax and international rules**

The company tax system is designed to be a backstop for taxing the personal income of domestic investors. Company tax is deducted at 28%, but New Zealand based investors can claim imputation credits for tax paid by the company when the income is taxed upon distribution at the personal level. At the same time, the company tax is designed as a final tax on New Zealand-sourced income of foreign investors and foreign-owned companies earning New Zealand-sourced income.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge in the area of international tax is to ensure that multinational firms pay a fair and efficient amount of tax in New Zealand. Anti-avoidance rules and base protection measures are important part of ensuring that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

## 2.3 What is the policy problem or opportunity?

**The problem of hybrid mismatch arrangements**

Businesses can use hybrid mismatch arrangements to create tax advantages through exploiting inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. For example, using a hybrid entity or a foreign branch, a single expense may be deducted in two different jurisdictions, potentially reducing the tax payable on two different streams of income. Another example is a payment that is tax-deductible in one jurisdiction with no corresponding taxable income in the jurisdiction where the payment is received. However it is achieved, the result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates when compared with a straightforward arrangement that is seen consistently by both relevant countries. Hybrid mismatch arrangements also have the effect of subsidising international investment relative to domestic investment, which distorts the efficiency of global markets.

Since releasing its final recommendations on hybrid mismatch arrangements, the OECD expanded the scope of BEPS Action 2 to include branch mismatches. Branch mismatch arrangements are a result of countries approaching the allocation of income and expenses between a branch and a head office in different ways. Branch mismatch arrangements can also result in a reduction in the overall taxation of a corporate group, so are similar in effect to hybrid mismatch arrangements.

It is important to note that the policy problem is limited to circumstances when global tax is reduced as a result of a hybrid mismatch. This project does not address other mechanisms that taxpayers may use to lower their global tax liability, such as the use of low-tax jurisdictions to trap income.

**Hybrid mismatch arrangements in New Zealand**

New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the effects of a hybrid mismatch arrangement. However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way. Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements.

New Zealand also has some specific rules in its domestic law that go some way to addressing particular recommendations made by the OECD in relation to hybrid mismatch arrangements.

Inland Revenue is aware of a significant volume of hybrid mismatch arrangements involving New Zealand. For example, the amount of tax at issue in recent litigation for a prominent type of hybrid financial instrument was approximately $300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to the most prominent hybrid entity structure results in approximately $50 million less tax revenue for New Zealand per year.

## 2.4 Are there any constraints on the scope for decision making?

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Consistent with the OECD approach, the analysis has been focused on arrangements between related parties or where a hybrid mismatch has been created through a structured arrangement between unrelated parties.

We have also chosen to restrict the policy thinking to cross-border activity. Purely domestic hybrid mismatches (some of which are contemplated by the OECD Action 2 final report) are outside the scope of this regulatory proposal.

## 2.5 What do stakeholders think?

**Stakeholders**

Stakeholders of this regulatory proposal are primarily taxpayers (typically multinational businesses that have hybrid mismatch arrangements) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules. The proposed rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

Another stakeholder of this regulatory proposal is the OECD, which is aiming to eradicate hybrid mismatch arrangements to the extent possible. This goal can only be achieved through countries adopting hybrid mismatch rules of some kind and neutralising the mismatches that arise when different sets of rules apply to the same transaction or entity. In addition, other countries that have enacted or are proposing to enact hybrid mismatch rules (for example, Australia and the United Kingdom) will be interested in the interaction between their own hybrid mismatch rules and any rules that New Zealand introduce into law.

The Reserve Bank of New Zealand (RBNZ) is interested in the regulatory proposal to the extent that it affects bank regulatory capital.

**Submissions to discussion document**

There were 20 submissions made to the September 2016 Government discussion document. Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions of some variety. However, a greater number of 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.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

**Further and ongoing consultation**

We have engaged in approximately a dozen workshops (with the Corporate Taxpayers Group and Chartered Accountants Australia and New Zealand) and attended various other meetings with private sector submitters (including the New Zealand Bankers' Association) in order to discuss specific design issues relating to hybrid mismatch arrangements.

We have also consulted with officials representing Australia and the United Kingdom, as well as the OECD secretariat, on an ongoing basis to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation.

We have also consulted with the Reserve Bank.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

# Section 3: Options identification

## 3.1 What options are available to address the problem?

Four options were considered in the development of this regulatory proposal. These options are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) New Zealand aligns itself with the OECD recommendations in dealing with hybrid mismatch arrangements.

None of the options (with the exception of the status quo option) are non-regulatory options. This is because our judgment is that the policy problem of hybrid mismatch arrangements cannot be addressed without changing tax rules, and that is something that can only be done through the use of legislation (as per section 22(a) of the Constitution Act 1986).

These options are what we consider other countries dealing with hybrid mismatch arrangements will consider in their policy development process. The United Kingdom and Australia can both be said to have chosen their own version of option 2. Some other countries have had rules to deal with hybrid mismatches that predate the OECD's work in this area.

**Status quo: No action**

This option relies on New Zealand's existing law (including the GAAR) to counter hybrid mismatch arrangements and avoids the increased compliance costs and administrative costs of the other options. The status quo option also contemplates that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to New Zealand.

**Option 1: Strict adoption of OECD recommendations**

The OECD recommendations as set out in its BEPS Action 2 report are a comprehensive set of principle-based rules to counteract all types of hybrid mismatch arrangements. Option 1 is to strictly adopt those recommendations as described by the OECD into New Zealand domestic law. This option would deal with the range of hybrid mismatch arrangements targeted by the OECD to the extent they are found in or affect New Zealand. It would have the advantage of interacting well with other countries that similarly adopt the OECD recommendations into their domestic law.

**Option 2: Tailored adoption of OECD recommendations**

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the New Zealand context. This option bears close relation to Option 1 as it involves introducing OECD-consistent hybrid rules unless there is a compelling reason to depart from the OECD approach. Thus, this option would solve the policy problem while ensuring that particular New Zealand issues are addressed.

Option 2 also recognises that there are some instances where New Zealand's existing tax laws are sufficient (or can be made sufficient with relatively minor amendment) to achieve the effect intended by an OECD recommendation.

**Option 3: Targeted hybrid rules**

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid enacting rules targeted at arrangements which are not currently seen in New Zealand.

**Consultation**

These four options were identified prior to consultation. The September 2016 discussion document proposed adoption of the OECD recommendations (options 1 and 2) and sought feedback on how that should be done. The document stated the Government's alternative options as option 3 and maintaining the status quo and concluded that they were not the best way forward. Consultation has affected the nature of option 2 in particular and has been helpful for options analysis generally.

### 3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible
- Neutrality – the tax system should bias economic decisions as little as possible
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality and fairness impacts without some increase in compliance costs and so there are some trade-offs that were and continue to be considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

### 3.3 What other options have been ruled out of scope, or not considered, and why?

We ruled out designing a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This is for reasons of international compatibility and to save compliance costs.

# Section 4: Impact Analysis

| | Status quo: No action | Option 1: Strict adoption | Option 2: Tailored adoption | Option 3: Targeted rules |
|---|---|---|---|---|
| **Efficiency of compliance** | 0 | - -<br>Option 1 has a significant compliance burden because some of the OECD recommendations as drafted would not mesh well with New Zealand's existing tax laws. | -<br>Option 2 imposes increased compliance costs on taxpayers and advisors, but is focused on reducing those costs where possible. | -<br>Option 3 imposes increased compliance costs on taxpayers and advisors, but by its nature it reduces those costs in proposing rules that only address currently observed exploitation of hybrid mismatches. |
| **Efficiency of administration** | 0 | 0<br>We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR. | 0<br>We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR. | 0<br>We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR. |
| **Neutrality** | 0 | ++<br>Option 1 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains. | ++<br>Option 2 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains. | +<br>Option 3 will remove the tax benefit of currently observed hybrid mismatch opportunities involving New Zealand. This will likely provide some efficiency gains. However, other hybrid mismatch arrangement opportunities will remain available. This means that, depending on the extent to which taxpayers respond to an option 3 approach by simply moving into "uncovered" tax-efficient hybrid structures, there will still be some inefficient allocations of investment due to ongoing hybrid mismatch arrangements. |
| **Fairness and equity** | 0 | +<br>Option 1 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability. | +<br>Option 2 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability. | +<br>Option 3 has fairness and equity benefits as it ensures that taxpayers able to use currently observed hybrid mismatch arrangements cannot reduce their tax liability. However, this option's fairness impact depends on the behavioural effects of introducing these rules to a greater extent than options 1 and 2. |
| **Sustainability** | 0 | ++<br>Option 1 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand. | ++<br>Option 2 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand. | +<br>Option 3 will remove currently known hybrid mismatch arrangement opportunities involving New Zealand. However, this option's sustainability is limited. It will leave some hybrid mismatches unaddressed, which may be exploited at a later date by opportunistic taxpayers. |
| **Overall assessment** | Not recommended | Not recommended | **Recommended** | Not recommended |

**Key:**

++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
**0** about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

# Section 5: Conclusions

**5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?**

We consider that option 2 is the best option for addressing the problem of hybrid mismatch arrangements. It is an internationally consistent, proactive option which delivers net benefits to New Zealand greater than that of the other options considered.

Option 2 will improve the neutrality of New Zealand's tax system. Businesses that are able to exploit hybrid mismatch arrangements can currently operate at lower effective tax rates when compared with other businesses. This can result in a 'hybrid' business crowding out more productive investment and making international investment decisions based on whether a mismatch is available rather than commercial grounds. In addition, the imposition of higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrid mismatches is likely to be less efficient than imposing more moderate taxes across all economic actors. By eliminating the tax benefit of hybrid mismatch arrangements in a comprehensive way, these inefficiencies can be removed.

In a related sense, option 2 will help to improve the equity and fairness of the New Zealand tax system. Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally.

Option 2 will also have revenue collection benefits. The New Zealand tax revenue loss caused by the use of hybrid mismatch arrangements is difficult to estimate because the full extent of arrangements involving New Zealand is unknown and because the behavioural effects of introducing hybrid mismatch rules are difficult to ascertain. However, the tax revenue at stake is significant in the cases that Inland Revenue is aware of.

Importantly, the case for New Zealand to adopt the OECD recommendations is strengthened by the fact that other countries have enacted, or are proposing to enact, hybrid mismatch rules. This is because a hybrid mismatch arrangement involving a New Zealand counterparty may still be neutralised by the other country if they have a 'secondary' right to counteract under OECD principles. In that case, the tax benefit of the hybrid mismatch would be eliminated, but the tax collected would be by the counterparty country. In these circumstances, New Zealand would be better off having its own hybrid mismatch rules so that it can collect revenue when it has the priority to do so under the OECD recommendations. Whether New Zealand or the counterparty country collects any additional revenue as a result of implementing the rules depends on the actions taken by the affected business.

Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as "unstructured imported mismatches". This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

Accordingly, the compliance costs of the regulatory proposal are to be minimised to the extent possible, while still introducing a comprehensive set of rules to deal with the range of OECD-identified hybrid mismatches. This is where option 2 shows its advantage over option 1 which we view as having similar efficiency, fairness and revenue benefits. Option 1 would result in relatively higher compliance costs because the OECD recommendations are designed as a general set of best-practice rules and, in regards to their detail, are not necessarily optimal for individual countries such as New Zealand. When compared with option 1, option 2 ensures that the rules are workable and appropriate for the New Zealand tax environment.

It is also important to note that the ongoing compliance costs relating to this regulatory issue are expected to be optional in the majority of cases. The proposed rules will apply to taxpayers who use a hybrid mismatch arrangement after the rules become effective. Those taxpayers will generally have the option of incurring one-off costs to restructure into non-hybrid arrangements and remove themselves from the scope of the proposed rules.

Any higher tax payments resulting from the non-status quo options will make cross border investment less attractive for taxpayers using hybrid mismatch arrangements. However, these taxpayers should not be allowed to exploit hybrid mismatches to achieve a competitive advantage over taxpayers that do not use hybrid mismatch arrangements (such as purely domestic firms). Further, a significant number of New Zealand's major investment partners have introduced or will introduce hybrid mismatch rules. Other countries adopting these rules means that in many cases the tax efficiency of hybrid mismatch arrangements in New Zealand will be negated through the operation of the other country's rules on the counterparty, As a result, we believe that any impacts on inbound and outbound cross border investment from introducing hybrid mismatch rules in New Zealand will be low.

The status quo option would involve the least complexity and lowest compliance costs. However, similar to the cross-border investment discussion above, taxpayers whose groups deal with New Zealand's major trading partners that are adopting hybrid mismatch rules would have to understand the impact of those rules. The additional complexity of New Zealand having hybrid mismatch rules would therefore be lessened by the international momentum in this area.

Option 3 is an option that was preferred by many submitters to the Government discussion document on hybrid mismatch arrangements. Submitters pointed out that many of the structures considered by the OECD to be problematic have not been seen in New Zealand and therefore do not need to be counteracted. They also argued that the OECD recommendations are complex and have the potential for overreach. We do not think a targeted approach would serve New Zealand well when compared with option 2. The OECD recommendations are a coherent package intending to deal to the problem of hybrid mismatch arrangements exhaustively. Deliberately omitting aspects of the recommendations from New Zealand's response may cause taxpayers to exploit those remaining hybrid mismatch opportunities (which may even be seen as tacitly blessed). To the extent that happens, the efficiency, revenue, and fairness benefits of option 3 would be eroded. In

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| addition, other countries such as the United Kingdom and Australia have introduced or are intending to introduce a relatively comprehensive set of hybrid mismatch rules. If New Zealand does the same it will ensure our rules are internationally comparable and that they interact well with the rules of other countries without significant compliance issues. By favouring option 2, we also have consulted extensively on the OECD recommendations and how they should best be introduced into New Zealand law. This consultation has enabled us to design suitable modifications to the OECD recommendations to reduce complexity and compliance costs, limit overreach, and in some cases, increase the efficiency of the outcomes. |

## 5.2 Summary table of costs and benefits of the preferred approach

| **Affected parties** *(identify)* | **Comment**: *nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks* | **Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts* | **Evidence certainty** *(High, medium or low)* |
|---|---|---|---|
| **Additional costs of proposed approach, compared to taking no action** | | | |
| Regulated parties | Compliance costs: Increased costs from understanding the rules and applying them to taxpayers' transactions and structures. Or, restructuring costs of transitioning to non-hybrid arrangements to fall outside the scope of the rules. | Medium | Medium |
| | Tax payable: Foreign hybrid entity double deduction structures are included in the rules and we are confident of collecting a significant amount of revenue from the disallowance of that type of hybrid mismatch arrangement. | Approximately $50 million per year on an ongoing basis | Low* |
| Regulators | Administrative costs: Inland Revenue staff, particularly investigations staff, need to develop their knowledge of the hybrid mismatch rules. | Low | High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Cost** | Tax payable | Approximately $50 million per year on an ongoing basis | Low* |
| **Non-monetised** | Compliance costs | Medium | Medium |

| | | | |
|---|---|---|---|
| **costs** | <u>Administrative costs</u> | Low | High |

| **Expected benefits of proposed approach, compared to taking no action** | | | |
|---|---|---|---|
| Regulated parties | | | |
| Regulators | <u>Revenue:</u> Revenue collected from tax payable item described above. | Approximately $50 million per year on an ongoing basis | Low* |
| | <u>Reduced administrative costs:</u> Less investigations and disputes resources spent on hybrid mismatch arrangements using the general anti-avoidance law (GAAR). | Low | High |
| Wider government | | | |
| Other parties | | | |
| **Total Monetised Benefit** | <u>Revenue</u> | Approximately $50 million per year on an ongoing basis | Low* |
| **Non-monetised benefits** | <u>Reduced administrative costs</u> | Low | High |

*Note that the evidence for the $50 million figure is strong, but it is a conservative estimate made in light of the behavioural uncertainty associated with introducing hybrid mismatch rules together with the fact that the full extent of hybrid mismatch arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be higher, but this cannot be estimated with confidence.

## 5.3 What other impacts is this approach likely to have?

As discussed above, allowing the use of hybrid mismatch arrangements is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders as it is something that is fundamental to the tax system itself.

## 5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 2 (tailored adoption of OECD recommendations) conforms to the expectations for the design of regulatory systems document.

# Section 6: Implementation and operation

## 6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its Tax Information Bulletin (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018. The major exceptions are:

- the proposed rule for "unstructured imported mismatch arrangements", which we recommend be delayed until income years starting on or after 1 January 2020; and
- the proposed rules applying to New Zealand "reverse hybrids", which we recommend be delayed until income years starting on or after 1 April 2019.

Another exception we recommend is a grandparenting rule that exempts from application of the rules (until the next call date) hybrid financial instruments issued by banks as regulatory capital (in Australian or New Zealand) to third party investors before the discussion document release date of September 2016.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider an application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

## 6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. Audit staff will need to familiarise themselves with the proposed rules and how they operate in practice. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their hybrid mismatch arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we are minimising compliance costs where possible under our tailored adoption of the OECD recommendations. For example, and as mentioned above, we have delayed the application date of the unstructured imported mismatch rule contained in the OECD recommendations to acknowledge that it would be significantly more difficult and costly to comply with than the other rules if it applied at the outset.

# Section 7: Monitoring, evaluation and review

### 7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

However, it may be difficult to assess the true impact of this regulatory proposal. This is because many taxpayers using hybrid mismatch arrangements may rearrange their affairs to fall outside the scope of the proposed rules. It will be difficult to measure the full extent of this behavioural effect.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

### 7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.