

Taxation (Neutralising Base Erosion and Profit Shifting) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

March 2018

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Bill overview

Since late 2012, there has been significant global media and political concern about evidence suggesting that some multinational corporations engage in aggressive tax planning strategies to pay little or no tax anywhere in the world. These strategies are known as base erosion and profit shifting or “BEPS”.

The issue of BEPS formed part of the G20 agenda in 2013, who asked the OECD to report back to it with global strategies to address international concerns. The end result was the adoption of an OECD/G20 15-point Action Plan recommending a combination of domestic reforms, tax treaty changes, and administrative measures that would allow countries to strengthen their laws in a consistent manner and work together in combatting BEPS.

Recognising our own vulnerability to BEPS and the value of working cooperatively, New Zealand actively participated in the OECD/G20 project, which was finalised at the end of 2015. In June 2016, in response to the OECD’s BEPS work, the New Zealand Government released its own BEPS programme to address BEPS issues in New Zealand.

New Zealand’s response to BEPS is generally aligned with Australia’s. It is also broadly consistent with the OECD/G20 Action Plan, although the specific proposals are tailored for the New Zealand environment. In some instances, New Zealand’s existing tax laws are already consistent with OECD recommendations. In other cases, however, tax treaty and domestic law changes are required to address BEPS.

The measures proposed in this Bill will prevent multinationals from using:

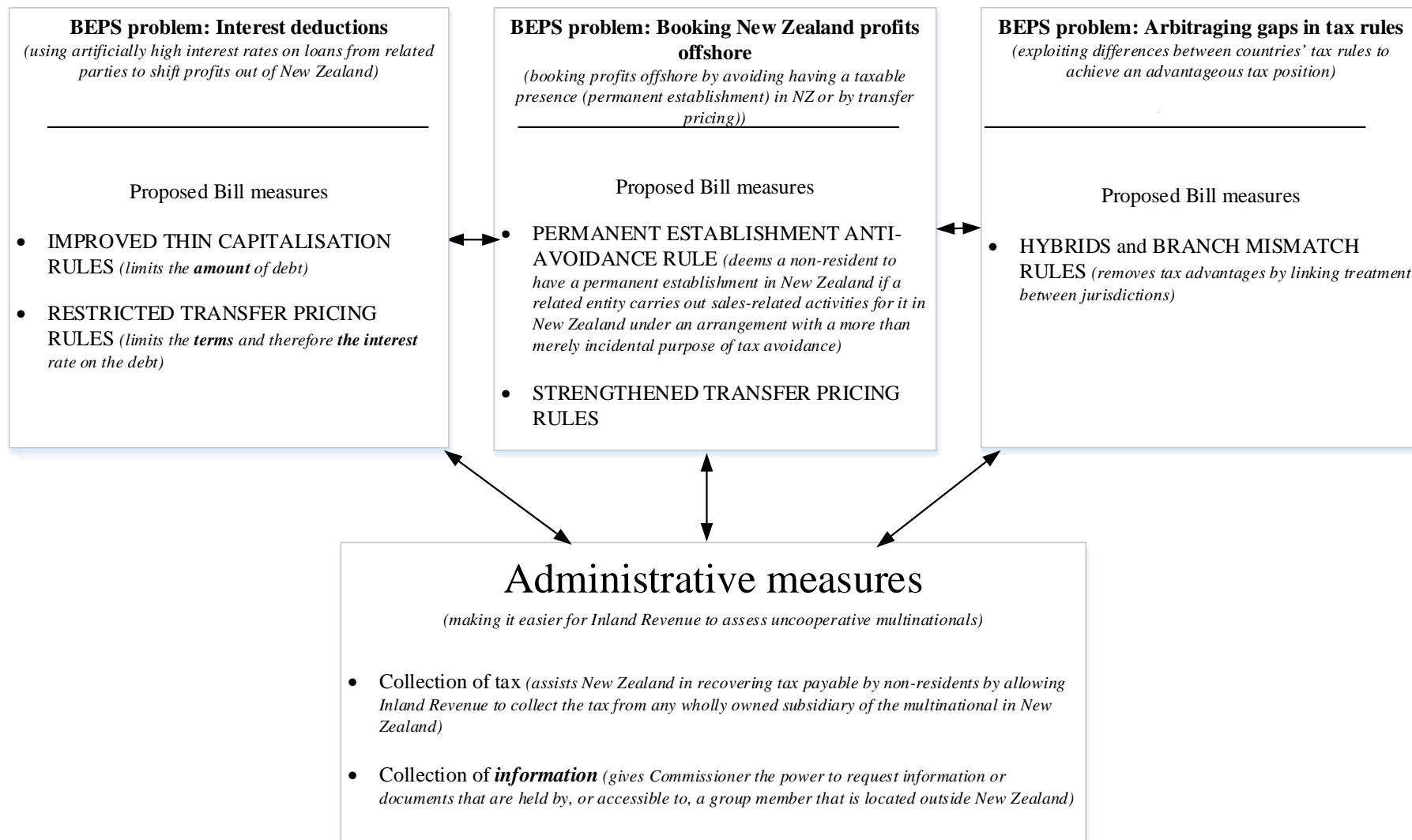
- artificially high interest rates on loans from related parties to shift profits out of New Zealand (interest limitation rules);
- hybrid mismatch arrangements that exploit differences between countries’ tax rules to achieve an advantageous tax position;
- artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand; and
- related-party transactions (transfer pricing) to shift profits into offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore.
- certain tactics which can be used by non-cooperative multinationals to stymie an Inland Revenue investigation, such as withholding relevant information that is held by an offshore group member.

These proposed measures were the subject of public consultation beginning in September 2016 with proposals to address hybrid mismatch arrangements.

The Bill makes amendments to the Income Tax Act 2007 and the Tax Administration Act 1994.

Each provision of the Bill comes into force on the date specified in the Bill for that provision. For most provisions this is income years beginning on or after 1 July 2018.

BEPS problems and the Bill's proposed measures



General Bill issues

Issue: Support for the intent of the Bill

Submission

(ANZ, ASB, BNZ, Bryce Jensen, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, Human Rights Commission, KPMG, New Zealand Bankers' Association, New Zealand Council of Trade Unions, New Zealand Law Society, Powerco, Oxfam, Public Health Association of New Zealand, Westpac)

Most submitters recognised that base erosion and profit shifting (BEPS) is a problem and most expressed at least some support for the Government's approach and intent on BEPS.

In particular, one submitter urged the Finance and Expenditure committee to not weaken the Bill in light of critical submissions. *(Public Health Association of New Zealand)*

Support was also expressed for the consultative approach taken in developing the proposals. *(ANZ, Chartered Accountants Australia and New Zealand, EY, KPMG, New Zealand Bankers' Association)*

A number of submitters who noted their support for the rationale underlying the proposals in the Bill caveated that support with specific concerns, which are set out below.

Comment

While officials understand that submitters have concerns with various aspects of the Bill, it is good that there seems to be general acceptance of BEPS as an issue and some support for the Government's proposals to address international tax avoidance. This report notes the specific concerns raised by submitters as separate issues.

Recommendation

That the support be noted.

Issue: Deferred application of proposed rules

Submission

(ANZ, ASB, Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, KPMG, PwC, New Zealand Bankers' Association)

Some submitters have proposed that the application of the Bill (or parts of it) should be deferred or that a transitional period should be included in the measures. Submitters generally support deferral for various reasons, in particular with regard to a perceived rushed timeframe and minimal interval between enactment and coming into effect.

Submissions on this point were as follows:

- The application date of the Bill should be deferred by twelve months. *(ASB, New Zealand Bankers' Association)*
- The interest limitation proposals should be delayed by 12 months to income years beginning on or after 1 July 2019. *(ANZ, New Zealand Bankers' Association)*

- New Zealand should delay the application date of the hybrid mismatch proposals by at least a year. (*Chapman Tripp*)
- New Zealand should wait to see the effect of 2017 US tax reform before proceeding with BEPS and hybrid proposals. (*Chapman Tripp*)
- The application date should be amended to income years beginning on or after 1 April 2019. (*Chartered Accountants Australia and New Zealand*)
- The structured imported mismatch part of the hybrid and branch mismatch rules should apply from 1 January 2020, consistent with the unstructured imported mismatch rule. (*Chartered Accountants Australia and New Zealand, EY*)
- The application date for certain aspects of the Bill (notably interest limitation rules and transfer pricing changes) need to be deferred to allow taxpayers the opportunity to understand the final form of the rules and to restructure, as necessary, prior to the rules taking effect. Those rules should apply to income years beginning on or after a date six months after the Bill receives Royal Assent. Without extra time after enactment, businesses with June balance dates will be applying rules very soon after the rules are made certain which is not optimal given the complexity of the rules. (*Corporate Taxpayers Group*)
- The application date should be (income years on or after) 1 January 2020 or for 2019/20 tax years for alignment with the expected implementation of Australian hybrid mismatch rules. (*KPMG*)
- The application date should be deferred such that the rules apply no earlier than the first income year after 31 March 2019. In addition, there should be a further two years until the imported mismatch rule (which is part of the hybrid mismatch rules) applies. The proposed application date will not allow taxpayers time to properly understand the rules or restructure if they need to. (*PwC*)
- The proposed application dates contained in the Bill do not recognise that restructures, particularly in the context of large multinationals, generally take a reasonable amount of time and resources to implement. The Bill should contain provisions for transitional periods to be implemented alongside the proposed new rules, or the proposed application dates should be delayed to give multinationals an opportunity to restructure (New Zealand Law Society)
- In relation to the permanent establishment rules, the rules will apply to non-residents with no current New Zealand tax obligations. The rules will apply from 1 April 2019 as those non-residents will not have an agreed balance date for New Zealand tax purposes. (*KPMG*)

Comment

The proposals in the Bill are the result of a measured consultation process which began over a year ago in accordance with the Generic Tax Policy Process. Discussion documents were used to consult on the proposals in September 2016 and March 2017. The major policy decisions were announced and underlying policy reports and Cabinet papers were published in August 2017. Officials also had some targeted consultation on the detailed design of key items with submitters in September-October 2017.

The proposals are to apply from 1 July 2018 in order to balance the need to provide certainty to taxpayers and to efficiently respond to the fairness and fiscal concerns associated with BEPS.

Officials consider that the proposals have been well heralded and businesses concerned about the application of the Bill's new rules have been given sufficient time to undertake any restructuring which they may feel appropriate. Any additional tax imposed by the hybrid rules should reflect a rational and sensible taxation outcome, so taxpayers who for some reason have not restructured to avoid their application are unlikely to be prejudiced.

Recommendation

That the submission be declined.

Clauses 34 to 37, 44, 46 and 47

Issue: Grandparenting of existing advance pricing agreements

Submissions

(Chapman Tripp, Corporate Taxpayers Group, EY, New Zealand Law Society, PwC)

Support the Bill's proposed grandparenting of Advance Pricing Agreements. *(Corporate Taxpayers Group)*

The grandparenting for existing Advance Pricing Agreements should be expanded to Clause 35, to extend grandparenting protection for existing APAs to all of the transfer pricing changes, including the restricted transfer pricing rule; and Clause 34, to extend grandparenting protection for existing APAs to the PE anti-avoidance. *(Chapman Tripp)*

Clause 36(6) provides that an arrangement complying with an advance pricing agreement (APA) issued before 1 July 2018 is grandparented from the proposed changes to sections GC 6 to GC 14. Clause 37(2) should clarify that sections GC 15 to GC 18 do not apply to an arrangement complying with an APA issued before 1 July 2018. *(EY, PwC)*

A number of Advance Pricing Agreements (APAs) would have been issued by Inland Revenue to taxpayers with structures to which the PE anti-avoidance rule could potentially apply. Given APAs only rule on the transfer pricing element of an arrangement, it is not clear how the proposed PE anti-avoidance rules would apply to taxpayers who have existing APAs in place. *(New Zealand Law Society)*

APAs should be grandfathered from the PE anti-avoidance rule. This was previously recommended by officials and agreed to by ministers. In particular, if a taxpayer has obtained an APA in relation to whether the amount payable by a non-resident to its New Zealand subsidiary is on arm's length terms, then section GB 54 should not be able to apply to deem the non-resident to have a PE under the arrangement. This is because the non-resident has already obtained a ruling on the appropriate amount of tax payable in New Zealand under the existing legislation. In addition, the amount of tax payable as a result of the application of the transfer pricing rules pursuant to the APA should be the same as if the non-resident had a PE in New Zealand. *(Chapman Tripp)*

If the PE source rule and new section YD 5B are to proceed with the potential to apply to a non-resident's sales income from sales to non-NZ customers, existing binding rulings on apportionment under section YD 5 should be grandparented for the period of the ruling to protect taxpayer certainty. *(Chapman Tripp)*

Comment

Advance Pricing Agreements (APAs) are binding rulings between the Commissioner and taxpayers to agree on how a transaction will be priced for the purposes of the transfer pricing rules.¹ They do not have any effect for other transactions or tax positions taken by that taxpayer.

It was intended that all of the changes to the transfer pricing rules (including the new restricted transfer pricing rules for related party loans) would be grandfathered so they do not apply to transactions subject to an APA issued before 1 July 2018. However, the current grandfathering provision in clause 36(6) only applies to the proposed changes to clause 36.

Officials therefore recommend extending the grandfathering of APAs so it applies to all the transfer pricing changes in clauses 35, 36 and 37 of the Bill.

Previous reports did include a standalone recommendation that APAs be grandfathered from the BEPS proposals in the Bill. This was agreed to by Ministers. However, APAs only cover the application of the transfer pricing rules to transactions between related parties and the allocation of income between New Zealand and overseas sources under section YD 5. APAs do not rule on whether a PE exists. Therefore grandfathering the APA from the proposals does not affect the application of proposed section GB 54.

In addition, APAs and other rulings only provide taxpayers with certainty in respect of the particular tax laws to which apply. Accordingly, a taxpayer that acquires an APA on transfer pricing has no certainty as to whether they have a PE. In fact the APA would not even indicate Inland Revenue's view on the issue. Officials also disagree that the application of the transfer pricing rules on their own would produce the appropriate amount of tax where a PE exists or is being avoided (this is for the reasons stated in response to Chapman Tripp's submission on the issue).

Accordingly, officials consider that it is not appropriate to grandfather APAs from the PE anti-avoidance rule in clause 34.

Apportionment under section YD 5 is dealt with under APAs. The proposed changes to the source rules in the Bill could upset the application of an APA that ruled on the amount of income attributable to New Zealand under section YD 5. For this reason officials also recommend that the APAs which ruled on the amount of income attributable to New Zealand under section YD 5 be grandfathered from the proposed new source rules in clauses 44, 46 and 47 of the Bill. This should be for the remaining duration of the APA.

Recommendation

Accept those submissions that propose extending grandfathering provisions for Advance Pricing Agreements issued prior to 1 July 2018 to:

- all of the changes to the transfer pricing rules, including the restricted transfer pricing rules in clauses 35, 36 and 37;
-

¹ More information on APAs can be found at <http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-apas.html>

- the changes to the source rules in clauses 44, 46 and 47 of the Bill.

The submissions for extending grandparenting to the PE anti-avoidance rule in clause 34 be declined.

Clause 36

Issue: Drafting of the provision to Grandparent of existing advance pricing agreements

The grandparenting of Advance Pricing Agreements should be codified in its own section. (*Corporate Taxpayers Group*)

The drafting of the grandparenting provision should adopt language used in Part 5A of the Tax Administration Act to specify when a private ruling remains binding, rather than “complies with”. (*Chapman Tripp*)

Comment

Grandparenting provisions are generally drafted as part of the Bill’s application date clauses. Officials do not consider it is necessary to change this approach and have a standalone section for the grandparenting of APAs.

Officials consider that the language used in the current drafting is appropriate and achieves the policy intention of applying to the set of advance pricing agreements issued before 1 July 2018, which remain binding on the Commissioner.

Recommendation

That the submissions be declined.

Please ignore this issue - the correct version for this topic is on page 9.

Issue: Grandparenting of existing advance pricing agreements

Submissions

(*Chapman Tripp, Corporate Taxpayers Group, EY, New Zealand Law Society, PwC*)

Support the Bill’s proposed grandparenting of Advance Pricing Agreements (*Corporate Taxpayers Group*)

The grandparenting for existing Advance Pricing Agreements should be expanded to Clause 35, to extend grandparenting protection for existing APAs to all of the transfer pricing changes, including the restricted transfer pricing rule; and Clause 34, to extend grandparenting protection for existing APAs to the PE anti-avoidance. (*Chapman Tripp*)

Clause 36(6) provides that an arrangement complying with an advance pricing agreement (APA) issued before 1 July 2018 is grandparented from the proposed changes to sections GC 6 to GC 14. Clause 37(2) should clarify that sections GC 15 to GC 18 do not apply to an arrangement complying with an APA issued before 1 July 2018. (*EY*)

There should be a specific grandfathering provision to allow taxpayers with inbound related party debt subject to an existing APA with Inland Revenue to continue with the agreed pricing until the end of the APA period. (*PwC*)

A number of Advance Pricing Agreements (APAs) would have been issued by Inland Revenue to taxpayers with structures to which the PE anti-avoidance rule could potentially apply. Given APAs only rule on the transfer pricing element of an arrangement, it is not clear how the proposed PE anti-avoidance rules would apply to taxpayers who have existing APAs in place. (*New Zealand Law Society*)

Comment

Advance Pricing Agreements (APAs) are binding rulings between the Commissioner and taxpayers to agree on how a transaction will be priced for the purposes of the transfer pricing rules.² They do not have any effect for other transactions or tax positions taken by that taxpayer.

It was intended that all of the changes to the transfer pricing rules (including the new restricted transfer pricing rules for related party loans) would be grandfathered so they do not apply to transactions subject to an APA issued before 1 July 2018. However, the current grandparenting provision in clause 36(6) only applies to the proposed changes to clause 36.

Officials therefore recommend extending the grandparenting of APAs so it applies to clauses 35 to 37 of the Bill.

A standalone recommendation that APAs be grandfathered from the BEPS proposals in the Bill was considered by officials. However APAs only cover the application of the transfer pricing rules to transactions between related parties and the allocation of income between New Zealand and overseas sources under section YD 5. They do not rule on whether a PE exists. Accordingly it would not make sense to grandfather APAs from the PE anti-avoidance rule in clause 34 of the Bill.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Quality of the Bill

Submission

(*Corporate Taxpayers Group, PwC*)

Submitters raised issues with the quality of the drafting of the Bill, noting that it contained several errors. They also noted that in some cases the Commentary to the Bill was inconsistent with the Bill itself.

The bill should be redrafted. (*PwC*)

² More information on APAs can be found at <http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-apas.html>

Comment

By way of background, although not mandatory to provide, a Bill Commentary has typically been made available by officials whenever tax legislation has been introduced to Parliament. They are intended to provide useful background to what can often be complex proposed legislation. They are not a legal document and are intended solely as an aid to comprehension.

Over recent years additional steps have been added to the quality control processes in place around the compilation of proposed legislation and associated Bill commentaries. Despite this, and while every endeavour is made to ensure that all legislation and associated commentaries are technically correct in every way at publication, some errors (and variances between the Bill and the Commentary) can occur when a Bill is introduced.

The BEPS policy issues that form the basis of this Bill are very complex in nature, and this is reflected in complex legislation to deal with the issues involved. Given this complexity as much time as was possible in the circumstances prior to the Bill's introduction was devoted to consulting with stakeholders on developing the policies and proposed legislation, and this consultation on the technical detail has continued whilst the Bill has been at select committee. Officials have greatly appreciated all the feedback received on this, as it ultimately helps improve the quality and the resulting legislation.

Where appropriate, any errors (or discrepancies between the proposed legislation and issues referenced in the Commentary) identified by submitters and/or officials have been clarified under the relevant items in this officials' report.

Recommendation

That the submitters' comments be noted, and individual issues addressed where appropriate.

Issue: Need for guidance

Submission

(ANZ, Deloitte, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, New Zealand Bankers' Association, PwC)

Due to the complexity of the Bill and its effects on various existing tax regimes, thorough guidance on application of any new rules should be provided by Inland Revenue on a timely basis to assist taxpayers and advisors with compliance. Some submitters asked for guidance on specific parts of the Bill, and others asked for more general guidance to be issued. A number of submitters requested an increased number of examples from the amount that were in the Commentary on the Bill.

One submitter suggested that the guidance, when issued, should be subject to a public consultation process.

Comment

Officials agree that guidance will be useful to taxpayers who are affected by these rules, and will provide guidance and examples in a Tax Information Bulletin after the rules are enacted.

Recommendation

That the submission be accepted.

Issue: The proposals go too far

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, PwC)

Submitters commented that some of the proposals went further than they felt was necessary, and suggested there were several examples of overreach.

The proposals apply to (and will impose compliance costs on) a large population of businesses, the majority of which are compliant and acting within the spirit of the tax rules (and complying with Inland Revenue's requests for information, such as the international questionnaire). It would be more appropriate to better target rules at those taxpayers who are non-compliant, and to better use the existing legislative tools (such as section BG 1 tax avoidance). *(Corporate Taxpayers Group)*

The Bill contains substantial reforms which will put New Zealand in the forefront of worldwide approaches to BEPS implementation. We are concerned that several measures, including the restricted transfer pricing approach and the scope of the hybrid and branch mismatch rules, appeared likely to overreach in the New Zealand context. *(EY)*

A number of areas of the proposed new tax regimes are significant overreaches by New Zealand and will potentially be of significant detriment to ordinary commercial arrangements. *(PwC)*

The proposals are out of proportion relative to the problem being addressed. *(Chartered Accountants Australia and New Zealand)*

Conversely, one submitter noted that they were concerned the proposed legislation was not comprehensive or ambitious enough to effectively tackle the problem of tax avoidance by multinational companies. *(Oxfam)*

Comment

Officials consider that the proposed measures in the Bill provide a comprehensive response to BEPS strategies that can be used to avoid paying tax. These are intentionally broad in their application. Officials acknowledge that some of the proposals will increase compliance costs for some taxpayers; however, officials think this is necessary to address the problems created by BEPS strategies.

Officials recommend changes to some proposals which aim to address submitters' concerns that some proposals have too broad a reach. These recommended changes are outlined later in this report in relation to specific submissions.

Recommendation

That the submissions be noted, and individual issues addressed where appropriate.

Issue: The proposals put New Zealand out of step with other countries

Submission

(Chartered Accountants Australia and New Zealand, KPMG, Corporate Taxpayers Group, ANZ, New Zealand Bankers' Association, New Zealand Council of Trade Unions)

If this package of reforms is enacted, New Zealand will be going further than most other OECD countries. Other countries have not adopted the measures proposed by the OECD in full because they have determined that it is not in their national interest to do so. It is not in New Zealand's best interests to be an outlier from international norms in any international tax regime. *(Chartered Accountants Australia and New Zealand)*

Some proposals contained in this Bill are outside of international norms and will create double taxation. *(Corporate Taxpayers Group)*

It is important that New Zealand does not rush into new rules before other jurisdictions or take unilateral action which is out of step with either the OECD or the consensus of the international community. It is also important that any measures remain proportional to the scale of the problem. *(Corporate Taxpayers Group)*

Any measures to address concerns about BEPS should be multi-lateral to ensure consistent and certain application of tax rules across tax jurisdictions. *(New Zealand Bankers' Association)*

One submitter raised a further concern that the unilateral measures in the Bill would have a detrimental effect on New Zealand's international reputation, and would potentially have significant ramifications for future tax treaty negotiations and international agreements. *(Corporate Taxpayers Group)*

Implementation of the recommendations on a unilateral basis may disadvantage New Zealand. To the extent that the BEPS recommendations produce a fairer tax system, they are best implemented on a consensus basis. *(KPMG)*

Conversely one submitter noted that while BEPS would best be addressed by international cooperation, it is important that New Zealand acts promptly to take advantage of such agreement both to protect revenue and to support other countries acting or considering acting to do the same. They expressed that they would not like to see New Zealand lagging in these important matters. Some matters will not find international agreement or will take many years to find agreement. That should not stop New Zealand from taking what action it can. *(New Zealand Council of Trade Unions)*

Comment

Officials have closely monitored the OECD/G20 work to address BEPS and have followed the multilateral consensus where appropriate. However, parts of this Bill are unique or tailored to the New Zealand context, including existing tax laws and frameworks.

Recommendation

That the submissions, aside from the supporting submission, be declined.

Issue: Cost of capital and wider economic impact

Submission

(ANZ, Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, PwC, New Zealand Council of Trade Unions)

The proposed BEPS measures will increase the effective tax rate on inbound investment which is undesirable due to the country's position as a capital importer.

The rules in the Bill should be as consistent as possible with other jurisdictions (particularly Australia) due to the importance of foreign capital to the New Zealand economy. *(ANZ)*

Investors from countries such as China and the United States of America will be sensitive to proposals that tax foreign direct investment at a higher rate. *(Chapman Tripp)*

New Zealand's economy relies on foreign investment to grow. There has been no actual analysis of the effect of the proposals on cost of capital and the wider economy. *(Chartered Accountants Australia and New Zealand)* Such an analysis should be undertaken before the rules proceed. *(Corporate Taxpayers Group)*

The balance between discouraging tax avoidance and encouraging commercial behaviour has not been appropriately found. *(Corporate Taxpayers Group)*

The proposed rules will negatively impact on foreign direct investment and will discourage multinational corporations from using New Zealand as a hub for their commercial activities. *(Corporate Taxpayers Group)*

If these rules are enacted this will materially impact on the perception of New Zealand as an easy place to do business. *(Deloitte)*

Inbound investment will be at risk if the proposals proceed. *(PwC)*

Conversely, one submitter noted that they did not believe that New Zealand should be swayed by concerns or threats of disinvestment by multinational companies. They further state that if investors' presence in New Zealand depends on tax avoidance then it is questionable what value they add to New Zealand and whether their character should be welcomed, let alone encouraged by weak tax laws. *(New Zealand Council of Trade Unions)*

Comment

Officials acknowledge that, in some limited cases, the cost of investing in New Zealand will be increased because of the BEPS proposals without any change in New Zealand tax revenues. This argument is dealt with in detail in the 2016 joint Treasury/IRD paper *New Zealand's taxation framework for inbound investment*:³

There are more general arguments in favour of joining a multilateral effort to remove arbitrage possibilities (which are at the heart of many BEPS issues). When companies engage in BEPS, the result is that no tax is paid anywhere on a portion of income. This clearly leads to an inefficient allocation of investment internationally as cross-border investments are subsidised relative to domestic investments. Eliminating this

³ *New Zealand's taxation framework for inbound investment*, Policy and Strategy, Inland Revenue and the Treasury, June 2016 at 21.

misallocation would increase worldwide efficiency, leading to higher worldwide incomes. The best approach for New Zealand may be to co-operate with other countries in eliminating this worldwide inefficiency in the hope of gaining its share of this extra worldwide income.

Double non-taxation reduces company taxes worldwide. While there may be arguments that in certain circumstances the cost falls on other countries, it would be naïve to suggest that the cost never falls on New Zealand. Experience suggests that once taxation is eliminated in the residence country, source country taxation is placed at risk. For example, the BEPS-induced decline in US taxation of US residents' foreign-sourced income is often cited as a major reason for the increased focus on reducing source-country taxation by US multinationals. In that case, a general move to eliminate BEPS possibilities would make tax collections in all countries, including New Zealand, more secure and less vulnerable to unexpected tax planning.

Officials therefore consider that the proposed measures are in the best interests of New Zealand's economy.

Recommendation

That the submission be declined.

Issue: The package of reforms lacks coherence

Submission:

(Chartered Accountants Australia and New Zealand)

The submitter is of the view that the package of BEPS reforms in the Bill lacks coherence. They note that each major part appears to have been developed in isolation rather than as part of an overall package.

Comment

Officials agree that the measures in the Bill can be viewed as separate measures, however when taken as a whole address the various BEPS strategies that the Government is concerned with. Officials would refer to the diagram on page 4 as an indication of how the proposed measures fit together.

Recommendation

That the submission be noted.

Issue: Consultation on draft legislation

Submission:

(Corporate Taxpayers Group)

The Group had the opportunity to provide comments on aspects of the Bill in draft form. We found this process extremely valuable and welcome the opportunity to work further with Officials on these proposals. We believe that Officials would agree that this led to the positive refinement of aspects of the legislative drafting. The difficulty is that not enough time was afforded to this process. The Group was only able to review and comment on a limited number of aspects of the Bill and the consultation time period was constrained. There was not time to work through updated iterations of the Bill and in the Group's view this has meant that the overall quality of the Bill is not as high as it would have been if more time had been afforded to this process.

Comment

The submitter has requested that more draft legislation provisions be made available for consultation, and more time be allowed to review and comment on such material.

Officials agree that where appropriate to do so, and where time permits, consultation on certain draft legislative provisions should occur, in particular when dealing with complex or technical regulatory issues. Such targeted consultation is a very useful way to identify and resolve practical problems with complex legislation before being introduced to Parliament (as part of a wider policy consultation process).

To that end, it should be noted that the *Attorney-General's Protocol for Release of Draft Government Legislation outside the Crown* (CO (14) 4 refers) specifically allows for consultation on proposed wording for new or amended legislative provisions that a department prepares for consultation purposes as part of the policy development process.

Officials agree that, in respect of the consultation on this Bill that was able to be undertaken in the time permitted, this process did indeed lead to positive refinement to aspects of the legislative drafting.

Recommendation

That the submission and officials' comment be noted.

Interest limitation rules

OVERVIEW

The use of related-party debt to fund New Zealand operations is one of the simplest BEPS strategies. Interest payments are generally tax deductible in New Zealand. This means a related-party cross-border loan between a foreign parent and its New Zealand borrowing subsidiary will reduce taxable profits and therefore taxes payable in New Zealand. Of particular concern is that some firms have borrowed from their foreign parents at high interest rates resulting in large interest deductions in New Zealand.

The Bill proposes new rules requiring related-party loans between a non-resident lender and a New Zealand-resident borrower to be priced using a restricted transfer pricing approach. Under this approach, specific rules and parameters are applied to inbound related-party loans to:

- determine the credit rating of New Zealand borrowers at a high risk of BEPS, which will typically be one notch below the worldwide group's credit rating; and
- remove any features not typically found in third-party debt in order to calculate (in combination with the credit rating rule) the correct amount of interest that is deductible on the debt.

In response to submitters' concerns officials recommend a number of changes including increasing the allowable difference between the New Zealand borrower's credit rating and the worldwide group be extended to two notches provided the New Zealand borrower is a BBB- or higher credit rating.

The Bill also contains some amendments to New Zealand's thin capitalisation rules so they are better at protecting the New Zealand tax base from BEPS techniques. Thin capitalisation rules limit the amount of debt for which a foreign-owned subsidiary can claim deductions for interest paid. Interest deductions are generally denied to the extent the debt exceeds 60% of the subsidiary's assets.

Currently, debt percentages determined under the thin capitalisation rules are based on an entity's debt relative to its gross assets. A significant issue is that the current treatment of non-debt liabilities allows companies to have higher levels of debt (and therefore higher interest deductions) relative to the capital invested in a company by its shareholders. For example, at present if a company purchases some inventory on deferred payment terms, the amount of debt allowed under the thin capitalisation rules will increase (because the new inventory has increased its assets but its interest bearing debts have stayed the same). The Bill proposes to change this, so that debt percentages are based on an entity's assets net of its "non-debt liabilities".

The Bill also provides an exemption to the thin capitalisation rules for infrastructure projects which have little risk of BEPS activity. The exemption allows all of an infrastructure project's third party debt to be deductible even if the debt levels exceed the normal thin capitalisation limits, provided the debt only provides recourse against the assets associated with the infrastructure project and the income arising from those assets. The purpose of this rule is to improve the competitiveness in the bidding process for Public Private Partnership (PPP) procurement contracts by allowing investors that are subject to the thin capitalisation rules to make bids on a level playing field with investors that are not subject to the thin capitalisation rules.

The Bill's other thin capitalisation changes are as follows:

- introducing a de minimis in the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;
- new rules for when a company can use an asset valuation for thin capitalisation purposes that is different from what is used for financial reporting purposes;
- an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of a year to circumvent the thin capitalisation rules; and
- a minor remedial to clarify how the owner-linked debt rules apply when the borrower is a trust.

GENERAL

Issue: Support for rules

Submission

(Chartered Accountants Australia and New Zealand)

Chartered Accountants Australia and New Zealand in principle supports the proposals to prevent taxpayers from using excessive interest rates and debt volumes to shift profits out of New Zealand.

Comment

Officials note the support.

Recommendation

That the submission be noted.

Issue: The restricted transfer pricing rule should not proceed

Submission

(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Bankers' Association, PwC)

CA ANZ fully supports adjustments to the price of interest via the transfer pricing provisions. However we have significant concerns about the restricted transfer pricing rule that seeks to limit New Zealand interest deductions by reference to the parent company's actual or implied credit rating. This approach conflicts with recognised tax policy principles, is at odds with the approach in other jurisdictions, causes double taxation and is commercially difficult to apply. *(Chartered Accountants Australia and New Zealand)*

The restricted transfer pricing rule will be imposed unilaterally by New Zealand. It has not been implemented or otherwise proposed by any other jurisdiction. The restricted transfer pricing rule is a substantial departure from generally accepted orthodox transfer pricing approaches for determining arm's length interest rates on related-party loans.

The potential effect of such a rule needs to be carefully considered from a national welfare perspective. New Zealand adopting a BEPS position that is outside of the norm may provoke countermeasures that may adversely impact NZ multinationals operating in those jurisdictions.

Comment

Officials consider the restricted transfer pricing rule is broadly consistent with both the arm's length test and standard transfer pricing principles. These restrictions, which are limited to borrowers with a high BEPS risk, remove much of the subjectivity and manipulability from standard transfer pricing of related party interest but are still aimed at determining an

appropriate interest rate that would apply if the New Zealand borrower had borrowed from a third party.

There is now widespread acceptance by most of New Zealand's trading partners that standard transfer pricing does not result in appropriate outcomes when applied to related party debt. The OECD, as part of its BEPS Action 4 report recommended the introduction of an earnings before interest, tax depreciation and amortisation (EBITDA)-based rule to limit interest deductions. The European Union issued a directive in July 2016 that all member states must adopt an EBITDA-based interest limitation rule by 31 December 2018. The United Kingdom and United States are also introducing similar measures.

While the restricted transfer pricing rule is a departure from the OECD (EBITDA)-based rule officials consider the New Zealand approach avoids some of the issues inherent in the OECD's recommendation. Many of the concerns raised by submitters, such as the risk of double taxation, are also present in an EBITDA rule and it would be more difficult to introduce many of the safeguards that the restricted transfer pricing rule includes. The European Union directive also allows member to states to introduce other targeted rules against intra-group debt financing.

Officials note that Australia has now proposed a rule denying an interest deduction where the lender is a related party in a low tax country and certain other conditions are met. Officials are yet to review this rule and consider its appropriateness in the New Zealand context. For the purposes of the current debate, it is significant in demonstrating that our nearest neighbour is also concerned about deductions for related party interest expense, and does not believe that its thin capitalisation and transfer pricing rules are themselves sufficient to deal with the base erosion issue such deductions present.

Recommendation

That the submission be declined.

Issue: Existing legislative tools are sufficient

Submission

(BNZ Bank, Corporate Taxpayers Group, Powerco, PwC, Russell McVeagh)

The existing legislative tools available to Inland Revenue (for example sections BG 1 and GB 2) can be applied to target those specific situations where excess deductions are being claimed. These targeted measures are less likely to have an adverse impact on compliant taxpayers, than the proposed restrictions on the existing transfer pricing rules. *(BNZ)*

The proposed rules achieve nothing that could not be more appropriately achieved through the proper application and enforcement of standard transfer pricing practice. In particular, with the introduction of reconstruction provisions as part of the Bill, the need for the proposed restrictions is unclear. *(Corporate Taxpayers Group)*

It would be strongly preferred to have guidelines rather than legislation which help taxpayers determine an appropriate rate (we understand this is the approach of the Australian Tax Office). *(Powerco)*

The rules are unnecessary to address Inland Revenue's concerns about excessive interest expenditure deductions given other amendments being proposed in the Bill. (*Russell McVeagh*)

Comment

Relying on existing transfer pricing and anti-avoidance rules, as suggested by submitters, will not necessarily achieve the desired policy outcomes.

The international consensus is moving away from using ordinary transfer pricing to limit interest expenses in relation to related party debt. Concerns over highly-priced related party debt were part of what was behind the OECD's recommended interest limitation rule based on EBITDA. Interest denial could result under an EBITDA rule even if the interest expense is determined by the arm's length standard.

The detail of the transfer pricing rules are "soft law". They are contained in the OECD transfer pricing guidelines to support the application of tax treaties. Most countries rely on them to solve transfer pricing issues even in the absence of a treaty. The transfer pricing guidelines take the form of guidance rather than set rules. Officials consider that, once amended as proposed in the Bill, the transfer pricing rules will work well for non-debt items. However, because of the significant BEPS risks associated with related-party interest payments, we consider that the rule for such payments needs to be stronger, less subjective, and less open to interpretation. We note, for example, the Australian Taxation Office has stated that the recent Chevron case in Australia had cost them \$10 million in external experts (not taking into account the cost of their own staff) even though it involved related-party interest of about 9% when the parent had raised external funding at a rate of about 2%.

In addition, transfer pricing does not adequately take account of the fact that related-party debt financing is fundamentally different to third-party debt financing. For example, subordinated debt is less likely to be repaid compared to senior debt, and so carries a higher interest rate. This is appropriate in a third-party context: the higher interest rate compensates for the higher risk. However, in a related-party context, debt and equity are highly substitutable. The riskiness of a parent's investment in a subsidiary does not change whether it invests through equity (which would generate no deduction) or debt. We do not consider that related-party debt being subordinate to other debt should justify a higher interest rate.

Recommendation

That the submission be declined.

Issue: Restricted transfer pricing rule may not meet the internationally accepted arm's length principle

Submission

(*ANZ, ASB Bank, BNZ, Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, EY, KPMG, New Zealand Bankers' Association, OliverShaw, Powerco, PwC, Russell McVeagh*)

The proposed restricted transfer pricing rules will require taxpayers to alter the terms and conditions of certain related party lending, or the circumstances of the borrower itself, in determining an arm's length price. Requiring taxpayers to step away from the actual terms and

circumstances of a loan in determining the interest rate, raise a significant risk that the resulting pricing may not meet the internationally accepted arm's length principle, which the overseas revenue authorities will generally be applying. This may result in the respective tax authorities being unable to agree on the appropriate pricing of the transaction, and therefore significantly increase the likelihood that taxpayers will face double taxation.

The interest limitation rule is inconsistent with our double tax treaties – OECD Model Convention Article 7 (as it was prior to the 2010 update that New Zealand has not adopted and Article 24 Non-discrimination). The result would be that the legislation would be overridden by the treaties and these proposals will not apply as the Treaties apply an arm's length test.

Comment

We do not agree with the argument that the restricted transfer pricing rule is systematically inconsistent with the arm's length standard. On the contrary, we consider the rule will generally be consistent with the standard because of the transfer pricing concept of "implicit parental support". "Implicit parental support" is the notion that a foreign parent will stand behind a New Zealand subsidiary in the event of a default. That is, multinational groups generally do not let their local subsidiaries go under. "Implicit parental support" is a significant factor in transfer pricing analysis because it hypothesises that, as a commercial matter, it would affect what rate a third party lender would charge the New Zealand subsidiary and what that subsidiary would be prepared to pay. Accordingly, the credit rating of the foreign parent is a strong element in determining the credit rating of the New Zealand subsidiary.

Inland Revenue administers transfer pricing having regard to the concept of implicit parental support but some taxpayers do dispute it.

We acknowledge that there may be cases when the restricted transfer pricing rule would not produce an arm's length interest rate because, for instance, the New Zealand subsidiary is in a completely different line of business from the rest of the multinational group and has a different risk profile. Nevertheless, we do not accept that in these cases the restricted transfer pricing rule would frequently result in double taxation. This is partly because the cap is not arbitrary (unlike the EBITDA test recommended by the OECD and rejected by submitters in previous consultation). Moreover, in our view, the shift in the international consensus makes it less clear that our treaty partners (especially Australia) would dispute the result of the restricted transfer pricing rule under a treaty.

Recommendation

That the submission be declined.

Issue: Rebuttable safe harbour

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, OliverShaw, PwC)

Many of the problems with the presumed credit rating rules could be more simply addressed by legislating the highest credit rating of a member of the borrower's worldwide group as a

rebuttable factor in determining the credit rating of the New Zealand borrower. Rules that force a presumed credit rating will have neither commerciality nor international acceptance.

Comment

Much of the problem with applying standard transfer pricing principles to related party debt is the subjectivity of the analysis which results in highly qualified experts on both sides debating the accuracy of opinion and not facts. Given the large size of some related party loans even small differences in an interest rate can make a large difference to the amount of deductible interest.

The problem with applying the restricted transfer pricing rule as a safe harbour, as the submitters has suggested, is it will result in the rule being ineffective as all taxpayers would argue they had commercial justification why the rule could not be applied to them.

Instead the rule has been designed with a number of exceptions to reflect commercial considerations. For example:

- The rule will not apply to taxpayers with less than \$10 million of related party cross-border loans
- The rule will not apply to taxpayers that have less than 40% debt unless they are borrowing from a low tax jurisdiction
- Recommendations elsewhere in this report will allow a high BEPS risk borrower to base their credit rating on third party debt. Related party debt can be up to four times the size of third party debt so only 20% of debt would have to be from a third party.

Officials are not aware, and submitters have not provided, any further objective measures that could be used to justify a departure from the proposed linkage to the parent's credit rating for a high BEPS risk borrower with an identifiable parent.

Recommendation

That the submission be declined.

Issue: Rationale used to justify restricted transfer pricing approach

Submission

(EY)

The rationale used to justify the restricted transfer pricing rule, based on the parent company cost of funding is flawed.

The parent cost of funding does not typically represent the cost of borrowing to a standalone borrower in a group given the different asset and hence credit profiles. A third party would only lend to a standalone New Zealand subsidiary at the parent's cost of borrowing where the New Zealand subsidiary is considered a core investment to the group (that is, full implicit support equates to an explicit guarantee) or the parent company gives an explicit guarantee.

In our experience, few New Zealand subsidiaries are considered core or highly strategic to a group and a guarantee from a stronger party comes at a cost to the borrower which takes the total cost of borrowing closer to a company's standalone situation.

Comment

The restricted transfer pricing rule recognises that a New Zealand borrower (other than an insuring or lending person) will frequently have a slightly lower credit rating than their foreign parent. This is the reason the New Zealand borrower is allowed to be one notch lower than the group rating and why officials are recommending in this report that this be extended to two notches for borrower that have a rating of BBB- or higher.

While a New Zealand borrower, if it was a standalone entity, may have a credit rating that was lower than their foreign parent this would only be true if implicit parental support was not included. The international consensus, as demonstrated by the 2017 OECD transfer pricing guidelines, is that implicit parental support must be included. The relevant extracts of these guidelines were included in the Commentary to the Bill.

The restricted transfer pricing rule is attempting to codify implicit parental support and remove the subjectivity and manipulability inherent in the current approach to transfer pricing of related party debt.

Recommendation

That the submission be declined.

Issue: Group credit rating approach should not proceed

Submission

(KPMG)

If the restricted transfer pricing rule proceeds the group credit rating approach should not be used. Instead each New Zealand borrower should be able to apply either the standalone credit rating approach in proposed section GC 16(7) or the restricted credit rating approach in proposed section GC 16(8).

Using the ultimate parent's credit rating as the starting point to derive an interest rate on New Zealand inbound debt is not economically correct. This implies that the New Zealand subsidiary has a similar business profile to that of the parent in all cases, which is often not the case with global multinationals. Typically, the New Zealand operations of foreign multinationals are often several multiples smaller and will typically comprise a single function or asset or, at the very most, a less diverse set of functions or assets when compared to the ultimate parent. Often entities within the group have much higher risk profiles than others, based on these features.

Instead, a transfer pricing approach for cross-border related party loans which starts with the borrower's credit rating is more in line with the arm's length principle. Not only does it have regard to the credit quality of the specific borrower, but it provides flexibility to notch the borrower's standalone credit rating upwards to reflect the specific circumstances of that company and its position in relation to the wider group.

Comment

As discussed in other items in this report, officials accept that a New Zealand borrower, if they were truly standalone, may have a lower credit rating than their foreign parent. However, this does not acknowledge the implicit parental support provided by being a member of the worldwide group. This support has been internationally accepted, for example in the 2017 OECD transfer pricing guidelines. It is often the degree of this implicit support, and the effect that has on an interest rate, that is the subject of most of the disagreement between taxpayers and Inland Revenue. The restricted transfer pricing rule is designed to remove this subjectivity by inserting non-manipulable objective rules that reflect the level of support a worldwide group provides to their New Zealand subsidiary.

The restricted credit rating in GC 16(8) has been introduced for borrowers that are controlled by a co-ordinated group as there is no identifiable parent from which to benchmark an appropriate credit rating. This approach removes some of the problems with applying general transfer pricing rules to related party debt but would not resolve disagreements over the level of implicit support if it were applied more widely to borrowers with an identifiable parent.

Recommendation

That the submission be declined.

Issue: Defer until further OECD research completed

Submission

(Corporate Taxpayers Group)

It is premature for New Zealand to impose a restricted transfer pricing rule and it would be advisable to defer any action until we see the outcome of the OECD's research and can review any multilateral recommendations.

Comment

The restricted transfer pricing rule has been developed in response to the OECD recommendations under Action 4 and attempts to achieve the purpose – to limit excessive related party interest deductions. Introducing the restricted transfer pricing rule at this time aligns with the Government's other responses to BEPS included in this Bill. Officials will continue to monitor future developments whether further legislative or other responses are necessary but this does not negate the importance of the restricted transfer pricing rule.

Recommendation

That the submission be declined.

Issue: Inconsistency with the approach taken in Australia

Submission

(PwC)

The Government has noted that it is important that New Zealand's transfer pricing rules are aligned with Australia's to reduce compliance costs and the risk of double tax with one of our key trading partners. We agree that this is of critical importance, and are concerned that adopting the restricted transfer pricing (RTP) rule would be inconsistent with the approach taken by the ATO.

Consistent with international consensus, Australia adopts the arm's length principle in its transfer pricing legislation and its approach to related party debt pricing. The ATO has supplemented the application of the arm's length principle with a Practical Compliance Guideline (PCG 2017/4), which sets out a risk assessment framework for related party debt.

This approach is much more preferable to the RTP rule in a number of important respects:

- The approach is not embedded in legislation, but rather is a supplementary guide that allows taxpayers to assess risk and enter into transactions accordingly;
- Using appropriate third party comparables (including traceable third party debt) as a starting point is a key feature of the PCG;
- The risk factors are similar to those identified by the Government, but are less stringent (e.g. leverage ratios of 60% rather than 40% representing high risk) and are able to be updated, as and when appropriate to reflect changing market conditions;
- Credit ratings are not prescribed; and
- The approach applies to both inbound and outbound debt.

Comment

The approach taken by Australia is, as noted by the submitter, broadly similar to New Zealand with the main difference being Australia's approach is a risk assessment framework rather than legislation. The issue with the Australian approach is that if a taxpayer is brought to the ATO's attention by failing their framework the ATO is still required to determine an appropriate price under standard transfer pricing rules – which have been internationally acknowledged as not being sufficient when applied to related party debt. While the Australian approach is likely to reduce the number of disputes, by taxpayers reducing their risk factors (as officials expect will also occur in New Zealand), for the disputes that do occur the PCG will not assist in reducing the uncertainty, cost and complexity of these disputes for either taxpayers or the ATO.

Some of the submitters' other points, for example the use of third party comparables and the 40% debt percentage are addressed elsewhere in this report as they are not specific to a New Zealand and Australia comparison.

New Zealand officials have discussed the restricted transfer pricing rule with Australian officials and are confident that the two approaches are sufficiently similar that double taxation is highly unlikely to occur. As noted elsewhere in this report if this were to occur the Mutual Agreement Procedure will continue to be available for these limited number of cases.

Recommendation

That the submission be declined.

Issue: Withholding Tax

Submission

(BNZ Bank, KPMG, PwC)

There were varying submissions on this point.

As proposed in the Bill, New Zealand withholding tax (or Approved Issuer Levy) would continue to apply to the actual interest payments made, regardless of the amount of interest deemed to be deductible under the restricted transfer pricing rules. This position appears to be inconsistent – either the payment is interest, in which case it's deductible, or it is something else and should be taxed accordingly.

A conceivable argument is that the amount by which the interest payment exceeds the deductible interest under the restricted transfer pricing rules is a transfer of value and is therefore a dividend. If this view is adopted, it is more appropriate for withholding tax to apply on the basis that the deduction that is available under the restricted transfer pricing rule is interest and should be subject to New Zealand tax (or levy) as appropriate. The excess interest payment is a dividend.

Taxpayers who have been denied a deduction for the interest payable under a financial arrangement ought to be able to treat that excess amount as a dividend, including attaching imputation credits and calculating withholding tax due under the dividend withholding tax rules. *(BNZ)*

We support the extension of the non-deductible treatment applied to interest denials under the current thin capitalisation rules. That is, any non-permissible (i.e. non-deductible) interest under the restricted transfer pricing rule should still constitute interest for non-resident withholding tax (NRWT) purposes and not a deemed dividend. *(KPMG)*

There is no reduction in NRWT where interest deductibility is denied. If an amount of interest is not deductible, and it is also subject to NRWT on the full interest rate, New Zealand is overtaking the interest. This outcome is not appropriate and will be detrimental to New Zealand's reputation as a favourable place to invest. We strongly submit that NRWT is not imposed for interest deductions that are denied under the restricted transfer pricing rule. *(PwC)*

Comment

Related party interest payments are already subject to the transfer pricing rules and thin capitalisation rules therefore interest denial is already a feature of the existing rules. The restricted transfer pricing rules supplement the existing rules so that an adjustment may be required more frequently or to a larger amount but the denial of interest deductions in itself is not a new concept. The Income Tax Act 2007 already covers this issue in section GC 11 and GC 12 and officials consider this is the correct position.

Recommendation

That officials' comments be noted.

Issue: Application date drafting

Submission

(EY, PwC)

Clauses 35(8) and 37(2) state that the interest limitation rules are to apply “on and after the first balance date of the person...on or after 1 July 2018, for a financial arrangement that the person enters before the first balance date...”.

For example, assuming a 31 December balance date and a loan entered into on 1 January 2017, the interest limitation rules would apply on 31 December 2018 and thereafter. It would not seem to be a policy intent that the interest limitation rules apply for the last day of an income year and thereafter.

Consistent with the broader changes to the transfer pricing rules, the application date proposed in clauses 35(7) and 36(6) is income years beginning on or after 1 July 2018. Therefore in the example above, the rules would apply from 1 January 2019 for the whole of the 2020 income year. *(EY)*

The term “balance date” is not defined and drafting is complicated. Drafting should refer to income years as per other sections dealing with enactment dates, or balance date defined to mean balance date for tax purposes. *(PwC)*

Comment

It was not intended that the interest limitation rules would apply to an existing loan from the last day of the income year finishing on or after 1 July 2018 and instead they should apply from the first day of the income year starting on or after 1 July 2018. Officials recommend drafting changes to these application clauses to ensure the rule apply correctly.

Recommendation

That the submission be accepted.

Issue: Restricted transfer pricing de minimis

Submission

(Chartered Accountants Australia and New Zealand)

We support the inclusion of a de minimis but submit that it should be increased from \$10 million to \$20 million. A de minimis should be set at a level where interest deductions are material and the associated compliance costs are warranted.

Comment

There are two de minimis thresholds in the proposed restricted transfer pricing rules in section GC 16(1)(a) for the credit rating adjustment and GC 18(1)(a) for the loan feature adjustment. Both of these are set at \$10 million of cross-border related loans.

These thresholds are consistent with the existing administrative guidance issued by Inland Revenue in relation to transfer pricing of related party finance costs which endeavours to strike a balance between protecting the tax base and containing compliance costs. This guidance includes that “[F]or all loans in excess of the \$10m guideline above, we expect far more science and benchmarking to support interest rates applied”.

This guidance is available at:

<http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html>

The \$10 million threshold for administrative guidance was only set on 1 July 2014 and there has not been significant inflation since that time. Officials consider a \$10 million de minimis appropriately balances compliance costs with the risk of excessive interest rates materially affecting taxable income.

Recommendation

That the submission be declined.

Issue: Grandparenting existing loans

Submission

(Chartered Accountants Australia and New Zealand, KPMG)

A grandparenting provision should apply to existing related party loans. A limited grandparenting provision is proposed for the worldwide debt threshold for non-residents acting together. Barring this exclusion, once the restricted transfer pricing rule takes effect it will apply to existing related party cross border financial arrangements. The exclusion of a grandparenting provision is contrary to stated policy on prospective and retrospective tax law changes and grandparenting.

All cross border related party loans in place as at the date of introduction of the Bill should be grandparented for a maximum period of five years from the date of the Bill. *(KPMG)*

Comment

The restricted transfer pricing rule is proposed to apply prospectively to income years starting on or after 1 July 2018. Although this will also apply to arrangements entered into before that date it will not change any tax positions for prior periods. The restricted transfer pricing rule will ensure that the price and features of related party debt is appropriate and it therefore is reasonable to apply this to borrowers that are a high BEPS risk on a prospective basis.

Recommendation

That the submission be declined.

Issue: Mutual Agreement Procedure

Submission

(Corporate Taxpayers Group)

In the event taxpayers are subject to double taxation they may seek resolution under our double tax agreements (DTAs) through the Mutual Agreement Procedure (MAP). Where a New Zealand taxpayer invokes the MAP provisions, Inland Revenue will bear the onus of proving to the corresponding jurisdiction that any transfer pricing adjustment ultimately made correctly applies the arm's length principle. Accordingly, rather than the intended simplification suggested in the commentary to the Bill, diverting from the arm's length principle will render this process more complicated and resource intensive, if not impossible to resolve double taxation imposed on taxpayers.

Comment

As noted by the submitter the Mutual Agreement Procedure will be available for any situations where New Zealand and other revenue jurisdictions do not arrive at the same price for related party debt. Officials do not expect this process to be frequently utilised as they expect taxpayers will remove unnecessary features and other terms that increase the interest rate on this debt so that the borrower is no longer a high BEPS risk or even where they are a high BEPS risk the restricted transfer pricing rules arrive at the same price as under standard transfer pricing principles. In this circumstance no risk of double taxation arises.

Recommendation

That the submission be noted.

Issue: Application to thin cap groups

Submission

(Corporate Taxpayers Group)

We are strongly of the view that the ambit of the restricted transfer pricing rule be limited to transactions subject to the transfer pricing rules (which is what the Bill does). We are pleased to see that a wider application, as originally proposed in the Discussion Document and which the Group opposed, has not proceeded. In our view this is appropriate as the rule has been suggested as a solution to over-priced debt which is a transfer pricing issue.

Comment

Officials do not agree that the restricted transfer pricing rule be limited to transactions subject to the transfer pricing rules as this would create the ability for certain groups to structure to avoid the restricted transfer pricing rules by varying the rights attached to shares and thereby charge inappropriate interest rates that are not comparable to those paid by more compliant businesses. Further discussion on this point is elsewhere in this report.

Recommendation

That the submission be declined.

Issue: Second transfer pricing analysis required

Submission

(EY)

A single transfer pricing analysis is currently undertaken to justify the arm's length conditions of a loan for both borrower and lender. As the restricted transfer pricing rule does not necessarily comply with article 9 and OECD principles, a second transfer pricing analysis will likely be required for a lender to justify the amount the lender's country would accept as arm's length.

Comment

A large reason for these rules is the inclusion of extra debt, terms and features within related party debt that would not be present in third party debt. The exclusion of these features will result in a price that would arise in an arm's length situation. Where the borrower is not a high BEPS risk and does not include disregarded features in the loan only a single transfer pricing analysis will be required to determine an arm's length price appropriate to both jurisdictions. Officials expect taxpayers will reduce the level of debt and other features so that related party debt is more comparable with what could have been borrowed from a third party so that a single transfer pricing analysis will result in an arm's length price acceptable to New Zealand and the lender jurisdiction's revenue authority.

Recommendation

That the submission be declined.

Issue: Asymmetric application of rules to inbound and outbound loans

Submission

(EY, PwC)

The restricted transfer pricing rule is being applied asymmetrically to inbound loans and not to outbound loans. The same transfer pricing rules should apply in New Zealand to a transaction whether a New Zealand party is a supplier or recipient of goods, services or money.

There is no rationale for treating inbound debt and outbound debt differently. Australia's transfer pricing rules do not differentiate between inbound and outbound related party dealings, and the ATO's practice guidance on related party funding arrangements explicitly applies to both. New Zealand's differentiating approach will result in a lack of understanding between Inland Revenue, offshore tax authorities and affected international groups (in turn resulting in increased uncertainty and compliance costs for all).

Comment

While the primary focus of the BEPS reforms is on foreign-owned businesses, similar base protection considerations can arise where New Zealand-owned businesses have offshore operations. For this reason New Zealand's international base protection measures (such as the thin capitalisation rules and the transfer pricing rules) apply to both foreign-owned and domestically-owned businesses.

Officials are not aware of any concerns regarding the pricing of outbound related party loans that would require a similar restricted transfer pricing approach to be applied to outbound loans. Officials will continue to monitor the transfer pricing of outbound related party loans to identify whether any issues arise in the future. Any such proposals, if they were considered to be necessary, would need to be subject to consultation under the Generic Tax Policy Process.

Recommendation

That the submission be declined.

Issue: Pricing date for existing loans

Submission

(KPMG)

Interest rates on existing cross-border related party loans should be calculated by determining the interest rate that would have applied at the time the loan was entered into, had the new restricted transfer pricing rules been in force at the time.

Comment

Officials agree that the restricted transfer pricing rules, where they apply to existing loans, should reflect the fact that the cross-border related party loan was legally entered into at an earlier date and would have been priced based on the creditworthiness and market conditions in effect at that time.

While this was always the intention, officials agree that this position could be clearer in the legislation. Officials recommend drafting changes to clarify that existing loans should be priced at the date they were entered into rather than the date the new rules apply.

Recommendation

That the submission be accepted.

Issue: Interaction with wider transfer pricing rules

Submission

(Corporate Taxpayers Group, EY, PwC)

It is problematic that the Bill also proposes to give legislative force to the OECD guidelines. Proposed section GC 6(1B) will provide for New Zealand's transfer pricing rules to apply "consistently" with the OECD guidelines, while proposed sections GC 15 to GC 18 will provide for a methodology in respect of certain related party debt that is inconsistent with the arm's length standard on which those OECD guidelines are based. *(Corporate Taxpayers Group)*

The restricted transfer pricing rules are inconsistent with the general requirement to establish transfer prices based on arm's length conditions. Section GC 13 requires the determination of

an arm's length amount of consideration for a transaction to produce a reliable measure of the amount that independent parties would have agreed upon under arm's length conditions. The altered conditions on the related party loan brought about by sections GC 15 to GC 18 would not necessarily satisfy section GC 13(4) as being conditions that would be agreed between independent parties. The proposed legislation would also seem to require that any conditions imposed by sections GC 15 to GC 18 could in turn be replaced with other conditions that meet the arm's length test in section GC 13. *(EY)*

The restricted transfer pricing rule had originally been included as part of the proposed changes to the thin capitalisation regime rather than the domestic transfer pricing regime. This was strongly opposed during the earlier submission phase and the drafting is not included as an addition to the general transfer pricing regime, which is the correct approach if specific legislative change is required in this area. However, given its origin, there has not been enough consideration to the application of the proposed general transfer pricing rules to be able to address the Government's stated policy concerns and the likely impact of having the restricted transfer pricing rule as well – which is a unilateral and untested approach that other countries such as Australia are not adopting. *(PwC)*

Comment

During the earlier submission phase the equivalent of the restricted transfer pricing rule was proposed to be situated in the thin capitalisation rules as they both had the same purpose – to limit excessive interest deductions. However in determining the final version of the rules it was decided these interacted more closely with the general transfer pricing rules so should be situated accordingly. Officials note the submitter's support for this decision.

The restricted transfer pricing rule has been developed in coordination with the transfer pricing changes that are also included in the BEPS Bill. Officials consider the restricted transfer pricing rule interacts consistently with the general transfer pricing rules. For example, if a New Zealand borrower structured to achieve a credit rating of BB but the restricted transfer pricing rule required this borrower to have a credit rating of BBB, the general transfer pricing rules would follow the same methodology and arrive at the same result as an otherwise identical borrower that had a credit rating of BBB without the application of the restricted transfer pricing rule.

Recommendation

That the submission be declined.

Issue: The drafting of the restricted transfer pricing rule is too complicated

Submission

(PwC)

There are a number of key aspects that should be simplified to reduce the scope for error in application, and to ensure the intended policy objectives are achieved. In particular:

- when the rule applies (proposed sections GC 6(1C) and GC 15) particularly outside wholly-owned groups;
- clarification of (a) the interaction of the concepts “acting together”, “acting in concert”, “control group” and “non-resident owning body” – each of these terms are complicated in

their own right, let alone when they need to be interpreted together, and (b) how broad the terms are intended to be – for example clarity is needed as to whether securitisation vehicles, unit trusts and private equity funds are caught in the rules;

- simplifying what the safe harbours/exceptions are and extending when they can be used;
- determining the credit rating to be applied (including whether all members of a group must be credit rated); and
- whether the term of a loan over 5 years needs to be adjusted for transfer pricing purposes.

Comment

Many of these themes were also raised by other submitters and have been addressed separately in this report. In response to the specific queries raised by the submitter:

- Sections GC 6 and GC 15 are recommended to be partially redrafted, as supplied to submitters on 22 February 2018, which will remove and simplify the multiple application tests that are in the Bill as introduced. A copy of this proposed redrafting was provided to all submitters on the Bill with the opportunity for further submissions which have been incorporated into the final version recommended by officials.
- The acting together, acting in concert, non-resident owning body terms have previously been used in either legislation or official’s documentation and the application to the interest limitation proposals is not intended to change this. Officials are recommending a number of changes to simplify this, particularly in relation to proposed sections GC 5 and GC 6 where the worldwide debt test for groups acting together has been reduced from 110% to 100%.
- By removing the borrower’s credit rating proposed in section GC 16(7) of the Bill and returning these borrowers to the general transfer pricing rules this will simplify the use of the safe harbour.
- It was never intended that a group be required to obtain a credit rating for all members of that group. Recommendations in this area will ensure this requirement only applies to a single member of that group.
- Changes are recommended to the over 5 year term formula to ensure it operates correctly.

Recommendation

That the submission be noted.

Issue: Duplication of terms

Submission

(PwC)

A number of the requirements in section GC 15(3) are already covered by requiring that there be a “transfer pricing arrangement”, which in turn requires a “control group”. A transfer pricing arrangement may not include an indirect associated funding arrangement” so it is not clear how GC 15(3)(a)(ii) fits into the statutory scheme.

Comment

Officials agree that the drafting of section GC 15(3) as well as its interaction with GC 6(1C) and GC 15 created uncertainty through the use of multiple application tests with different terminology. Officials recommend a number of drafting changes to these sections to clarify their application as discussed elsewhere in this report.

Recommendation

That the submission be accepted.

Issue: Cross-border related party loans taxable within New Zealand

Submission

(Westpac)

Interest income on funding advanced to New Zealand subsidiaries via the New Zealand or foreign branches of an overseas entity is taxable in New Zealand either as part of attributed New Zealand branch profits or under the source rules in section YD 4(11)(b)).

It would be wrong to restrict the interest deductibility of cross-border loans where the corresponding income is also returned for New Zealand tax purposes given there is no loss to the New Zealand tax base. Under the proposed rules, a taxpayer would be required to rely on the Commissioner of Inland Revenue to exercise her discretion under section GC 11 to make a corresponding adjustment to the income recognised. A corresponding adjustment in these circumstances should be automatic and should not require discretionary approval, which would create uncertainty, delay and cost for the taxpayer.

Cross-border related party loans should be automatically exempted from the new rules where the corresponding loan interest income of the overseas loan holder is returned for New Zealand tax purposes.

Comment

The purpose of the restricted transfer pricing rules is to ensure an appropriate interest rate is charged on cross-border related-party loans. In a limited number of circumstances these interest deductions may be matched by income of the non-resident or branch. As noted by the submitter section GC 11 allows discretion for the corresponding income to receive a matching treatment.

Even where an adjustment to a cross-border deduction is matched by an adjustment to cross-border income, officials consider it is appropriate for this loan to be priced consistent with the restricted transfer pricing approach. For example ensuring this loan is priced appropriately supports the analysis as to whether an anti-avoidance rule may apply to the overall arrangement.

Where a cross-border related party loan is back-to-back or reflected in the features of a third party loan the restricted transfer pricing rules contain a number of provisions to ensure this pricing is reflected in the related-party transaction.

Officials consider it is appropriate for the restricted transfer pricing rules, including the various exemptions, to apply to cross-border related party loans where the corresponding interest income of the overseas loan holder is returned for New Zealand tax purposes.

Recommendation

That the submission be declined.

Issue: Minor drafting issues

#	Section	Submitter	Submission	Response
1.	FE 6(3)(e)(iiib)	Corporate Taxpayers Group	Clause 19(4) inserts proposed section FE 6(3)(e)(iiib). This should be FE 6(3)(e)(iv).	Section FE 6(3)(e)(iv) already exists. Proposed section FE 6(3)(e)(iiib) is not a replacement of this section and is intended to be inserted between existing sections FE 6(3)(e)(iii) and (iv) therefore the numbering in the Bill is correct.
2.	FZ 8(5)	Corporate Taxpayers Group	The transition period for the grandparenting of the worldwide group acting together test applies for a period beginning from the first balance date after 1 July 2018. Is this intended to be the end of the first full income year beginning after 1 July 2018? i.e. if a taxpayer had a September balance date, you would count from 30 September 2019 not 30 September 2018.	The amendments to the worldwide group test for acting together apply from the first income year after 1 July 2018 so the transition period should match this. For a taxpayer with a September balance date the transition period should start on 1 October 2018. Officials recommend drafting changes to achieve this.
3.	GC 6(1C)	PwC	Section GC 6(1C) is unnecessary and should be removed as it is poorly drafted.	Elsewhere in this report officials recommend the removal of proposed section GC 6(1C) as part of a package of amendments that clarifies the application of the restricted transfer pricing rules.
4.	GC 15(1)	PwC	Section GC 15(1) is unclear in its reference to providing funds to a “group of persons”.	While a group of persons can provide funds to a person it would not be normal for a person or group of persons to provide funds to a group of persons. In this instance each borrower would be treated as having a separate loan. Officials recommend this reference is removed.
5.	GC 16(1)(b)(i)	PwC	The cross reference in section GC 16(1)(b)(i) seems wrong.	Section GC 16(1)(b) applies only to co-ordinated groups and subsection (i) requires that section GC 16(1)(d) does not apply. As GC 16(1)(d) applies to borrowers not controlled by co-ordinated groups subsections (b) and (d) can never apply to the same borrower anyway. Therefore the cross-reference to paragraph (d) can be omitted.
6.	GC 16(1)(b)(iii)	PwC	It is unclear why sections GC	This wording was included to provide for a situation where a

#	Section	Submitter	Submission	Response
	and (e)(iii)		16(1)(b)(iii) and (e)(iii) references to “each lender”. If one lender does not meet criteria, is the borrower a high BEPS risk for all of its related-party debt? It should just be for that loan.	single loan is provided by more than one person and they are in different jurisdictions. This wording is not intended to extend the scope to other related-party loans which would continue be individually considered.
7.	GC 16(1)(b)(iii) and (e)(iii)	Corporate Taxpayers Group	The reference to the lender’s “ultimate parent” in section GC 16(1)(b)(iii) and (e)(iii) is not adequately defined. This is linking to FE 34 which applies only to registered banks.	Officials agree that the definition of “ultimate parent” in section YA 1, which references to FE 34, applies only to registered banks. However, subparagraph (2) of that section provides a definition that could be usefully repurposed more generally. This would be a company – <ul style="list-style-type: none"> • That has an ownership interest in the lender of 50% or more; and • In which no other company that has an ownership interest in the lender of 50% or more has an ownership interest. Officials recommend drafting changes to clarify this treatment.
8.	GC 16(1)(c)	Corporate Taxpayers Group	Should “controlled by a co-ordinated group” in section GC 16(1)(c) be a defined term?	This is already defined as a nonce term in section GC 16(1)(b).
9.	GC 16(1)(d)(ii)	EY, PwC	Section GC 16(1)(d)(ii) should refer to a borrower electing to use a credit rating given by GC 16(9) rather than GC 16(7)	Officials agree. However, this issue will be superseded by the recommended changes to the borrower’s credit rating recommended elsewhere in this report.
10.	GC 16(1)(d)(ii)	Corporate Taxpayers Group	The use of “made when or before” in section GC 16(1)(d)(ii) is unusual wording.	The intention of this provision is a borrower who is above the \$10m de minimis can elect to use the group credit rating. This can be done in the return of income that includes the interest deduction or at an earlier date when they determine the interest rate on the loan. The current wording does not achieve this and officials recommend drafting changes to correct this.
11.	GC 16(1)(e)(ii)	PwC	It is not clear what is required by GC 16(1)(e)(ii). If a borrower has a 60% ratio but only 100% worldwide debt percentage, is the requirement met? We assume this is the intention.	It is only necessary for a borrower to meet either the 40% debt percentage or be within 110% of the worldwide group. In the submitters example as the borrower is less than 110% of their worldwide group they would still meet the requirement despite having a 60% debt percentage. Officials consider no

#	Section	Submitter	Submission	Response
				amendment is necessary to achieve this.
12.	YA 1	PwC	The amended definition of related-party debt is unclear – the only definition of related-party debt is in RF 12H(1) so beginning words of paragraph (a) and para (b) should be removed.	Although RF 12(1) provides the definition of related-party debt this is restricted to not apply to banks by section RF 12(2). This restriction is necessary for the NRWT rules but not the restricted transfer pricing rules therefore the amended definition ensures that banks can have related-party debt for the purpose of the restricted transfer pricing rules. No further amendment is necessary.

Recommendation

That the officials' recommendations, as shown above, be accepted.

APPLICATION TO THE SAME GROUPS AS THIN CAPITALISATION

Overview

Officials have become aware that as the Bill is drafted, the use of the general transfer pricing ownership threshold means this rule does not apply as widely as was intended. Officials recommend that in line with the stated policy intention, the ownership threshold is changed to align with that in the thin capitalisation rules, which also deal with the issue of interest deductibility.

In short, as the Bill is drafted, the restricted transfer pricing rule applies where a person or group holds 50% or more of the voting interests in a New Zealand company. Voting interests are the average percentage a person holds of four shareholder decision-making rights in a company. Officials recommend that ownership should be calculated using the same approach taken in determining whether the thin capitalisation rule applies. This means it will be calculated:

- a) taking into account of non-voting shares and rights to receive distributions of income or capital, as well as voting interest;
- b) in determining a person's voting interests, it is the highest of the shareholder decision making rights that will be relevant, not the average.

This change will have no impact in the usual case where shareholders all hold ordinary voting shares.

From a policy perspective, the restricted transfer pricing rule is closely related to the thin capitalisation rule. Both rules deal with the very significant BEPS issue of interest deductions on cross border related party debt. In an EBITDA rule, as recommended by the OECD in BEPS Action 4, thin capitalisation and transfer pricing are effectively combined, and thus necessarily subject to the same ownership threshold. What has now been developed as the restricted transfer pricing rule was initially seen by officials as sitting appropriately in the thin capitalisation subpart of the Act.

However, it was decided the restricted transfer pricing rule should sit within the transfer pricing rules than the thin capitalisation rules. This was because:

- the restricted transfer pricing rule restricts certain terms and features of related-party debt but still relies on the general transfer pricing rules to determine the final price of that debt;
- embedding the restricted transfer pricing rule in the general transfer pricing rules allows certain related adjustments to be made, e.g. the adjustment for the payee in section GC 11.

An unintended consequence of locating the restricted transfer pricing rules outside the thin capitalisation rules is that the ownership test in the thin capitalisation rules does not automatically apply. As the restricted transfer pricing rule, as included in the BEPS Bill, does not include a provision to determine ownership in accordance with the thin capitalisation rules, it does not apply as widely as was intended.

Given the close policy connection between the thin capitalisation rules and the restricted transfer pricing rule, it is not appropriate for the two to have different ownership thresholds.

This information was publicly released and provided to submitters on this Bill on 15 February 2018 and proposed legislation was released on 22 February 2018. The Finance and Expenditure Committee called for further submissions on this issue and a summary of these and officials' comments are shown below.

Issue: Officials' proposal should not be accepted

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Te Kakano Investment Limited Partnership)

The change to align the "related party" rules with the thin capitalisation rules is more than a drafting amendment and is fundamental to the rule. A change to the "related party" rules by way of an Officials' submission is inappropriate and undermines the generic tax policy process. Such an approach assumes that Officials' view of the policy intent is correct and increase the risk that the rule will be enacted based on ill-considered policy principles. *(Chartered Accountants Australia and New Zealand)*

The matter raised in the letter is not a drafting error. It is a significant policy change which should not proceed. The proposal contained in the letter received from officials is a significant change that would be introduced outside of the generic tax policy process. Further this has been introduced without any accompanying commentary or explanatory note. The normal accompanying commentary/ explanatory note is a vital resource for both the taxpayer and Inland Revenue that will be missing in relation to the restricted transfer pricing rule. *(Corporate Taxpayers Group)*

Any proposals along these lines could only be justified if the investments are clearly foreign controlled and interest rates are set on non-commercial terms. The measures being considered seem to go well beyond this and should be rejected. *(Te Kakano Investment Limited Partnership)*

Comment

The error is a minor change in the scope of the proposed rule. Officials acknowledge that this change may not be minor for an affected taxpayer as they will become subject to the rules when they would not be without this change. However, any such taxpayer, or their advisors, that has been following the policy development process would have been aware they were intended to be covered by the proposed rule as this was included in the Government discussion document as well as subsequent consultation documents and discussions with officials. This error does not change the operation of the rule for any other taxpayers.

While the commentary to the Bill and explanatory note will not refer to this error, taxpayers and Inland Revenue officials interpreting the application of this rule in the future will be able to find guidance in this officials' report and other documentation including a Tax Information Bulletin item published shortly after the enactment of the Bill.

Recommendation

That the submission be declined.

Issue: Policy development

Submission

(Chartered Accountants Australia and New Zealand, KPMG)

In original consultation on the proposals, it was suggested that the new interest limitation rules form part of the wider thin capitalisation regime. We and others submitted that it would be more appropriate that the new rules formed part of the transfer pricing regime because the rules concerned the pricing of offshore related party debt and not the volume of debt. The Cabinet Paper issued in August 2017 stated that the Government had agreed to replace the interest rate cap proposal with a restricted transfer pricing rule. The Cabinet Paper noted submitters concerns that the proposed rule would be difficult to apply and could result in double taxation. It stated that the new rule would be more flexible. We believed that the change to a transfer pricing based rule was in response to submissions. The change to a transfer pricing based rule was confirmed when the Bill was introduced. *(CA ANZ)*

The officials' letter of 15 February does refer to the February 2017 Discussion Document which did take a thin capitalisation based approach. However, that release was for consultation purposes. It was not supported by the August 2017 Cabinet Paper, which seemingly accepted the submissions made on the approach to be taken.

As we read the August 2017 Cabinet Paper, at best, it is silent on the exact related party test to be applied. However, in the context of a restricted transfer pricing rule, it is reasonable to assume that the transfer pricing "related party" test would apply in the absence of a clear statement to the contrary.

We are therefore not convinced by officials' reasoning that there is a clear policy intent to the contrary and the Bill and Commentary positions are a drafting error. *(KPMG)*

Comment

Officials have been consistent in their intention that the restricted transfer pricing rule (and the interest rate cap as was earlier proposed) should apply to the same entities as thin capitalisation. For example on 8 September 2017 officials provided a note to all submitters on the March 2017 BEPS – Strengthening our interest limitation rules Government discussion document which set out the current proposals. This document included at paragraph 34 that:

"We propose that a financial arrangement will be subject to the restricted transfer pricing rule if:

- the borrower is an entity that is subject to the thin capitalisation rules (the inbound rules, the outbound rules, and the banking rules); and"

Both before and after the release of this note officials held meetings with interested parties to develop the restricted transfer pricing rule. As part of these discussions officials discussed their continued intention to apply the restricted transfer pricing rule to entities that are subject to the thin capitalisation rules.

Recommendation

That the submission be declined.

Issue: Effect on iwi

Submission

(Te Kakano Investment Limited Partnership, CNI Iwi Holdings, Teresa Farac)

These changes need considered and detailed analysis and full consultation with Iwi that has not occurred.

To develop the potential of our assets, Iwi often find it productive to enter into joint venture arrangements sometimes with foreign investor participation. To protect our kaitiātanga these joint ventures often involve varying voting rights and rights to income. In this way Iwi can ensure sustainable development and fulfil our obligations as stewards of Iwi assets.

The interest limitation proposal is likely to intrude on these endeavours by imposing an artificial interest limitation on the funding provided by joint venture partners. Our investments have varying degrees of debt and equity balancing the interests of the different parties. All prices and returns (including interest rates) are set at market prices so that all parties are fairly remunerated. Foreign investors do not have control of these investments.

Iwi often want debt funding because this best protects our stewardship of Iwi resources. If enacted an interest rate cap will undermine existing investment partnerships and hinder the development of new partnerships.

The proposed amended policy by officials seems especially directed at varying voting and income rights. The officials' letter of 14 February notes that in the usual case shareholders do not have varying rights. That may be true but is false with respect to Iwi ventures. The officials' proposal, to us, appears to be a direct attack on the commercial interests of Iwi. *(Te Kakano)*

As Maori entities, it is important that we maintain our right of Rangatiratanga over our resources going forward. It is also important that we protect our rights on whom we partner with along with the structure or financing that is used in creating these partnerships going forward. We see that this rule may hinder potential debt structured entities from claiming all of the interest costs that is charged on loans with foreign partners. This will likely decrease some of the value that these partnerships with foreign partners will have if this limitation is adopted into the BEPS bill. *(CNI Iwi Holdings)*

The proposal will penalise NZ tax preferred investors such as Iwi and charities in non-foreign controlled companies by imposing artificial credit ratings, credit support and debt terms to otherwise commercially negotiated loan terms.

Comment

The proposal will have no direct impact on the tax implications for Iwi and other New Zealand investors as the restricted transfer pricing rules only apply to interest paid to non-residents. However, there are two indirect impacts that may arise. First, foreign investors may limit their investment or reduce the price they are prepared to pay for New Zealand assets due to a lower after tax return. But this is true of the impact of all the BEPS measures that address strategies to exploit weaknesses in those laws applying to in-bound investment. Second, New Zealand residents, including Iwi, may be shareholders in a company which has non-resident shareholders and which is subject to interest disallowance under the restricted transfer pricing rule. This outcome could only be avoided if the restricted transfer pricing rule applied only to 100%

foreign owned companies. Such a limitation would allow the rule to be circumvented by including a small element of New Zealand ownership. This would significantly reduce its effectiveness. Furthermore, this kind of effect can already arise for New Zealand investors in a company subject to the thin capitalisation regime. As already referred to in this report, the restricted transfer pricing rule is designed to buttress the thin capitalisation regime. Furthermore, if the New Zealand borrower does not adopt a tax-aggressive capital structure, there will be no interest disallowance.

Recommendation

That the submission be declined.

Issue: More than 100% combined interests

Submission

(Teresa Farac)

Taking the highest percentage is artificial as it has the capacity to attribute more than 100% shareholding interests to a company and can result in there being more than one parent (which renders the credit rating provisions unworkable).

Comment

The restricted transfer pricing rules do not require calculating the aggregate interests of all shareholders therefore the situation where total interests total to more than 100% does not cause any concerns. There is a possibility for more than one shareholder to have interests of 50% or higher but the only consequence of this is the restricted transfer pricing rules could apply to loans from both shareholders if the other requirements (such as being non-resident) were met. Officials are not proposing the highest percentage interest approach be extended beyond the restricted transfer pricing rules so general concerns, such as a company being required to be a member of two separate groups, do not arise.

Recommendation

That the submission be declined.

Issue: Lack of control over New Zealand entity

Submission

(Corporate Taxpayers Group, KPMG, Teresa Farac)

The scope of the rule should be limited to those with the ability to control a New Zealand entity, such that it is in a position to artificially inflate the price of debt or “shift” profits. *(Corporate Taxpayers Group)*

The further from the transfer pricing “related party” test the boundary is drawn, the more likely it is that the restricted transfer pricing rule will inappropriately apply. The transfer pricing rules apply because of an assumed ability to influence pricing to achieve a “non arms-length” result.

The extended (i.e. thin capitalisation-based) “related party” test would also apply in circumstances where there is no or limited ability to influence to achieve a non arms-length result. (*KPMG*)

Parent status will be attributed to a foreign company that from a commercial, accounting and economic perspective does not control the NZ entity. The foreign company will be deemed to have provided credit support and mirror credit rating, which is factually incorrect. The proposal is inconsistent with the intent of the debt pricing rules in having the capacity to apply to transactions without the requisite control and ability to use artificial or commercially irrational debt pricing. It is unnecessary given the breadth of the current provisions in the Bill. (*Teresa Farac*)

Comment

Officials agree that the intent of the restricted transfer pricing rules is to apply them to related party transactions where the lender has the requisite control and ability to use artificial or commercially irrational debt pricing.

Without this proposal certain taxpayers will be able to structure around the restricted transfer pricing rules by having varying shareholder rights so that their average rights are less than 50% while still having control over debt pricing.

Recommendation

That the submission be declined.

Issue: Consistency with CFC and thin capitalisation rules

Submission

(*Teresa Farac*)

The use of the highest shareholding interest test is based on an incorrect interpretation by Inland Revenue of the international tax rules. The CFC rules recognise that it is not sensible to attribute >100% shareholding interests to a company and they reduce shareholder interest on a pro rata basis for the purpose of the taxing provision which attributes income of the CFC to the NZ taxpayer. In particular, section EX 12 of the Income Tax Act 2007 applies where the total interests exceed 100% interest and operate to reduce a person’s income interest by the formula: $\text{income interest before reduction} \times 100 \div \text{total income interests before reduction}$.

The thin capitalisation rules use the highest percentage interest which a shareholder has in the 4 categories listed in section EX 5(1) which are the percentage of shares held, shareholder decision-making rights, rights to distribution of net income and distribution of net assets. Section FE 39 only refers to “...categories listed in EX 5(1)...” and does not expressly refer to EX 5(4) (which takes the highest shareholder decision-making rights).

Comment

Section EX 12 is necessary for the purpose of the CFC rules as it would be inappropriate to attribute more than 100% of the income as this could result in double taxation. There is no need for an equivalent provision in the restricted transfer pricing rule as no double taxation can arise

from potentially having more than one investor with 50% control. As noted in the item above, in this situation the only consequence is two or more investors, subject to meeting or failing other criteria, may be prohibited from including terms and features that would not be present in third party debt from affecting the pricing of related party debt.

Section FE 39 refers to EX 5(1) as a list of direct control interests existing prior to the introduction of the thin capitalisation rules. Although there is no direct reference from subpart FE to EX 5(4) this is not necessary as section FE 39 already takes the highest percentage of shares or rights held by the investor.

Recommendation

That the submission be declined.

Issue: Non-voting preference shares

Submission

(Teresa Farac, OliverShaw)

The proposal will penalise companies with material non-voting preference shareholders that have borrowed from otherwise third parties on commercial terms (noting that in distress situations it is not uncommon for lenders to hold preference shares). The rules would deem parental support when factually none exists and disregard features that are commercial and entered into by third parties operating at arm's length. *(Teresa Farac)*

Where a lender has minority voting interests but high income interests (because, for example, it has provided non-voting preference share funding to assist a New Zealand entity in financial difficulty) it will be deemed to control the New Zealand borrowing entity whose interest rate should be capped at the lender's borrowing rate. *(OliverShaw)*

Comment

In general preference shares should not be excluded from the restricted transfer pricing tests, particularly when they are held by shareholders who also hold ordinary shares, as they can be used as part of wider investment decisions by owners of the business.

Officials accept that in a case of financial difficulty a lender may convert debt to preference shares and that implicit parental support is unlikely to be provided in such a situation as the lender is more interested in getting some or all of their investment returned rather than operating the business. Officials recommend preference shares are removed from the control tests in the restricted transfer pricing rule provided that:

- the preference shares were issued in satisfaction of or as a replacement for outstanding debt;
- that outstanding debt was provided by the lender in the ordinary course of their business of providing funds to unrelated parties; and
- the debt was originally issued by the same entity that now holds the preference shares.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Appointment of directors

Submission

(OliverShaw)

A shareholder with majority rights to elect just one of say 12 directors with otherwise only a minority shareholding interest will be deemed to control the borrower and the borrower's interest rate should be capped at the lender's borrowing rate. For example, it is not uncommon for a cornerstone foreign investor to provide debt funding. If the cornerstone shareholder owns say 20% of the company but has the majority rights to appoint a director, the tax deductible interest will not be the market or arm's length interest rate, rather it will only be deductible based on the rate determined based on the credit rating of that foreign shareholder.

Comment

The shareholder decision-making right the submitter refers to is the right to participate in any decision-making concerning the appointment of a director of the company. A cornerstone shareholder with the right to appoint a single director out of 12 would have a 100% right to appoint one director but a 0% right to appoint the other 11. This would only provide that shareholder with an 8.3% right to appoint the directors of the company.

In addition to the definition in section YA 1 the term "shareholder decision-making right" appears in 8 other existing sections. To apply the interpretation suggested by the submitter, would result in each of these sections not operating correctly.

The example provided by the submitter shows that a shareholder who owns 20% of the company, even if all other rights were held equal to their ownership would only hold a 17.1% average interest because their rights to appoint a director were less than proportional to their ownership. In contrast, the approach proposed by officials would result in the shareholder having a 20% interest for the purpose of the restricted transfer pricing rules, as they already do for the thin capitalisation rules.

Recommendation

That the submission be declined.

Issue: Scope of draft legislation

Submission

(EY)

The draft legislation provided to submitters on 22 February 2018 is unnecessarily complex. A number of aspects previously included in clause 37 appear to have been shifted into clause 35, with various wording and definitional changes made to both clauses. This complexity, along

with the short period allowed for submissions on the proposed changes, makes it hard to determine whether the draft legislation goes further than indicated in the Note. We would have strong concerns around any extension to the scope of the restricted transfer pricing rule or to the transfer pricing rules in general beyond that indicated in the Note.

Comment

Officials provided all submitters on the BEPS bill with proposed draft legislation to rectify the error discussed above. In preparing this draft legislation officials, and other submitters as noted elsewhere in this report, recognised the complexity in proposed sections GC 6 and GC 15 of the Bill. As well as addressing the identified error this draft legislation reduced this complexity by removing a number of the entrance tests to the restricted transfer pricing rule. These changes were not intended to change the scope, rather they intended to clarify the rule's application. These changes were consistent with the changes that would normally be recommended by officials as part of the revision tracked version of the bill provided to the Finance and Expenditure Committee.

Recommendation

That the submission be declined.

Issue: Application of thin capitalisation threshold to restricted transfer pricing

Submission

(EY)

Provided the recasting of the ownership interest test for the purposes of the restricted transfer pricing rule is not seen as further increasing the scope of the restricted transfer pricing rule or the transfer pricing concept across the board (which we would strongly oppose), we consider the proposed change will have limited application. That is, it will only apply to relatively rare situation where the various rights differ. As stated at [3] of the Note, "this change will have no impact in the usual case where shareholders do not have varying rights".

In our view, the proposed extension to the restricted transfer pricing rule is unnecessary and is not justified given that it will cover, at most, a handful of rare situations which would not in themselves appear to carry a high risk of base erosion and profit shifting. We find it hard to envisage taxpayers restructuring their affairs in such a way as to change ownership and dilute control simply to escape the restricted transfer pricing rule.

Comment

Officials agree that this change will not affect many taxpayers. However, officials believe that it is appropriate for the restricted transfer pricing rule to be able to apply to loans between a New Zealand borrower and any non-resident lender where that lender is part of the group whose control of the borrower has triggered application of the thin capitalisation rules to the borrower's interest deductions.

Recommendation

That the submission be declined.

Issue: Public perception of integrity of Parliamentary process

Submission

(EY, KPMG)

Submitters should be able to rely on the Bill as introduced as representing the Government's policy intent in all but the most extreme situations.

The Committee itself should be able to scrutinise the Bill and the recommended changes safe in the knowledge that officials will not seek to introduce alternative measures on which the Committee is unable to deliberate. Supporting the change recommended by officials risks weakening public perception of the integrity of the Committee's processes.

The fact that draft legislation was not released at the same time as the Note which called for submissions on the proposed change is also likely to have a negative impact on public perception, especially as the draft legislation appears to go further than originally indicated in the Note. *(EY)*

The officials' letter of 15 February description of the proposed extension – that the restricted transfer pricing rule should apply if the highest, rather than the average of, the four types of ownership interest, is 50% or greater – is inconsistent with the proposed legislative re-draft. The new wording imports the full thin capitalisation "related party test". This includes counting rights arising from options and similar pursuant to current section EX 6. This goes beyond the officials' letter description of the policy intent. It gives effect to the September 2017 note and not to the second paragraph of the officials' letter. This further reinforces our submissions. The policy intent either remains unclear, is shifting, or the drafting does not achieve the intent. *(KPMG)*

Comment

While officials and the Government make every effort to ensure a Bill as introduced represents the final position it is common for officials to make a submission on items that are not correctly reflected in a Bill but have not been reflected in external submissions. These items are usually identified as such and considered by the Committee, and by the independent advisor to the Finance and Expenditure Committee, without calling for further public submissions.

Officials recognised that in the case of this error, notwithstanding that it affects a very small group of taxpayers, there would be public interest in this correction. While there was less time for submitters to consider this issue, officials note that this is a discrete issue that would be expected to be less resource intensive to review than the Bill as a whole.

Officials released the note in advance of the draft legislation as they sought to provide all submitters with the maximum time to consider this issue while the necessary draft legislation was still being prepared. The draft legislation, as could be expected, provides greater detail than the note on the operation of the proposed correction; however both are consistent in their intent that the restricted transfer pricing rule should apply to the same taxpayers that the thin capitalisation rules apply to and as the submitter notes this is consistent with the September 2017 note.

Recommendation

That the submission be declined.

ADJUSTED CREDIT RATINGS

Overview of three policy recommendations

In response to concerns by submitters, officials are recommending three particular changes to the credit rating adjustments in proposed section GC 16. These changes will reduce compliance costs and go some way to addressing submitters' concerns regarding double taxation but do not fundamentally alter the operation of the credit rating adjustment portion of the restricted transfer pricing rule. In order to provide for a better understanding of the intended policy they are summarised in the following paragraphs.

These three changes are:

- Removing the income-interest ratio high BEPS risk test;
- Allowing credit ratings to be implied from significant third party debt; and
- Allowing the borrower's credit rating to be within two notches of the group credit rating provided the borrower has a credit rating of BBB- or above.

Income-interest test

The Bill as introduced had three high BEPS risks tests where the borrower must apply a restricted credit rating or group credit rating if any of these three tests are not passed.

Two of these tests were aimed at similar features being the amount of debt the business was sustaining. The first test in section GC 16(1)(b)(ii) and (e)(ii) calculates the borrower's debt a proportion of net assets. The second test in section GC 16(1)(b)(iv) and (e)(iv) calculates the borrower interest expenditure as a proportion of their earnings before interest, tax, depreciation and amortisation (EBITDA).

When considering all businesses, debt will be highly correlated with interest. Net assets will be highly correlated with EBITDA. While this relationship will not always hold, for example where a business is making losses or is paying a very low rate of interest, the majority of businesses that fail one test would also fail the other test. Where a borrower passes the debt/net assets test and fails the EBITDA test this may be because of reasons that do not necessarily indicate they are a high BEPS risk.

The debt as a percentage of assets test will show that borrowers who are sustaining a high level of debt (either as a proportion of assets or compared to their worldwide group) are a high BEPS risk. A borrower that has a lower percentage of debt would only fail the income-interest test if they had a smaller amount of higher priced debt. The standard transfer pricing rules, including the amendments in this Bill, would continue to apply.

Accordingly, officials recommend that the income-interest test be removed and whether a borrower is a high BEPS risk is determined on the remaining two tests. This will reduce compliance costs and remove a number of borrowers from the high BEPS risk credit rating who were not the intended target of the proposals.

Third party credit ratings

The part of the restricted transfer pricing rule relating to disregarded features allows a borrower to include a feature in pricing if it is a feature in significant third party debt. That an unrelated borrower would provide debt with this feature provides objective support that the feature is included for commercial reasons and the requirement that the debt be significant prevents a borrower obtaining a small amount of expensive uncommercial debt to justify high priced related party debt.

The Bill as introduced does not include an equivalent feature for credit ratings. A borrower who is not a high BEPS risk would be able to continue to use third party debt to imply a credit rating for related party debt under a standard transfer pricing approach but this would not be available to a borrower that was a high BEPS risk.

Officials recommend the third party test is extended to the credit rating of high BEPS risk borrowers. This is for the same reason as the disregarded features third party test, that if an unrelated lender is willing to lend at a particular implied credit rate this is objective evidence of the credit rating of the New Zealand borrower.

In order to apply this rule a number of requirements must be met:

- The related party debt must be no more than four times the amount of the relevant third party debt – this is the same requirement in the disregarded features third party test and prevents a borrower having a very high level of related party debt to appear riskier than borrowing a small amount of third party debt to justify the higher interest rate.
- The third party debt must be unsubordinated. As with the disregarded test, subordinating debt will increase its interest rate as there is a reduced chance of the lender getting their money back if the borrower gets into financial difficulty.
- The third party debt must be unsecured. Unsecured debt better represents the risk of the borrower whereas secured debt represents the credit risk attached to the secured asset and can also be influenced by the size of the borrowing compared to the value of the secured asset.

Two notches below group credit rating

The group credit rating, for borrowers that are a high BEPS risk and have an identifiable parent, limits the borrower's credit rating to one notch below their group's credit rating⁴. Officials now recommend that this spread be increased to two notches provided the New Zealand borrower's credit rating is BBB- or higher. This is aimed at addressing submitters' concerns about double taxation. This change means a borrower using the group credit rating will be less likely to suffer double taxation and reduce the need for reliance on the Mutual Agreement Procedure in Double Tax Agreements.

BBB- is the lowest grade investment credit rating. Below this rating the difference in interest rates from a single notch movement becomes much larger so officials consider the original proposal for a single notch spread should be retained.

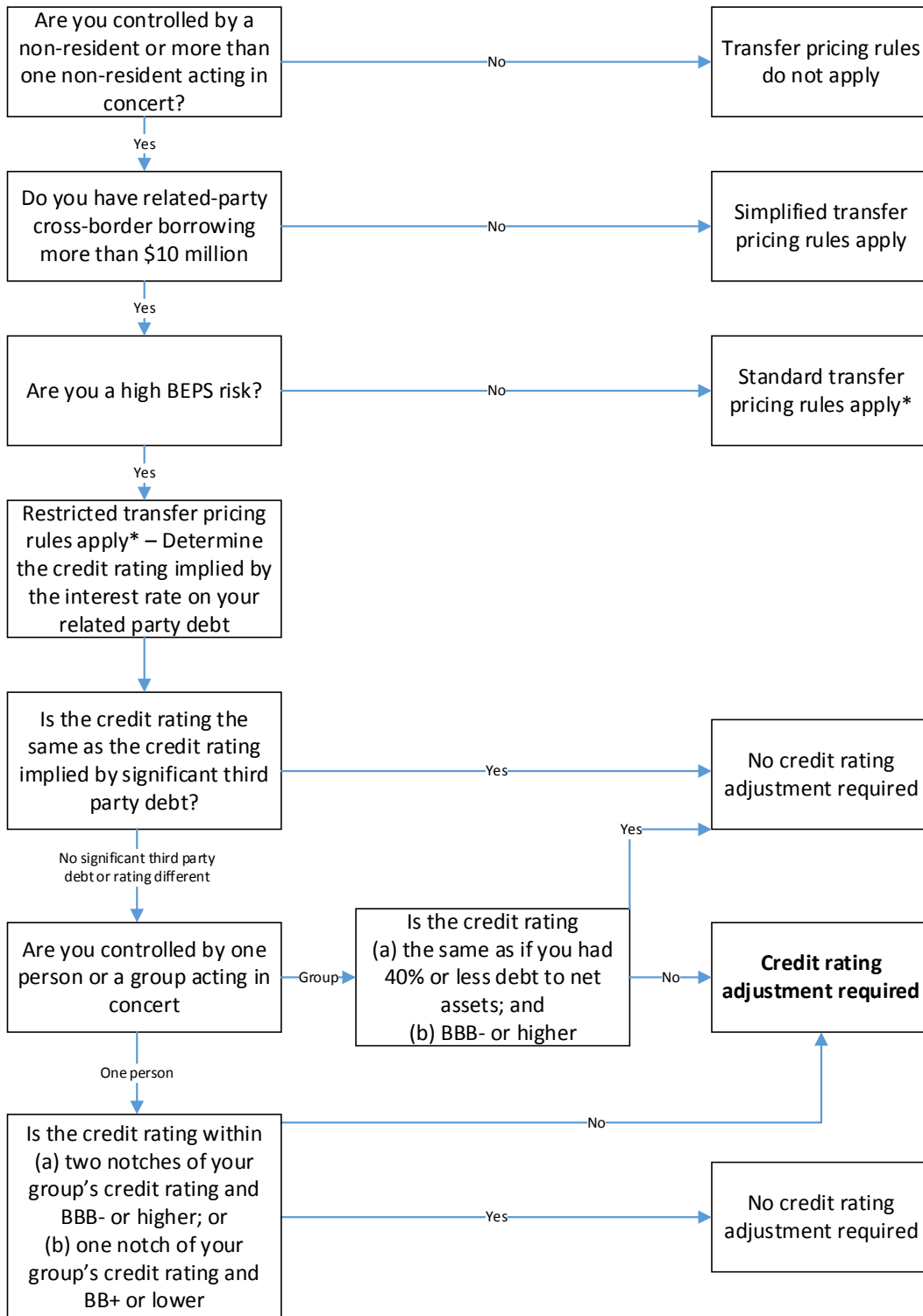
⁴ As introduced this was the highest credit rating of the group, this report explains that officials now recommend this be replaced by the credit rating of the member of the group with the highest unsecured third party debt.

The following table sets out the lowest available credit rating for a high BEPS risk borrower with an identifiable parent for certain credit ratings:

Group credit rating	Borrower's credit rating	Maximum spread
A	BBB+	2 notches
A-	BBB	2 notches
BBB+	BBB-	2 notches
BBB	BBB-	1 notch
BBB-	BB+	1 notch
BB+	BB	1 notch

These changes are incorporated into the following flowchart which provides a high level picture of whether a credit rating adjustment would be required under the proposed rules.

Restricted Transfer Pricing: Process for determining NZ borrower's credit rating



*Also disregard exotic terms – not covered by this flow chart

Issue: Linkage with parent's credit rating

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, KPMG, PwC)

Submitters do not support a restricted transfer pricing rule deeming a subsidiary to have a credit rating one notch below its parent. They consider this approach:

- Is unique, and an inappropriate departure from the internationally accepted norm of an arm's length transfer pricing principle;
- Arbitrarily and inappropriately disregards the facts and circumstances of the New Zealand taxpayer, and will yield unfair and inconsistent results;
- Will almost certainly give rise to double taxation in circumstances where the credit ratings are more than one notch different;
- Is inconsistent with New Zealand's Double Tax Agreements;
- Will create significant complexity and increase compliance and administration costs; and
- Could limit flexibility in raising capital.

The proposals do not adequately take into account significant differences among businesses in terms of their scale, their credit ratings, the industries and countries in which they operate, different levels of external leverage, where the entity is at in terms of its business life cycle, its risk weighting and different policy considerations that countries may have in determining how related party debt should be priced. All of those factors are reflected in the business' operating results and it seems illogical to totally disregard them when pricing the cost of debt.

Comment

Applying a credit rating is already standard practice for transfer pricing. Applying the restricted transfer pricing limits on a high BEPS risk borrower is a straight-forward, simple and non-manipulable way of pricing related-party debt. The rules have been designed to limit compliance costs and have minimal application for borrowers that have similar debt structures for the New Zealand borrower and their worldwide group. Officials expect many of the businesses that would currently be subject to the restricted transfer pricing rules will adopt more orthodox structures so they pay appropriate amounts of interest and are not at risk of double taxation.

However, as noted above, officials recommend the maximum allowable gap between the group credit rating and the borrower's credit rating be increased from one notch to two notches. This will alleviate some submitters' concerns regarding double taxation.

Recommendation

That the submission be declined and officials' recommendation to extend the group credit rating to two notches for borrowers at BBB- or above be noted.

Issue: Flat 40% gearing ratio limit

Submission

(Chapman Tripp)

We are uncertain whether a flat 40% gearing percentage is an appropriate measure for determining whether a taxpayer is a high BEPS risk across all industries. Consideration should be given to whether a fixed percentage is appropriate.

Comment

While a 40% limit will be easier for businesses in some industries to meet than others officials consider it is an appropriate indication of where a borrower represents a higher risk of BEPS. For borrowers that have higher than 40% debt percentages they will still be able to rely on a having a debt percentage within 110% of the worldwide group. Officials note that even where a borrower has a debt percentage putting them at high BEPS risk so the restricted transfer pricing rules apply; provided debt levels are appropriate so that the credit rating of the New Zealand group is within one notch (or two notches as recommended elsewhere in this report) of the parent (and there are no disregarded features), deductions for interest will not be adjusted under the restricted transfer pricing rule.

Recommendation

That the submission be declined.

Issue: 40% gearing limit is too low

Submission

(Chartered Accountants Australia and New Zealand, PwC)

The thin capitalisation threshold at which a New Zealand borrower is considered to have an excessive level of debt (taking into account all three factors) is too low. As we understand it, the 40% threshold is based on a median thin capitalisation ratio for New Zealand borrowers that were significant foreign owned enterprises. On this basis, the rule is designed to ensure that half of significant foreign enterprises are within its scope.

This appears arbitrary, and given the anti-avoidance nature of the rule the threshold should reflect the 60% thin capitalisation debt threshold rather than seeking to further constrain. *(Chartered Accountants Australia and New Zealand)*

The 40% leverage ratio is significantly lower than the risk factor ratio of 60% referenced in the ATO's guidance. It is also significantly lower than that allowable under our thin capitalisation regime, which is surprising given the Government has recently stated that it is satisfied with the current thin capitalisation ratio. While the proposed legislation does allow taxpayers the alternative of referencing the 110% worldwide leverage ratio, this is too difficult for taxpayers to calculate (as is the case under existing thin capitalisation rules where this ratio is rarely applied in practice).

Comment

Officials consider the high BEPS risk debt percentage and the thin capitalisation debt percentage should not be aligned. The high BEPS risk test is only an initial indication that the borrower may be structuring to achieve higher than commercial debt levels but does not necessarily result in any adjustment to interest deductions. Whereas, the thin capitalisation limit sits at a higher level as when debt is above this percentage interest starts being not fully deductible. As the consequences of breaching the thin capitalisation limit are more severe than breaching the high BEPS risk test it is appropriate that they are set at different levels.

The 40% threshold was set on the basis that the median debt percentage for significant foreign owned enterprises is between 30-40%. Data for the 2016 income year showed that 89 of 320 New Zealand groups (approximately 28%) had a debt percentage higher than 40%. The Bill also tightens the debt percentage calculation, so this percentage can be expected to increase (assuming no behavioural change). A reasonable estimate of the percentage of groups over the 40% threshold once this change is made might be a 10% increase, to 38%.

However, this is almost certainly an over-estimate of the groups who will need to consider whether the RTP rules may apply, because it does not take into account the fact that some New Zealand groups will:

- be able to establish that they are within 110% of their worldwide debt percentage
- have significant third party debt which they can use to determine their credit rating
- reduce their New Zealand debt percentage below 40%

Officials also considered the relative debt levels of NZX listed companies. While New Zealand is a relatively small market and thus suffers from the problem of having relatively fewer independent companies compared to other developed economies it is still possible to compare financial data of NZX listed companies to significant foreign owned enterprises. On the considered metrics of Debt/Equity, Debt/Assets and Net Finance Costs/EBITDA all three showed foreign-owned groups are biased toward holding more debt and paying more interest than NZX listed companies.

Recommendation

That the submission be declined.

Issue: Location of 40% gearing ratio

Submission

(Chartered Accountants Australia and New Zealand)

It would be preferable if the gearing rule were moved to the debt pricing section of the analysis, rather than the credit rating section so that taxpayers are simply required to price the debt assuming an arm's length amount of debt is in place. This would allow them to use their own debt credit rating adjusted for implicit parent support rather than being forced to the highest group member less one notch.

Comment

Applying a 40% maximum gearing ratio to a high BEPS risk borrower does not remove the potential for disagreement over the level of implicit parental support. For the majority of borrowers who do have an identifiable parent, linking the borrower's credit rating to their worldwide group's better reflects the implicit support available. While a maximum 40% gearing approach is proposed for borrowers who do not have an identifiable parent this was designed because there is no foreign parent to calculate the appropriate rate off. Officials consider basing the credit rating off the foreign group's rating more accurately reflects an appropriate credit rating when such an approach is achievable.

Recommendation

That the submission be declined.

Issue: Income-interest test

Submission

(Corporate Taxpayers Group)

The requirement to satisfy a 3.3 EBITDA / interest ratio will adversely impact a number of businesses operating in a completely commercial manner. Businesses with trading losses are likely to automatically fail the test. Start-up businesses are likely to fail the test (for example a petroleum miner undertaking exploration activities may have a long lead time between incurring expenses exploring for petroleum and finding fuel and generating income). Likewise, taxpayers who have a year in which there are one-off major transactions which result in a lower trading profit will be impacted (for example, an acquisition or merger may result in higher than normal expenses).

Comment

Officials accept that there are problems with an EBITDA test such as the inability to accurately forecast earnings in advance and the variability of such a measure. The bill as introduced attempts to mitigate these concerns by allowing an average EBITDA over up to three years. Upon further consideration officials consider the EBITDA test can be removed with its effect being covered by the 40% debt percentage test which has a broadly similar outcome of identifying taxpayers with higher levels of borrowing.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Annual income-interest test

Submission

(Chapman Tripp)

It is undesirable that a taxpayer be treated as a high BEPS risk simply because their income is less than 3.3 times their interest expense in any particular year – this test could cause taxpayers to drop in and out of the rules, greatly increasing compliance costs. We submit that this test should be dropped, or measured on a rolling three year average.

Comment

The proposals in the bill already applied an average of up to three years and only at the time each loan was entered into or repriced. However, as discussed in the item above officials recommend the EBITDA test is removed.

Recommendation

That the submission be accepted.

Issue: Income-interest ratio in a first year of operation

Submission

(PwC)

A company within its first year of operation will not be able to calculate an income-interest ratio as it will have less than 4 quarters/12 months of data. It should be clarified that the calculation can be done in a start-up year.

Comment

The bill proposal did not address this issue, however as officials now recommend the EBITDA test is removed this is no longer a concern.

Recommendation

That the submission be noted.

Issue: Income-interest ratio of 3.3 is too high

Submission

(PwC)

The income-interest ratio of 3.3 is too high. We appreciate that this is consistent with OECD BEPS interest limitations recommendations (which have not been adopted in our draft thin capitalisation legislation), but note that the ATO's guidance has recently relaxed its risk rating assessment in relation to this ratio (presumably in recognition of the requirement being too stringent).

Comment

As noted by the submitter this ratio is consistent with the 30% OECD recommendation. The OECD also suggested alternative ratios between 10% and 30% which would have made the equivalent income-interest ratio higher than 3.3. However as officials now recommend the income-interest test is removed this is no longer a concern.

Recommendation

That the submission be noted.

Issue: Residence test – having the usual tax status of a company

Submission

(Corporate Taxpayer's Group)

The reference to “or would be for a company having the usual tax status of a company” in section GC 16(1)(b)(iii) and (e)(iii) is not clear enough from the legislation what this is intended to cover.

Comment

The purpose of this wording is to cover situations where the lender is not subject to a tax rate of 15% or more because of a policy decision in the lender's jurisdiction other than the general company tax rate being below 15%. For example the lender may be a sovereign wealth fund that is tax exempt even though a company from the same jurisdiction would be subject to a higher rate than 15%. Entities that are not subject to tax because of a policy decision are not intended to be covered by the high BEPS risk tests.

Recommendation

That the submission be noted.

Issue: Two out of three high BEPS risk tests

Submission

(Corporate Taxpayers Group)

It should not be necessary to meet all three high BEPS risk tests in order to be a low BEPS risk. Two of the three tests should be sufficient.

Comment

As discussed above officials recommend that the EBITDA test be removed. Of the two remaining tests, officials consider if either of these is not met it is appropriate for the borrower to be considered to have a high BEPS risk.

Recommendation

That the submission be declined.

Issue: Credit rating adjustment when third party loan with similar features exists

Submission

(Chapman Tripp, EY, KPMG, PwC)

The credit rating adjustment is unnecessary where a taxpayer has an existing loan with a third party with broadly similar features to the taxpayer's related party debt. In this situation, a third party lender has already priced the implicit support that a New Zealand subsidiary will receive from its offshore parent. There is no need to adjust the credit rating of the subsidiary to account for implicit support.

This approach is also consistent with both achieving the Government's objectives (as the best evidence of a borrower's cost of funds is actual third party financing) and long-established international transfer pricing practice. This principle is fundamental to the approach taken by the ATO in addressing the same policy concerns the Government is seeking to address.

Comment

Officials agree that it would be appropriate for a borrower, including one that is a high BEPS risk or is an insuring or lending person, to apply a credit rating on related party debt that is equal to the credit rating implied from third party debt. To prevent abuse of this position officials recommend a third party credit rating should be subject to the following restrictions:

- The credit rating should be equal to the highest implied credit rating on outstanding long term senior unsecured debt that is not related party debt.
- The amount of related party debt cannot be more than four times the principal of the third party debt with that credit rating – this restriction is consistent with the third party debt exception applying for disregarded features.

Officials have considered whether it would be appropriate for a credit rating to be implied from cross-border related party lending that is back-to-back with a third party loan. This would require further consideration and consultation to ensure it was appropriately targeted at genuine back-to-back arrangements. This is not possible as part of the current select committee process so officials do not recommend the introduction of such a provision as part of this Bill.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Highest group credit rating

Submission

(Corporate Taxpayers Group, EY, KPMG, Powerco, PwC)

The legislation and commentary are inconsistent in describing what credit rating should be used with a taxpayer who is required to use the “group credit rating”. The commentary (and previous Government announcements) states that the group rating is “the higher of the parent’s credit rating minus one notch or the borrower’s own rating”, however, proposed section GC 16(9) states the credit rating is the higher of the borrower’s credit rating and the highest credit rating of a member of the borrower’s worldwide group. As drafted, the legislation is impractical and will not be able to be complied with. Worldwide groups can include hundreds of entities in different countries and they will not all have credit ratings (as they are not required or necessary). Section GC 16(9) should be amended to reflect the position in the commentary. *(Corporate Taxpayers Group)*

Using a rating that is the highest rating for any member of a borrower’s worldwide group could result in an interest rate below that which could realistically be obtained by the group from external borrowing to fund New Zealand operations. The interest limitation rule should reflect the most common scenario under which a parent (or special purpose finance entity) will issue group debt instruments. Further the pricing of related party debt to a New Zealand entity should reflect the group credit rating (less one notch) for its particular business operations and not some higher rating applying to a completely different type of business activity in the group. *(EY)*

Where borrowers are required, or choose, to apply the worldwide group approach for pricing their cross-border related party loans, they should only have to have regard to the credit rating of the ultimate parent of the worldwide group. *(KPMG)*

Comment

The group credit rating is intended to be the rating for long term senior unsecured debt of the highest rated member of the group. In most cases this highest rated member would be the ultimate parent company of the group, but this will not always be the case. For example, the ultimate parent company may be a holding company that holds shares in a higher-rated operating company.

It was not intended that a group would have to consider the credit rating of every company within the worldwide group. It is not obvious how to create a simple rule that identifies the relevant foreign operating parent in all situations and it is not appropriate to rely on the ultimate parent as this, as noted above, could be a lower rated holding company. Instead officials recommend this rule be amended so that the group credit rating is based on the member of the worldwide group that has the highest level of unsecured third party debt. In most instances officials expect this entity would be either the main operating entity or a treasury function for the group.

Recommendation

That the submission be declined and officials’ alternate suggestion to apply the credit rating of the member with the highest unsecured third party lending be accepted.

Issue: Access to credit ratings

Submission

(Corporate Taxpayers Group, EY, KPMG, PwC, Westpac)

“Credit rating” is itself not clearly defined in the Bill but appears to refer to a formal credit rating provided by a credit rating agency authorised by the Reserve Bank of New Zealand. This approach is problematic, as it is predicated on the borrower (and every member of its worldwide group) maintaining a credit rating provided by one of the authorised rating agencies.

Where a formal credit rating is not maintained, the transfer pricing rules provide an avenue through which a rating can be deduced, through the preparation of a credit scoring analysis typically following industry standards and commentary provided by the authorised rating agencies. The resulting indicative credit score provides a reasonably reliable approximation of the borrower’s credit rating for the purposes of applying the transfer pricing principles.

The term “credit rating” must be defined in the legislation so as to provide taxpayers with the ability to determine their indicative credit score, and should not enforce unnecessary compliance costs by requiring taxpayers to maintain a formal credit rating. This must also apply to situations under which the proposed rules require the use of a rating of any offshore related party. *(Corporate Taxpayers Group)*

Sections GC 16(7) and (9) should be clarified to state that the rating used should be the most recent actual rating at the most recent calculation date, or a rating that a rating agency would have given at that date where no actual rating exists. *(EY)*

Where no published long-term senior unsecured credit rating exists for the worldwide group (or a group member) preparation of a traditional transfer pricing interest rate benchmarking analysis for the consolidated worldwide group (using credit rating models published by organisations like Moody’s or S&P, or similar) should be acceptable for determining the worldwide group’s credit rating.

Credit rating should be a defined term, and should permit the taxpayer to use a credit rating from any major credit rating agency (for instance Moody’s Standard & Poor’s, and Fitch) for the purposes of GC 16 and GC 17. *(Westpac)*

Comment

Officials agree that taxpayers covered by the restricted transfer pricing rules should not have to obtain a formal credit rating from a credit rating agency if they do not already have one. Where a credit rating for an entity is not available it is common transfer pricing practice to imply one from external borrowing. Where there is no external borrowing transfer pricing will following additional steps to estimate an appropriate credit rating.

While the restricted transfer pricing rule will place some limits on an appropriate credit rating for a New Zealand borrower it is not intended to change the methodology used to calculate a credit rating where one is not available. Officials recommend drafting changes to reflect implied credit ratings and other transfer pricing methodology for estimating a credit rating when an entity does not have a formal credit rating. This is in addition to the use of published credit ratings by major rating agencies which are already available in the Bill as introduced.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Calculation date for interest rate on existing loans

Submission

(EY)

We understand the policy intent in relation to existing loans is to recalculate interest as if the new rules had been in place from the commencement of the loan, with any interest restriction applying only for interest relating to an income year commencing on or after 1 July 2018.

Section GC 16(4) provides for a calculation date that is the first balance date of the borrower on or after 1 July 2018 where the loan exists before 1 July 2018. For example, if the borrower has a 30 June balance date, the calculation date would be 30 June 2019 for a loan that commenced, say, 1 April 2017.

The debt percentage measurement in GC 16(1)(b)(ii) or (e)(ii) would appear to be determined based on a 30 June 2019 balance sheet rather than a 1 April 2017 balance sheet.

If a loan exists before 1 July 2018 the borrower's credit profile and factors in determining that profile need to be determined at the time the loan was entered into and not some subsequent date. The borrower's credit profile may have subsequently deteriorated. The balance sheet at the balance date proceeding 1 April 2017 would be more appropriate in determining whether the borrower's debt percentage is less than 40% or within 110% of the worldwide debt percentage.

The calculation date in GC 16(4) applying to existing loans under GC 16(1)(b)(ii) or (e)(ii) should be the balance date immediately before the loan was entered into. This approach is better aligned to arm's length conditions and takes into account taxpayers' ease of compliance and the need for certainty at the commencement of the interest limitation rules for existing loans.

Comment

The submitter is correct that GC 16(4), as included in the Bill, would set the calculation date for a borrower with an existing loan and a 30 June balance date as 30 June 2019 by which time the interest limitation rules would have applied to that loan for an entire year. In contrast a borrower with any other balance date which is the last day before the interest limitation rules apply, for example a balance date of 31 July would have a calculation date under GC 16(4) of 31 July 2018. It was not intended that the rules would apply differently for borrowers with a 30 June balance date than all other borrowers.

In considering whether to apply the high BEPS risks tests at the time the loan was entered into or immediately before the new rules applied it was decided to apply the latter. The reason for this is (1) the calculation would be on more recent data and therefore may be easier for taxpayers to calculate; (2) taxpayers who currently do not pose a high BEPS risk would not be required to apply the restrictions; and (3) taxpayers aware that the restricted transfer pricing rules would apply from their first balance date after 1 July 2018 would have a limited period to restructure related party debt so they were no longer a high BEPS risk.

However, officials accept that if the interest limitation rules were in place when the borrower entered into an earlier loan, say 1 April 2017, then a borrower who was not a high BEPS risk at that date would not be required to recalculate this at any later point including the point the restricted transfer pricing rules will apply to that borrower.

To address this issue officials recommend section GC 16(4) is extended so the calculation date for a borrower with a loan that exists before 1 July 2018 should be, at the option of the borrower, either of:

- the day before the restricted transfer pricing rules apply; and
- the day the arrangement was entered into.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Calculation periods for income-interest ratio

Submission

(EY)

For loans existing before 1 July 2018, the four periods in section GC 16(6) should be taken with reference to the quarters ended or balance dates immediately prior to the dates the loans were originally entered into.

Comment

This issue is very similar conceptually to the calculation dates for existing loans under GC 16(4) which is discussed above. For the same reasons GC 16(6), as included in the Bill, calculates the income-interest ratio for the most recent periods before the calculations are completed.

However, the recommendation elsewhere in this report to remove the EBITDA test makes this submission redundant as the calculation period will no longer be necessary.

Recommendation

That the submission be noted.

Issue: Data for the income-interest ratio calculation

Submission

(Corporate Taxpayers Group)

The calculation period in GC 16(6) refers to data being available “when the calculation is performed”. When is a calculation performed? Who performs the calculation? Is this just when the calculation is first performed or can it be reperformed?

It should be clarified whether this means the calculation includes periods in the subsequent income year if the calculation is being undertaken as part of the tax return process.

Comment

As officials have recommended removing the income-interest test this calculation will no longer need to be performed.

Recommendation

That the submission be noted.

Issue: 12 month period

Submission

(Corporate Taxpayers Group)

The calculation period in GC 16(6)(b) is for the 12-month period ending with the most recent balance date. How does this apply to taxpayers with more than 12 months to prepare a tax return?

Comment

As officials have recommended removing the EBITDA test this calculation will no longer need to be performed.

Recommendation

That the submission be noted.

Issue: Control by co-ordinated group

Submission

(Russell McVeagh)

The Bill should be amended to clarify that where a New Zealand entity is controlled by a co-ordinated group, but one of the members of the co-ordinated group holds more than 50% of the New Zealand entity on its own (and so the entity does have a worldwide thin capitalisation group), then the rule for co-ordinated groups in section GC 16(8) does not apply. Instead, the group credit rating rule in section GC 16(9) should apply (assuming the entity is high BEPS risk).

Comment

The purpose of the co-ordinated group approach is where the New Zealand entity does not have an identifiable foreign parent. The submitter is correct that when a single entity holds more than 50% of the New Zealand entity it is unnecessary for the co-ordinated group rules to apply. In

this circumstance a New Zealand borrower with a high BEPS risk should apply the group credit rating in GC 16(9) rather than the restricted credit rating in GC 16(8).

Recommendation

That the submission be accepted.

Issue: Co-ordinated group rules should apply to interposed special purpose vehicles

Submission

(KPMG)

Where a New Zealand borrower is held by an offshore special purpose vehicle (SPV) that is in turn owned by a “co-ordinated group”, the SPV will be considered to be the parent company of the New Zealand borrower rather than the co-ordinated group.

Where a New Zealand borrower is owned by a co-ordinated group via offshore SPVs that do nothing else other than hold shares in the New Zealand borrower (or other entities in New Zealand that are associated with the New Zealand borrower) it should be able to calculate the interest rate on its cross-border related party loans using its standalone credit rating in proposed section GC 16(7) or the restricted credit rating rule in proposed section GC 16(8).

Comment

Officials agree that requiring a New Zealand borrower to use a credit rating based on their worldwide group would be ineffective if the direct owner of the New Zealand borrower is a non-resident SPV (or holding company) owned by a coordinated group and that SPV has no business activity other than owning the New Zealand operations. In this circumstance it would be appropriate to apply the restricted credit rating rather than the group credit rating if the New Zealand borrower was a high BEPS risk.

Recommendation

That the submission be accepted.

Issue: Foreign government shareholders

Submission

(KPMG)

Where a foreign Government is the ultimate shareholder of the borrower, the sovereign credit rating should take preference over published credit ratings of interposed companies in the worldwide group.

Comment

Officials refer to the submission elsewhere in this report that the appropriate entity to base a group credit rating off is the group member with the highest level of external borrowings. Where a foreign Government is the ultimate parent of a New Zealand borrower it is likely that they would also have the highest external borrowings compared with any interposed companies. In this instance the sovereign credit rating minus two notches (assuming the sovereign credit rating is BBB+ or higher) would be the appropriate group credit rating. Officials agree with the submission but do not consider specific legislation is required to achieve this.

Recommendation

That the submission be accepted.

Issue: Local published credit ratings

Submission

(KPMG)

There should be specific allowance for use of a published credit rating of the borrower, where available for the restricted credit rating rule (proposed section GC 16(8) or group credit rating rule (proposed section GC 16(9)). This should supersede the need to apply the restricted credit rating or group credit rating rules.

The use of such a credit rating in the limited circumstances where a New Zealand borrower may have one would appear to be consistent with the overall purpose and intent of the Bill which is to reduce the level of subjectivity in the existing rules. Such a credit rating would also arguably achieve a more arm's length result as it has regard to the credit metrics of the borrower, as considered by third parties. It therefore naturally flows that a borrower's published credit rating should be acceptable and preferable to that of the worldwide group.

Comment

The use of a published credit rating for the NZ borrower is already included in proposed sections GC 16(8)(a) – subject to a BBB- minimum – and GC 16(9)(a). The availability of such a rating does not remove the necessity of considering whether GC 16(8)(b) or GC 16(9)(b) may arrive at a higher rating. Although use of a published credit rating would remove a level of subjectivity it would not remove the ability of a group to manipulate the New Zealand borrower's credit rating, for example by including more debt; particularly when that New Zealand borrower had not used that credit rating to obtain third party debt.

Recommendation

That the submission be declined.

Issue: Safe harbour for loans under \$10 million

Submission

(KPMG, PwC)

As drafted, the Bill requires taxpayers with cross-border related party loans to adopt the credit rating that the taxpayer has for long-term senior unsecured debt. This applies regardless of the loan value, including for “low value” loans of \$10 million or less. *(KPMG)*

To reduce compliance costs, Inland Revenue currently has a safe harbour that allows inbound related party loans under \$10 million to be priced with reference to a relevant base indicator plus a margin. The safe harbour is widely applied and should be maintained. As currently drafted the restricted transfer pricing rule would require even loans under \$10 million to be priced by reference to a credit rating. *(PwC)*

Comment

The intention of the “borrower’s credit rating” safe harbour in proposed section GC 16(7) was that the restricted transfer pricing credit adjustment would not apply when a borrower does not have a high BEPS risk. This was not intended to change the approach of a low BEPS risk taxpayer which is already required to follow transfer pricing analysis, or the administrative method for loans under \$10 million. As noted elsewhere in this report this can more efficiently be achieved by removing the borrower’s credit rating provision and instead relying on the standard transfer pricing rules in sections GC 7 to GC 14. This should provide the clarification, and continued access to the administrative method, requested by the submitters.

Recommendation

That the submission be accepted.

Issue: Application of \$10 million de minimis

Submission

(Corporate Taxpayers Group)

Does the \$10 million de minimis in section GC 16 (1)(a) apply to individual loans or all loans? Do taxpayers assess a loan under this section at the time the loan is taken out and they do not have to revisit for the life of the loan if this rule is satisfied?

Comment

The de minimis applies to all loans at the calculation date for the particular loan being taken out. This prevents a borrower being able to structure around the rules by taking out multiple loans each of less than \$10 million.

As the interest rate, or the margin, is set at the time the loan is entered into; if the de minimis applies at the time the pricing is set, this de minimis will apply for the term of the loan. If a subsequent loan is entered into without repaying the original loan such that total loans now exceed the \$10 million threshold this would result in the de minimis applying to the original loan but not the subsequent loan.

Recommendation

That the submission be noted.

Issue: Compliance costs

Submission

(EY, PwC)

Before traditional pricing analysis commences, analysis will be required to determine whether a company is at a high risk of BEPS. Further detailed analysis of external group debt instruments is required if a loan has a term of more than five years or other features that may be disregarded. This will increase compliance costs for companies with inbound loans over \$10 million. *(EY)*

Taxpayers should be given the option of a low compliance cost approach (e.g. allowing a default credit rating of BBB- with plain vanilla loan terms). The so-called “safe harbour” provided in the Bill as drafted is not a true safe-harbour – it effectively requires all members of the multinational group to be credit scored so is not a low cost compliance approach. *(PwC)*

Comment

The BBB- minimum rating is not available outside of high BEPS risk coordinated groups as in most instances this will not be an appropriate rating for a New Zealand group. Even for coordinated groups this is a minimum rating that the borrower cannot go below rather than a rating available to all borrowers irrespective of their circumstances. For higher rated borrowers allowing a safe harbour of BBB- could result in a significantly lower credit rating than their standalone or group credit rating.

While these proposals will result in some taxpayers incurring higher compliance costs this will not always be the case and the rules have been developed to minimise compliance costs where possible. For example the three high BEPS risks tests (which are recommended to be reduced to two elsewhere in this report) requires data that should easily obtainable and necessary for other purposes. For the majority of borrowers who are not a high BEPS risk no credit rating adjustment will be required. Where taxpayers do not include disregarded features in their loans these will not need to be considered in determining the appropriate price which will decrease compliance costs. Where taxpayers are a high BEPS risk the use of the group credit rating will eliminate much of the subjectivity, and potential for dispute, around the degree of implicit support which is also likely to reduce compliance costs.

A number of other recommendations in this report also lower compliance costs compared with the introduced Bill. These include:

- Where related party loans are less than \$10 million the existing administrative method will continue to be available.
- Where a taxpayer is a low BEPS risk the amendments recommended in this report will allow them to continue to use their existing transfer pricing methodology; and

- Where a taxpayer is a high BEPS risk and has to consider the group credit rating the recommendations in this report would limit this to considering only the rating of the entity within their worldwide group that had the highest amount of third party debt.

Recommendation

That the submission be declined.

Issue: Calculation dates

Submission

(PwC)

It is unclear why the calculation date in section GC 16(4) is only specified for limited subsections – all of the criteria in (a) to (e) need to be tested at a particular date and should have a calculation date specified.

Comment

The calculation date in GC 16(4) applies for calculations under section GC 16(1)(a), (b)(ii) or (e)(ii). These three provisions are whether the de minimis applies, and the debt percentage for borrowers controlled or not controlled by a co-ordinated group respectively.

For subsection GC 16(1)(b)(iii) and (e)(iii), which calculate the residence of the lender, there is currently no reference to a calculation date therefore listing these provisions within GC 16(4) would not in itself be effective. However, there is a possibility that these provisions could be met on one date and not met at a different date therefore a calculation date should be provided. This will require amendments to both of GC 16(1)(b)(iii) and (e)(iii) to refer to a calculation date in GC 16(4) as well as including these provisions in GC 16(4).

As the EBITDA test is recommended to be removed a calculation date will not be required for section GC 16(1)(b)(iv) and (e)(iv).

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Restricted credit rating debt percentage

Submission

(PwC)

The reference to the debt percentage of the New Zealand group in section GC 16(8)(b) should be removed as the debt percentage of the group must be above 40% for subsection (8) to be relevant.

Comment

The restricted credit rating in GC 16(8) applies to a borrower that is a high BEPS risk and controlled by a co-ordinated group. There are three tests to be a high BEPS risk in the Bill (and officials recommend reducing this to two) with only one of these being a debt percentage over 40%. As a borrower will be a high BEPS risk if they do not meet the residence of the lender (or under the bill the EBITDA) test it is possible for a borrower to be a high BEPS risk despite having a debt percentage below 40%.

The submitter is correct that if a borrower controlled by a co-ordinated group has a debt percentage above 40% then 40% will always be lower than their actual percentage. However, if a borrower controlled by a co-ordinated group is a high BEPS risk but has a debt percentage below 40% the current drafting will ensure their actual debt percentage is taken into account for the purpose of section GC 16(8)(b).

Recommendation

That the submission be declined.

Issue: Borrower's credit rating

Submission

(Corporate Taxpayers Group)

The borrower's credit rating in GC 16(7) is inconsistent with the Commentary (page 11). This should be a reference to the parent credit rating not the highest rating within a worldwide group. This is an impractical test which many taxpayers will not be able to comply with as not all members of a worldwide group will have credit ratings (or may be impractical to identify the highest rating in the entire group).

Comment

The borrower's credit rating reflects the credit rating of the New Zealand borrower rather than the worldwide group. This is the rating that can apply when the borrower is a low BEPS risk or is below the \$10 million de minimis. This is consistent with page 11 of the Commentary, specifically the second bullet point.

The submitter's comments in relation to identifying the highest rating in the entire group only apply to the group credit rating and have been addressed elsewhere in this report.

Recommendation

That the submission be declined.

DISREGARDED FEATURES

Issue: List of features

Submission

(Chartered Accountants Australia and New Zealand, PwC)

Proposed section GC 18(2) should be excluded. It is not correct to say that the features listed in proposed section GC 18(2) always exist for tax reasons. There may be genuine commercial reasons for these terms. If Government wishes to include these elements in legislation they should be part of a rebuttable presumption only and should not be determinative of an outcome. However, it is our strong preference that these factors are present in official guidance only and not part of the legislation. *(CA ANZ)*

The factors in section GC 18(2) should not be hard coded and specified in legislation because:

- it is unnecessary to do so if the general transfer pricing regime is strengthened as anticipated (which will in future require non-commercial terms to be disregarded);
- legislating for these factors does not allow for flexibility to take account of the individual commercial circumstances of the taxpayers or changes to general market conditions;
- legislating for a 5 year term is inappropriate (and loan term is not a factor the ATO takes into account) – there are many situations where it is entirely appropriate for debt to remain outstanding for longer than 5 years, such as where funding is required to match an investment profile of longer than 5 years (for example, in a fund or private equity context where assets are held for long-term investment, or in the forestry sector) but where there will not be other external debt;
- inclusion of other factors such as payment-in-kind interest have not been properly justified. These types of loan features are incorporated in situations where investment is riskier and cashflow may be used for other things in early years (e.g. expansion), whether the lenders are related parties or third parties. *(PwC)*

Comment

Officials recommend that subparagraphs GC 18(2)(a) and (b) are removed as set out elsewhere in this report. However, the remainder of the features should continue to be included. Without providing legislative guidance on the type of features that may be disregarded taxpayers will have less certainty over the type of features this section is targeted at. These features have been collated based on the practical experience of implementing the existing law and what are commonly observed features of third party and related party loans.

Recommendation

That the submission be declined.

Issue: Long-term loans with shorter term interest rate resets

Submission

(ANZ Bank, Corporate Taxpayers Group, New Zealand Bankers' Association)

Loans with a term of greater than 5 years but have interest rates re-priced more regularly should not be limited to have interest set every five years. Such debt should not be caught by the 5 year proposals as regular re-pricing removes any risk that the long-term loan presents.

Comment

It is possible, although less common, for loans to have a term exceeding five years but for the interest rate to be set at more frequent intervals, for example annually. The submitter is querying how the proposed rules will apply in this circumstance.

Money lent with a long, or perpetual, term with an annual interest rate reset faces an identical price risk to a one year loan that is expected to be replaced by a new one year loan upon its maturity. This is because any shift in the market rate of interest during that year can be factored into the applicable interest rate either upon the reset or as part of the new loan. Provided this reset happens within a period of five years or less there should be suitable comparables for this price risk to be accurately incorporated into transfer pricing calculations. Accordingly the proposals do not adjust this calculation.

However, depending on the terms of the instrument, the lender on a long term instrument may be subject to other risks, such as increased credit risk. For example after the expiry of a one year loan a lender may decide the borrower's credit risk has deteriorated and choose not to renew the loan whereas if the loan was perpetual this would only be available to the lender if the terms allowed them to demand repayment. To the extent the term of the loan was greater than five years, even though the interest rate was reset more frequently, and this feature increased the interest rate beyond that which would apply to a loan with a five year term with equivalent interest rate resets this feature should be disregarded.

If the term and the period the interest rate are fixed for are both beyond five years, section GC 18(2) will adjust both. If only the term is beyond five years but the interest rate is fixed for a shorter period section GC 18(2) will adjust the term without forcing the interest rate to be fixed for five years. Officials consider the drafting already achieves this.

Recommendation

That the submission be declined.

Issue: Total debt terminology

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, PwC)

Proposed section GC 18(6)(c) uses the term "total debt". From a financial perspective this generally means for an entity "the sum of current liabilities and long term liabilities". However, while it is not entirely clear, as a consequence of the interaction of GC 18(4)(a) it seems "total debt" in proposed section GC 18(6)(c) means total debt that has a term of more than five years.

The drafting of sections GC 18(4) to (7) is too complicated and it is very difficult to work out whether the term of a loan needs to be adjusted to five years. The formula in subsection (5) does not appear to give the intended result without the inclusion of the “threshold fraction”.
(PwC)

Comment

While the definition of total debt currently refers to total debt rather than total debt over five years, as submitters have noted, the formula would not operate correctly unless the denominator was total debt with a term of more than five years. Officials consider the current drafting already achieves this as the threshold term in section GC 18(4)(a) already limits the calculation to financial arrangements having a term of more than five years. However, as a number of submitters have noted that this is unclear officials recommend the drafting be clarified to ensure taxpayers calculate total debt only for arrangements with a term more than five years.

As noted elsewhere in this report, the third party exception for terms over five years is more complicated than the third party exception for other disregarded features as it needs to take into account that all loans with a term over five years cannot be considered homogenous. Officials consider the approach in the bill, once the clarification above is included, strikes an appropriate balance between accuracy and complexity.

Recommendation

That the submission to amend the definition of total debt be accepted.

Issue: Commissioner’s discretion

Submission

(Chartered Accountants Australia and New Zealand, EY)

The rules should allow for the Commissioner to recognise otherwise disregarded terms and conditions of loans to the extent she believes that recognition is consistent with the purpose and intent of the rules which is to allow deductions for interest on loans with arm’s length terms and conditions.

Comment

The rules include a third party exception so a borrower who has a commercial reason to include certain features can also include these features in related party debt. The requirement that the related party debt can be up to four times the size of third party debt with that feature means a borrower would only need 20% of their total debt to be from third parties and this debt would be equivalently priced to related party debt.

Allowing features to be included in pricing when there was no equivalent third party debt but a claimed commercial reason to do so would result in legislation with a very similar effect to the current position where the inclusion or not of certain features is very subjective and borrowers will often claim commercial justifications for tax driven decisions.

Recommendation

That the submission be declined.

Issue: Terms greater than five years

Submission

(Chartered Accountants Australia and New Zealand)

The requirement that the loan term be less than five years (or is assumed to be) is unduly restrictive. There are examples of commercial loans in the current market with terms of up to ten years. It should be open to a taxpayer to demonstrate that an independent person in similar circumstances would have had a loan term longer than five years. That is, the loan term should form part of a rebuttable presumption only.

In addition, a five year term ignores specific industries. For example, forestry and mining industries typically require long term loans of more than five years.

Comment

Where an independent third party has provided loans with a term more than five years this will be available to allow the borrower to also have related party debt with these terms. This is much less ambiguous than a view that a third party would provide funding for greater than five years even though none have done so. Where a borrower is funded for more than five years through related party debt and there is no longer term third party debt, the related party debt starts to more closely resemble the qualities of equity. The proposals do not prevent a borrower having related party debt for greater than five years but the tax deductions will more closely reflect a more likely commercial outcome of loans entered into for five years then rolled over for a further period.

Recommendation

That the submission be declined.

Issue: Terms greater than five years related party exception

Submission

(Chartered Accountants Australia and New Zealand)

The third party exception in proposed section GC 18 should be extended to include a single related party loan with a term of more than five years that has an interest rate reflecting the proportionate global funding mix. This is instead of the current proposal that requires related party debt to be structured in separate 'less than five year' and 'greater than five year' tranches matching the external debt to avoid all of the debt being forced to five years. Any adjustment to force to five years should only be on the balance that is disproportionate.

Comment

If the global funding mix is a mixture of loans above and below five years it would not be equivalent to allow a single loan to New Zealand with a term over five years. Although this could be given a price that reflected the worldwide cost of funds this would be more arbitrary given it would have to reflect the cost of funds and the makeup of funds at a particular point in time rather than being based on the term and risk of the funding actually provided.

Recommendation

That the submission be declined.

Issue: Exception from five year limit

Submission

(Powerco)

The exception from the five year limit for related party loans provided for groups with external loans with longer terms is a positive step although the exception is complex for groups with large multinational structures.

Comment

Officials note the support. There is an unavoidable increase in complexity for the small number of borrowers who will rely on the five year exception for third party loans of the worldwide group. However, these rules (subject to the amendments recommended in this report) have been designed to minimise this to the extent possible. Without knowing the amount and proportion of third party debt with terms over five years it would not be possible to determine whether the amount of related party debt with terms over five years is appropriate.

Recommendation

That the submission be noted.

Issue: Proportionality requirements in exotic terms

Submission

(Russell McVeagh)

Further work is needed on the operation of the proportionality requirements for exotic terms as the current “threshold” approach can produce anomalous outcomes. For example, currently it appears that a loan with an eight year term must (assuming 50% of third party debt has an eight year term and 50% a five year term) be priced assuming just a five year term, because the proportionality threshold has been breached. It would be better if a weighted average loan term could be used (eg, 6.5 years) or if 50% of the related-party loan could be priced at 8 years. There would be merit in having a regulation-making power and determination-making power to deal with outcomes such as these.

Comment

The proportionality threshold is necessary so that a worldwide group does not borrow third party debt with terms that makes it more expensive than to lend a portion of this debt to New Zealand that is greater than the New Zealand borrower's proportion of the overall business.

In the situation raised by the submitter, the borrower would not be able to include the eight year term in the pricing of the loan as 100% of their related party lending would be for a term more than five years whereas only 50% of their third party debt would be for over five years. While it would be possible to amend the relevant provisions to allow for such a scenario this would introduce an additional layer of complexity to provisions that have already been raised by other submitters as being complex. In this situation, as the loan is between related parties it would presumably be possible for the New Zealand borrower to have two loans, one for five years and a second for eight years. This approach would more closely reflect the underlying borrowing from third parties.

Recommendation

That the submission be declined.

Issue: Payment-in-kind

Submission

(PwC)

Section GC 18(2)(a) and (b) does not appear to catch "payment-in-kind" or deferred interest in all cases because capitalised interest is treated as "paid" under the Income Tax Act. Intention should be clarified.

Comment

Officials agree that the wide definition of "pay" in the Income Tax Act makes section GC 18(2)(a) not entirely effective. Capitalised interest is not the focus of this provision as it is not practical to distinguish between capitalised interest and new borrowing used to pay interest. Paying interest by capitalising interest does not necessarily increase the risk to the borrower other than by the increased exposure from the value of the loan increasing. The intention of this provision is to restrict an increase in risk of a loan by a borrower paying interest or repaying principal other than in money – for example by providing shares in the borrower. Officials recommend this provision is amended so that the provision of value must be in money, excluding money's worth.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Deferral of interest

Submission

(Corporate Taxpayers Group)

What time period does the deferral in section GC 18(2)(b) refer to?

Comment

Payment of interest in arrears is a common feature of many loans. It is significantly less common for this deferral to exceed 12 months. Officials agree that section GC 18(2)(b) should refer to a time period and consider this period should be a deferral of a liability to pay interest of more than 12 months.

Recommendation

That the submission be noted and officials' recommendation be accepted.

Issue: Calculation dates

Submission

(PwC)

The definition of calculation date in section GC 18(4), which refers to the calculation date for terms longer than five years, is not consistent with the definition in GC 16(4) which refers to the calculation date for the high BEPS risk tests.

Comment

The definition of calculation date in GC 16(4) is referenced to in some of the high BEPS risk tests in GC 16(1). The use of calculation date in GC 18(4) is a nonce term used only in the definition of term debt in GC 18(6)(b). There is no requirement for these two uses of the same term to be identical and each usage arrives at the intended policy outcome.

Recommendation

That the submission be declined.

Issue: Term of the loan approach

Submission

(PwC)

Term of the loan should not be included in subsection GC 18(2)(f) as it is dealt with separately in subsection (3), and it is not clear which set of rules takes priority. Alternatively, subsection (3) and related provisions could be deleted in favour of subsections 2(f) and (8)

Comment

Subsections 2(f) and (8) would not reach the correct outcome without section GC 18(3) to (7) as these set out the third party exemption to the five year term. Without these provisions all loans over five years would be treated equally. For example, if a borrower had a third party loan with a six year term that met the necessary criteria this could be used to justify a related party loan with a term of 60 years.

Including the term of the loan within GC 18(2) reduces complexity for the majority of borrowers who do not have third party loans with a term of over five years. It is also consistent with the approach for the other disregarded features which are included in GC 18(2) unless a third party loan with that feature qualifies for an exception under GC 18(8).

Recommendation

That the submission be declined.

Issue: Third party exception for acting together

Submission

(PwC)

The third party exception in section GC 18(8) does not appear to apply to loans advanced by parties “acting together”/a “non-resident owning body” (rather than associated) which presumably is not intended.

Comment

The third party exception allows a disregarded feature to not be disregarded if the New Zealand borrower or worldwide group has significant third party debt with this feature. When a New Zealand borrower is controlled by parties acting together or a non-resident owning body there is no identifiable parent and therefore no worldwide group.

This is the same problem encountered with the 110% debt percentage test in the thin capitalisation and high BEPS risk tests in the restricted transfer pricing rules. The thin capitalisation rules approach this by treating the New Zealand group as the worldwide group in section FE 31D. This approach would not be effective for the third party exception as there is already a New Zealand group test. In the restricted transfer pricing rules a worldwide group test is omitted from section GC 16(1)(b)(ii) which applies to co-ordinated groups compared with its inclusion in the equivalent section GC 16(1)(e)(ii) that applies to non-co-ordinated groups.

As there is no worldwide group it is correct that a worldwide group third party exception cannot apply to co-ordinated groups.

Recommendation

That the submission be declined.

INSURING OR LENDING PERSONS

Issue: General support for rules

Submission

(IAG)

The Bill treats insurers as a special case when applying the restricted transfer pricing rules to limit interest deductibility. We agree that the insurance industry has special features and that a bespoke rule is necessary.

Comment

Officials note the support.

Recommendation

That the submission be noted.

Issue: Insuring or lending persons applying the same credit rating as their parent

Submission

(ANZ, ASB Bank, New Zealand Bankers' Association, PwC, Westpac)

We understand from discussions with officials that the intention of the proposals is not to override observable market interest rates relevant to the New Zealand borrower with the foreign parent's borrowing cost. However, to mitigate this potential inconsistency and resulting uncertainty in application of the proposals, it would be beneficial for guidance to be issued confirming that the appropriate transfer price will not automatically be the foreign parent's borrowing cost but rather should reflect an appropriate comparable borrowing cost for a New Zealand borrower to unrelated parties (albeit after taking into account the effect of the interest limitation proposals). *(ANZ)*

There is market observable evidence that where New Zealand banks issue debt into the same market that their ultimate parent is issuing similar debt into, that the New Zealand bank must pay a higher rate of return to attract investment. This suggests that the market itself does not assume that the New Zealand bank has the same creditworthiness as its parent. This would appear to contradict the approach taken in the Bill to require the New Zealand bank to adopt the parent rating. It is notable that in a number of cases the New Zealand banks have their own credit ratings that are one notch below their parent ratings. *(ASB)*

Not all members of the NZBA have the same credit rating as their offshore parents. Restricting the ability for such banks to use, for example, their own credit rating would be unfair compared to other taxpayers who can use their own credit rating and does not reflect the market position prevailing for such banks (where they borrow from the market at rates reflecting a different credit rating than that of their parent). *(NZBA)*

The requirement for an “insuring or lending person” to base its credit rating on the highest rating within the group does not make sense given a number of these financial institutions will have their own formal credit rating. Alternatively, in instances where the New Zealand borrower does not have a formal credit rating, they should be able to apply a one notch downgrade to the group rating, consistent with the approach applied to other corporate taxpayers. (*PwC*)

Credit rating agencies will sometimes give subsidiary financial institutions in New Zealand a lower credit rating than that of its parent. This is relevant because, in the banking context, the prudential and regulatory framework under which banks operate does not permit parental support. Section GC 17 should therefore reflect this market reality and allow banks to use the same alternatives available to other taxpayers. (*Westpac*)

Comment

The proposals in section GC 17 require an insuring or lending person to apply the same credit rating as their parent but do not necessarily require them to have the same credit worthiness. This difference arises as a credit rating provides a range of possible prices, bounded by that credit rating, rather than a single appropriate price. Officials agree that there is market observable data of NZ banks issuing similar debt at a higher margin than their foreign parents despite both entities having the same credit rating. These differences in pricing will continue to be available to insuring or lending persons, within the bounds of a single credit rating.

Officials note that the majority of New Zealand banks – including the four Australian banks that provide the majority of lending in New Zealand’s banking sector – all have the same credit rating as their foreign parent in which case section GC 17 will impose no practical restriction for borrowing by the registered bank. Requiring an insuring or lending person to have the same credit rating as its parent reflects the different structure of financial institutions where the New Zealand operations are more integral to their worldwide group. It is highly unlikely a worldwide group would choose to let their New Zealand financial institution subsidiary fail as to do so would reflect on the reputation of the entire group even more so than in a non-financial institution.

However, as noted elsewhere in this report, officials agree with submitters that a credit rating should be able to be set with reference to the implied credit rating of significant senior third party debt. This proposal should apply equally to insuring or lending persons which should resolve some of the submitters concerns on this issue.

Recommendation

That the submission be declined.

Issue: Third party tests for insuring or lending persons

Submission

(*ASB Bank, New Zealand Bankers’ Association, Westpac*)

The interest limitation proposals inappropriately treat the financial services industry differently from other taxpayers by limiting the ability for this industry to apply certain of the exceptions within the proposals.

The proposed restricted transfer pricing rules require certain contractual terms or features to be ignored in determining the arm's length price. There are exceptions to this in proposed sections GC 18(8) and (9). Paragraph 8 applies to general taxpayers while paragraph (9) applies to banks and insurance companies and similar. While we agree with the direction of the paragraph 9 exceptions which acknowledge the fact that often the contractual terms may be driven by regulatory capital requirements, it is conceptually unclear why banks cannot also use the paragraph 8 exceptions where the terms of the related party debt reflect third party terms. Related party debt may be used to provide general funding, not just regulatory capital funding, and where the terms of non-regulatory capital funding provided by related parties nevertheless reflects third party funding terms, the paragraph 8 exceptions should be available to banks also.

Comment

Third party debt of a bank is much more likely to be senior debt without exotic features – as it is the cheapest form of funding – or regulatory capital – as it meets Reserve Bank requirements and reduces the risk of senior lenders not receiving their full investment return. In general there would be little commercial benefit in borrowing money at a higher interest rate than necessary without receiving any regulatory capital recognition. If a New Zealand bank had no non-regulatory capital third party debt with exotic features, there would be no benefit in section GC 18(8) also applying to them. This was part of the trade-off considered when including the exceptions in GC 18(9) of which there is no equivalent for non-insuring or lending persons.

Recommendation

That the submission be declined.

Issue: Definition of “insuring or lending person” is unclear

Submission

(PwC, Corporate Taxpayers Group)

The proposed definition of “insuring or lending person” (proposed section GC 15(2)) is too wide, leading to complexity on application in determining whether certain clients will have “a main business activity of providing funds” (for example the leasing of aircraft, commercial property and motor vehicles).

Paragraphs (d) and (e) are not drafted consistently with the Bill Commentary and appear to catch all group members rather than a member whose main activity is lending to non-associates.

Comment

The definition of “insuring or lending person” is necessary to apply the different treatment under the proposals. The submitter is specifically querying subsections (d) and (e) of the proposed definition. These subsections are aimed at groups and individual taxpayers respectively that have a main business activity of providing funds to non-associated persons. For example a person who was a commercial property developer who also arranged financing so their customers could purchase a property(s) after they had been completed would need to consider whether the majority of their time and profits came from the property development or from the financing. The group would only be an insuring or lending person under subsection (d) if their main activity was financing of commercial property rather than developing commercial

property. If the financing was undertaken by a separate subsidiary within the same group this financing subsidiary would be an insuring or lending person under subsection (e) but the rest of the group would not be unless that financing subsidiary was the main business activity of the entire group.

If a borrower meets paragraph (e), and does not meet paragraph (d), then that borrower will be an insuring or lending person but the rest of the group will not be. Officials recommend a drafting change to paragraph (e) to ensure this is clear.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Definition of insuring or lending person – securitisation trusts

Submission

(Corporate Taxpayers Group)

Separate consideration should be given to structured finance entities (including securitisation trusts). It is not clear how to measure the 'group of persons' where a trust is involved. There should be a separate rule to carve out structured finance entities.

Comment

When a group operates a securitisation trust as part of its wider business it would be appropriate for this to be included within a group of persons as this term is used in section GC 15(2). If this were not the case a securitisation trust would be unlikely to be treated as an insuring or lending person, even when their wider group was, as they will be raising funds for their own group rather than for non-associated parties.

The majority of securitisation will be with third parties and even where it is with related parties this will often be able to rely on the third party exemptions in the proposed rules or be between two New Zealand entities so that the restricted transfer pricing rules will have no effect. Developing a comprehensive rule for securitisation trusts that was appropriately targeted without excluding unintended entities would require further consideration and consultation and cannot be completed within the select committee process for this Bill.

Recommendation

That the submission be declined.

Issue: Long-term credit rating in section GC 17

Submission

(ANZ Bank, Corporate Taxpayers Group, New Zealand Banker's Association, Westpac)

Proposed section GC 17 should be amended to require the highest credit rating for “long term” senior unsecured debt of a member of the borrower’s worldwide group to be applied to the New Zealand borrower.

Comment

This section currently refers to the highest credit rating for senior unsecured debt of a member of the borrower’s worldwide group. There will frequently be a different credit rating for long term compared to short term debt. Adding the words “long term” would make this test consistent with the other equivalent tests in the restricted transfer pricing rules.

Recommendation

That the submission be accepted.

Issue: Credit rating of insurers

Submission

(EY, IAG)

An insurance operating company will typically have a higher issuer credit rating than a non-operating holding company in the same group. This difference reflects the structural subordination of the creditors in a holding company to those in a regulated insurance operating company. Where group funding is through a holding company of a special purpose finance company, the relevant cost of borrowing would reflect the holding company credit rating, not the operating company rating. A New Zealand insurer using a higher credit rating relating to an insurance operating company in the group would result in the New Zealand insurer paying an interest rate on related party funding that would be below the group cost of borrowing.

Comment

Officials note the recommendation elsewhere in this report that the reference to the highest rated member of the group be replaced by the entity with the highest amount of unsecured third party funding. In most circumstances a group will choose to borrow through the highest rated member of the group – to minimise their external borrowing costs – but where this does not happen, for example for regulatory reasons, the group rating would be determined by the rating of that funding entity rather than the higher rated operating company.

An insurer with significant third party debt in their New Zealand group would also be able to rely on the implied credit rating from this debt, provided it was senior-ranking and unsecured, as recommended elsewhere in this report.

Recommendation

That the submission be noted.

Issue: Reserve Bank capital requirements

Submission

(ANZ Bank, ASB Bank, BNZ, Corporate Taxpayers Group, New Zealand Bankers' Association, Westpac)

Proposed section GC 18(9) should be amended to refer to features of bank regulatory capital imposed by regulations set by the Reserve Bank of New Zealand as opposed to the conditions of registration under the Reserve Bank of New Zealand Act 1989

Comment

This section allows certain features to be included in pricing a loan if those features are included to meet regulatory capital requirements imposed by the Reserve Bank. As noted by submitters, these requirements are currently imposed by the relevant Reserve Bank Regulations which are currently BS2A (Capital Adequacy Framework (Standardised Approach)); and BS2B (Capital Adequacy Framework (Internal Models Approach)). The intention of the wording in the bill was to capture these regulations without specifically referring to them so the legislation continued to apply if and when these regulations were replaced.

Officials agree that the submitters' proposed change will improve the clarity of this provision.

Recommendation

That the submission be accepted.

Issue: Regulatory capital should be exempt from the rules

Submission

(Westpac)

What can be classified as bank regulatory capital is determined by the Reserve Bank of New Zealand (RBNZ). Given the characteristics of such instruments, the market for bank regulatory capital issued by New Zealand banks to third parties is limited in capacity. This is not the case for non-bank taxpayers, who have greater choice in how their debt capital is structured and/or sourced. In addition, non-bank taxpayers have much more flexibility to restructure their existing debt in response to the new rules, whereas the RBNZ imposes substantial limitations on a bank's ability to restructure its regulatory capital (which would also be prohibitively expensive). The proposed rules therefore have a discriminatory effect against banks who are tied into long term regulatory capital structures by the RBNZ.

Bank regulatory capital should be exempt from the new rules. Failing that, we submit that existing issues of bank regulatory capital should be grand-parented in the same manner as those under the new Hybrid mismatch rules in the Bill.

Comment

The rules include exemptions for features included in regulatory capital, including instruments that were issued as regulatory capital but no longer qualify, as well as back-to-back instruments used to fund regulatory capital. Officials are not aware of any current regulatory capital

instruments that would have their price altered as a result of the restricted transfer pricing rules but if this was the case it would be due to either the credit rating being lower than either the group rating or rating on third party debt or where terms were included that were not required for the instrument to qualify as regulatory capital. If this was the case officials consider it would be appropriate for the price of these related party instruments to be adjusted consistent with what would apply to the equivalent non-regulatory capital instruments in a similar situation.

Recommendation

That the submission be declined.

Issue: Regulatory capital that is an excepted financial arrangement

Submission

(ANZ Bank, Corporate Taxpayers Group, New Zealand Bankers' Association, Westpac)

Proposed section GC 18(9)(b) should be amended so that the features of a funding arrangement are not disregarded or adjusted if that funding arrangement provides funds in regulatory capital which may include an excepted financial arrangement

Comment

Section GC 18(9)(b) allows a banking group to include a feature in a cross-border loan from a related party if those features are also included in a back-to-back loan that is regulatory capital of the New Zealand bank. This is currently restricted to both arrangements being financial arrangements. The submitters point out that a cross-border loan can be used to finance the New Zealand entity investing preference shares into the New Zealand bank.

It is relatively common for a New Zealand bank to have a related party loan to its New Zealand holding company which then invests in equity of the New Zealand bank. The Reserve Bank imposes regulatory requirements on the New Zealand bank and its subsidiaries but not on its holding company.

Officials agree that, for the purpose of the bank-to-back provisions a cross-border loan that is used to finance preference shares should be treated consistently with a cross-border loan used to finance a financial arrangement.

Recommendation

That the submission be accepted.

Issue: Matching features of a back-to-back loan

Submission

(ANZ Bank, ASB Bank, Corporate Taxpayers Group, New Zealand Bankers' Association)

Clarification is required on proposed section GC 18(9)(b)(ii) and GC(b)(iii) on what is required for the features of funding arrangement to “reflect” the features of the funded arrangement as

well as the requirements for regulatory capital. The features of the loan should not need to be completely identical, it should be sufficient that the relevant terms are similar to the regulatory capital terms.

Comment

Officials note that this submission should apply equally to sections GC 18(9)(d)(ii) and (iii) for insurers and GC 18(9)(f)(ii) and (iii) for non-bank deposit takers.

The purpose of the back-to-back provisions in proposed section GC 18(9)(b), (d) and (f) is so an interposed resident entity can have similar terms on a loan (referred to as the funding arrangement) to the terms imposed by the Reserve Bank on the groups regulatory (or solvency) capital (referred to as the funded arrangement). Officials acknowledge that the features of two separate arrangements, albeit entered into for the same wider purpose, may not have identical features. This will particularly be the case in the scenario discussed above where a New Zealand company borrows to invest in preference shares.

For a particular feature that doesn't match between the funding and funded arrangement, this raises three possibilities:

- A feature is present in the funded arrangement but not in the funding arrangement – the feature is not present in the cross-border loan so no further action is necessary. The absence of the feature from the funding arrangement should not disqualify the entire loan from being a back-to-back loan for the purpose of considering other features.
- A feature is present in the funding arrangement but not in the funded arrangement – the feature is not necessary to meet a regulatory capital requirement so should not be included in considering the pricing of the funding arrangement. Again the absence of the feature from the funded arrangement should not disqualify the entire loan from being a back-to-back loan for the purpose of considering other features.
- A feature does not exactly match between the funding and funded arrangements – the example provided by the submitter is the funded arrangement has a conversion to equity feature while the funding arrangement has a mandatory repayment feature.

It is the third of these possibilities that could cause confusion. Officials consider there should not need to be perfect mirroring between features of the funding and funded arrangements but this should not provide the opportunity for carte blanche inclusion of any features in the funding arrangement under the pretext of imperfect mirroring. We consider an appropriate approach would be to include a feature in a funding arrangement, that does not exactly match a feature in a funded arrangement, only if the feature provides protection to the banking/insuring/deposit taker associate in a similar circumstance to that faced under the funding arrangement. Furthermore the increase in price due to the feature in the funding arrangement should not exceed the increase in price due to the feature in the funded arrangement.

Recommendation

That the submission be noted.

Issue: De minimis**Submission**

(Deloitte)

The \$10 million de minimis for non-insuring or lending persons in section GC 16 and disregarded features in section GC 18 should also be available for insuring or lending persons in section GC 17.

Comment

There is no restriction on entity types applying the existing \$10 million administrative practice as the same compliance cost compared with risk of excess interest rate trade-off applies. Officials agree that this approach should continue to be available for insuring or lending persons and this can be achieved by including a \$10 million de minimis for related-party cross-border lending in section GC 17.

Recommendation

That the submission be accepted.

THIN CAPITALISATION – EXCLUSION OF NON-DEBT LIABILITIES

(Clause 24, 25, 28)

Issue: Should the proposal to subtract non-debt liabilities from value of assets in calculating debt percentages for the non-bank thin capitalisation rules proceed?

Submissions

(Chapman Tripp, Chartered Accountants Australia New Zealand, EY)

Some submitters (Chapman Tripp) said that the proposal to subtract the value of non-debt liabilities from a firm's asset value for purposes of the thin capitalisation rules should not proceed. It is unnecessary, has no connection with BEPS, and the current "no subtraction" approach does not currently result in taxpayers exceeding commercial levels of debt. Along with other measures, it will have the effect of materially reducing the 60% safe harbour threshold.

Other submitters supported the proposal in principle *(Chartered Accountants Australia New Zealand, EY)*

Comment

Submitters are correct that this proposal is not part of the OECD's BEPS recommendations. However, those recommendations do include rules to limit interest deductions of a multinational group, which is exactly what this proposal is concerned with.

The proposal ensures that the thin capitalisation rules better measure the extent to which a group has used debt funding rather than equity funding to fund its New Zealand operations. Currently, the rules treat funding by way of non-debt liabilities as though it were equity. This is not the appropriate treatment.

Officials add that ever since the inception of Australia's thin capitalisation rules, those rules have subtracted non-debt liabilities in the same way as proposed in the Bill.

Recommendation

That the submissions that the proposal should not proceed be declined. That the submissions in support of the proposal be noted.

Issue: Should the exclusion of non-debt liabilities reflect how they would be treated by a third party lender

Submissions

(PwC)

PwC submitted that the treatment of non-debt liabilities proposal should better reflect how such liabilities would be treated by a third party lender. For example, they said that third party

lenders would not take deferred tax liabilities (DTLs) or remediation provision made by a mining company into account in determining a borrower's creditworthiness, and therefore those items should be treated in the same way as shareholders' funds in determining a New Zealand group's maximum level of deductible debt under the thin capitalisation rules.

PwC commented that the thin capitalisation rules are not trying to evaluate the true equity investment by a multinational group into its New Zealand business.

Comment

Officials agree that one of the objectives of the thin capitalisation rules is to limit a company to interest deductions on a commercial level of debt, and this was recognised at paragraph 4.7 of the March 2017 Discussion Document BEPS – Strengthening our interest limitation rules. However, experience around the world has shown that determining a commercial level of debt for a part of a multinational enterprise is very difficult. The approach of the thin capitalisation rules in New Zealand has always been to avoid doing this. Instead we provide a reasonable safe harbour, and in addition allow a group if it wishes to do so to take the metrics of the worldwide group as an objective measure on which to judge the New Zealand part of the group. So, we allow a New Zealand group to deduct the interest on up to 110% of its worldwide group debt percentage, with a reasonable safe harbour to reduce compliance costs. The 2017 Discussion Document recognised this approach when it listed, as another objective of the thin capitalisation regime, to ensure that only a reasonable portion of a multinational's worldwide debt is allocated to New Zealand.

The proposed exclusion of non-debt liabilities from the denominator in the debt percentage calculation is consistent with this approach. The exclusion applies to both the New Zealand and the worldwide debt percentages. It uses an apportionment approach based on the debt and net assets of the worldwide group to determine the amount of deductible debt that should be allocated to New Zealand.

The benefit of the non-debt liability exclusion is that it ensures that the amount of deductible debt that should be allocated to New Zealand is not able to be inflated because non-debt liabilities are treated in the same way as equity. For example, the current rules allow a group whose New Zealand operation has relatively high non-debt liabilities to operate with a much higher debt/shareholder's equity (i.e. net assets) ratio in New Zealand than it has on a worldwide basis.

An attempt to discriminate between liabilities which are and are not taken into account by creditors would be complex and difficult to administer. For example:

- there are some non-debt liabilities, such as trade payables or most derivative obligations, that other creditors would often take into account in determining a company's creditworthiness. However, not all creditors will treat these equally, eg they may be irrelevant to secured lenders;
- treating non-debt liabilities as equity allows a company to increase the amount of deductible interest bearing debt it is allowed by increasing the amount of its non-debt liabilities. While there will frequently be commercial constraints on such activity, there are other cases where these constraints do not apply.

Officials also note that whether or not non-debt liabilities are taken into account by lenders, they do have at least one very important commercial consequence. A company must take them into account in determining its solvency for corporate law purposes. They are thus an important

constraint in determining the amount of debt which a company can commercially borrow on a stand alone basis.

Recommendation

That the submission be declined.

Issue: Should deferred tax liabilities be included in non-debt liabilities

Submissions

(Chartered Accountants Australia New Zealand, Corporate Taxpayers Group, EY, KPMG, Powerco, PwC)

These submitters submitted that deferred tax liabilities (DTLs) should be excluded altogether from non-debt liabilities. Reasons included:

- DTLs are often the tax-effected expectation of future profits (eg deferred tax on building revaluations). *(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, Powerco)* They are relevantly different from other liabilities such as trade payables where the business transaction giving rise to the liability has already occurred
- DTLs may be volatile where an asset is valued at fair value, and the movements do not necessarily reflect future tax to pay *(Chartered Accountants Australia and New Zealand, EY)*
- lenders look to after tax cash flows of a business to determine a client's ability to service debts, and that is reflected in balance sheet debt levels. They do not look to adjust for deferred tax because that would be double counting the tax liability. The non-debt liability proposal should better reflect this perspective *(Corporate Taxpayers Group, EY, PwC)*
- calculating DTLs is complex and expensive, and DTLs are typically calculated at most once or twice a year. This means that requiring their inclusion in non-debt liabilities will impose a significant compliance burden on companies choosing to determine their thin capitalisation position on a quarterly or daily basis. *(Corporate Taxpayers Group)*
- It is not possible or else it is impractical and unnecessarily costly to split up a DTL into a portion which is included in non-debt liabilities and a portion that is not, in the way proposed by the Bill. *(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Powerco, PwC)*
- DTLs are excluded from non-debt liabilities in the Australian rules. *(Chartered Accountants Australia and New Zealand, KPMG, Powerco, PwC)*
- DTLs should not be taken into account because they do not fund a company's assets.

Comment

In principle, officials do not consider it is appropriate to exclude DTLs from non-debt liabilities. For example, where an asset held on revenue account at a balance date has a higher financial statement value than its tax value, the future sale of that asset for its financial statement value will generate a tax liability. The financial statement value of the asset will be included in the measurement of equity under the thin capitalisation rules. It is therefore unarguable that this tax

liability should also be taken into account in determining shareholders' equity in the financial statements. That is an example of why DTLs exist. For thin capitalisation purposes, this liability should not be treated as if it were equity provided by the shareholder of the company, as it currently is. Accordingly, to exclude DTLs from non-debt liabilities altogether would not be inappropriate in principle.

It is not relevant that the transaction giving rise to the DTL (eg the earning of income, or sale of the relevant asset) has not occurred at the time the DTL is created. The DTL is necessary to give an appropriate picture of the financial position of the company. Financial statements routinely include asset valuations which can only be justified on the basis of assumptions about future cash flows. For example, when assets are fair valued, this is often on the basis of an estimate of future cash flows. It is not appropriate for those kinds of assumptions to be made when valuing gross assets for thin capitalisation purposes, and then ignored when valuing associated tax liabilities.

Volatility of DTLs in general terms should support the proposal in the Bill. Volatility in deferred tax is generally caused by volatility in the value of assets (or sometimes liabilities) where the tax effect is deferred until sale. The two movements are inversely correlated and including them both in the thin capitalisation calculation rather than only including one will therefore decrease volatility. For example, if the financial statement value of a revenue account asset increases by \$100, this will increase the DTL by \$28. The overall increase in the denominator for the thin capitalisation calculation will be \$72 rather than \$100. Including the DTL has reduced volatility. Officials note that the role of DTLs in reducing volatility was not acknowledged by submitters.

Officials note that a re-categorisation of an asset from held for use to held for sale, or vice versa, can cause a change in the DTL associated with that asset. This volatility does not seem to be important for this issue. The change in the company's intentions with respect to the asset, if genuine, should be reflected in a change in the DTL, and that change in turn should be reflected in the amount of the company's net equity. Officials also note that submitters did not quantify this effect, and it seems likely to be minor.

Officials accept that the calculation of DTLs is complex and technical. Officials do not consider that this is a basis for their exclusion from non-debt liabilities. The calculation must be undertaken for financial reporting purposes, and no changes to the amount so calculated are required by the Bill (though we do propose an option to exclude certain DTL amounts from non-debt liabilities).

The approach taken by actual or hypothetical lenders to a borrower's DTLs is also not relevant.

- The thin capitalisation rules are not primarily concerned with creditworthiness as assessed by third party lenders. They are concerned with the extent to which a New Zealand group is funded by its shareholders rather than by external creditors.
- Lenders will often have priority over income tax liabilities, and may also consider that if a company is in trouble, its tax losses may well offset any tax liabilities. Their approach therefore may say little about the reality of DTLs in measuring shareholder equity.
- The submission that lenders look to a company's after tax cash flows to assess its creditworthiness leads logically to the conclusion that we should not be restricting interest deductions by reference to the balance sheet but instead by reference to earnings before interest, tax depreciation and amortisation (EBITDA). It does not support a submission

that DTLs in particular should be omitted from non-debt liabilities in a balance sheet based test.

Submitters did not explain why, if apportionment is not possible, it would be better to exclude DTLs from non-debt liabilities, rather than to include them.

Officials agree that DTLs arising from building revaluations, and any other revaluations of assets where the valuation already recognizes the owner's inability, or limited ability, to claim a deduction (including by way of depreciation) for the financial reporting value of the asset should be able to be excluded from non-debt liabilities. The reason for this exclusion is that in that case, the DTL should not be taken into account in determining the shareholder's equity in the company. That equity has already been accurately measured through the valuation of the asset. For instance, in the case of a building which is acquired or revalued after buildings became non-depreciable, the value of the building already recognizes that it is not depreciable. This outcome is intended to be achieved by proposed section FE 16B(1)(e)(iii), discussed in more detail below.

Officials note that there is no intention to exclude from non-debt liabilities a provision for depreciation on a building which was acquired before buildings became non-depreciable, if the building has not been revalued in the financial statements since that time. In that case the value of the building in the financial statements reflects an assumption of depreciability, so there is insufficient reason to exclude the DTL that was created when the building became non-depreciable.

The submission that requiring the inclusion of DTLs in non-debt liabilities will impose additional cost on entities choosing to calculate their thin capitalisation position quarterly or daily seems correct, but such entities are already accepting the imposition of what is presumably a much larger additional cost, being the cost of preparing a complete balance sheet for each quarter or day when the company would not otherwise do so. As a practical matter, officials expect that in a business as usual situation, a company wanting to use quarterly valuation might be able to make some simplifying assumptions to reduce the cost of calculating its DTL.

It is true that Australia does not include DTLs in the definition of a non-debt liability. When Australia introduced its thin capitalisation rules, DTLs were included in non-debt liabilities. They were only removed in 2008, in response to the change to the current accounting standards, which officials understand are materially the same as those applying in New Zealand. The published reasons for the removal are the same as those given by submitters in relation to our proposal. As set out above, officials consider those reasons do not warrant a carve out for deferred tax liabilities.

Recommendation

That the submissions in favour of excluding DTLs altogether from non-debt liabilities be declined.

Issue: The exclusion from non-debt liabilities for certain deferred tax liabilities should be clarified

Submissions

(Chartered Accountants Australia New Zealand, KPMG, Powerco, EY)

Some submitters (Chartered Accountants Australia New Zealand, KPMG) submitted that the exclusion from non-debt liabilities for certain deferred tax liabilities should be clarified.

Other submitters (eg Powerco) supported the intention of the exclusion from DTLs for certain amounts, as contained in proposed section FE 16B(1)(e), but were concerned that it was not workable.

Comment

Some submitters (Chartered Accountants Australia New Zealand, KPMG) submitted that proposed subsection (e) of the exclusion which is provided for certain DTLs is unclear.

- KPMG submitted that as the provision is drafted, it would not necessarily allow a DTL arising in connection with a building to be excluded. That is because the deferred tax liability in that case might arise due to the fact that the depreciation rate for buildings is 0%, rather than because of a difference between the financial statement value and the adjusted tax value.
- Chartered Accountants Australia New Zealand, along with a number of other submitters, were concerned that paragraph (iii) of the exclusion might only apply if the asset is valued in the financial statements at the value it has for tax purposes. This is not the purpose of the provision. The paragraph is intended to limit the exclusion to the situation where the difference between the tax and financial reporting value of an asset has already been taken into account in the valuation or cost exercise.

With respect to the submission that paragraph (iii) of the proposed exclusion from DTLs would be difficult to apply, officials consider that the concern may be overstated in many cases. Once taxpayers adjust to its existence, they will find it relatively easy to undertake the exclusion. Officials accept that it might be desirable for the legislation to be amended to make it explicitly optional for taxpayers to exclude any amount from DTLs. *(EY)*

With respect to the submission that a DTL on a building might not be able to be excluded under paragraph (e), officials agree that a DTL arising because an asset is depreciable at zero percent should be able to come within paragraph (e), and that a clarification is appropriate.

Contrary to PwC's submission, officials do not consider that proposed section FE 16B(1)(e)(ii) assumes that a gain on sale of an asset will remain consistently taxable or non-taxable. If the tax status changes, that may result in any DTL associated with that asset being in or out of proposed section FE 16B(1)(e)(ii). That does not seem problematic.

Recommendation

Officials recommend that the exclusion from non-debt liabilities for certain deferred tax liabilities proposed in the Bill should be made explicitly optional, and that this exclusion should clearly be able to apply to buildings which are depreciable at 0%.

Issue: Should derivative positions be included in non-debt liabilities

Submissions

(Chartered Accountants Australia New Zealand, Corporate Taxpayers Group, Powerco, Russell McVeagh)

Some submitters submitted that derivative liabilities (eg an “out of the money” forward contract to exchange US\$ for NZ\$) should not be included in the calculation of total assets or non-debt liabilities. *(Chartered Accountants Australia and New Zealand)*

Such liabilities should be excluded to the extent that they have not been used to fund the taxpayer’s balance sheet. *(Corporate Taxpayers Group, Powerco)*

Taxpayers should be able to elect to exclude certain classes of derivatives from the calculation of assets and non-debt liabilities. The submitter gave the example of a business with an interest rate swap which becomes out of the money. The interest rate swap hedges a floating rate loan (which officials understand cannot be fair valued). The non-debt liability proposal means that the derivative going out of the money would increase the business’s thin capitalisation ratio under the proposed exclusion for non-debt liabilities. *(Russell McVeagh)*

Comment

Under current law, a derivative position which is recorded in the financial statements as an asset is treated for thin capitalisation purposes as an asset, whereas a derivative position which is recorded in the financial statements as a liability is treated in the same way as shareholders’ funds. It is not treated as debt because it does not bear interest. This asymmetry is not appropriate, and there were no submissions in favour of its retention.

Where a derivative is a hedge of an item which is fair valued for purposes of the thin capitalisation calculations, then it is appropriate to include the derivative in assets (if it is in the money) or non-debt liabilities (if it is not). This treatment will be symmetric for the derivative itself, and will match the thin capitalisation treatment of the hedged item. This will reduce volatility in the thin capitalisation calculation.

Where the derivative is a hedge of an item which is not fair valued for thin capitalisation calculation purposes, or which is not included in the thin capitalisation calculations at all, officials consider there may be an argument for excluding the derivative from the measurement of assets and non-debt liabilities. There may also be cases when it should be taken into account. Take the case given by Russell McVeagh and described above. If the swap becomes out of the money, that does seem to be appropriately reflected in an increased debt percentage, since the value of the shareholder’s funds has been diminished, which will be recognised by way of a credit to the cash flow hedge reserve. Officials consider that the information provided in submissions does not provide a sufficient basis for excluding derivatives from non-debt liabilities.

Recommendation

That the submissions supporting excluding all or some derivatives from assets and/or non-debt liabilities be declined.

Issue: Liabilities of retirement village operators under occupational licences should be grandparented or excluded from non-debt liabilities

Submissions

(Corporate Taxpayers Group, PwC)

The non-debt liability proposal will have a significant impact on the retirement village industry, because of the substantial non-debt liabilities that are on their balance sheets from occupational right agreement. Either:

- a grandparenting provision should be provided for agreements entered into before enactment of the Bill (Corporate Taxpayers Group); or
- such provisions should not be treated as non-debt liabilities (PwC).

Comment

The Bill does not generally provide any grandparenting against the effect of the proposals relating to non-debt liabilities. The fact that the change will have a significant impact is not of itself a sufficient reason for grandparenting.

Recommendation

That the submission that retirement village operators be entitled to some form of grandparenting from the effect of the non-debt liability proposal in relation to liabilities from occupational right agreements be declined.

Issue: Should there be industry specific carve outs for certain non-debt liabilities

Submissions

(PwC)

A blanket approach to non-debt liabilities will severely adversely affect certain industries, including the securitisation, securities lending, retirement village and forestry industries.

Comment

The extent of such severe adverse effects has not been quantified by submitters during the policy formation or submissions process, and so is difficult to determine. Officials note that taxpayers are able to deduct interest on debt which does not exceed 110% of their worldwide debt percentage. Accordingly, if there are severe adverse effects, this would suggest that multinationals are putting much more debt, proportionately, into their New Zealand businesses than their non-New Zealand businesses. That is the practice which the thin capitalisation rules are trying to address.

Recommendation

That the submission be declined.

Issue: Related party trade payables should be excluded from non-debt liabilities

Submissions

(Russell McVeagh)

Trade payables owing to shareholders or members of a shareholder group should be excluded from non-debt liabilities. This is on the same basis as the exclusion for other forms of non-interest bearing financing provided by shareholders, eg an interest free loan.

Comment

Related party trade payables are not the same as an interest free loan from a shareholder. If a foreign company sells goods to a New Zealand group member on deferred payment terms, the price charged by the related party will be higher than the price that would be charged for a cash sale. The New Zealand purchaser's cost of goods deduction is in a sense a composite of a deduction for pure cost of goods and an interest charge. If the related party arrangement were changed so that the goods were sold for cash, and the purchase price obligation were funded by a loan, in order for the arrangement to produce the same tax result as the pre-change arrangement, the loan would have to bear interest. It would then be a financial arrangement, and included in the denominator of the debt percentage calculation.

The proposed thin capitalisation treatment (treating the related party trade payable as a non-debt liability) is more favourable to taxpayers than alternate treatment of it as a financial arrangement providing funds. There was no consultation on that alternative, and accordingly we do not recommend it here. It does demonstrate though why this submission should be declined.

Recommendation

That the submission be declined.

Issue: Inconsistent measurement approaches in determining non-debt liabilities

Submissions

(Corporate Taxpayers Group, Powerco)

Corporate Taxpayers Group and Powerco submitted that there is a measurement inconsistency in the drafting of proposed section FE 16B. Whereas "total liabilities" in the opening words of proposed subsection (1) are measured by reference to the outstanding balances shown in the financial statements, the reductions for liabilities which should not be treated as non-debt liabilities do not have a clear measurement test. It could, for example, refer to the outstanding balance for income tax purposes. This would not be desirable.

Powerco also submitted that there is a measurement inconsistency when a taxpayer uses spot exchange rates to calculate income or expenditure from hedged foreign currency financial arrangements.

Comment

Officials agree that consistency in this regard is important.

Recommendation

That the submissions in favour of consistency be accepted, and that the subtractions listed in section FE 16B(1) be clearly measured by reference to the outstanding balance of the items as shown in the financial statements. Similar amendment may also be required to section FE 16B(2).

Issue: Other exclusions from non-debt liabilities

Submission

(Chartered Accountants Australia New Zealand, PwC)

Chartered Accountants Australia New Zealand supported the exclusion from the definition of non-debt liabilities of interest free loans, preference shares and provisions for dividends. They also submitted that the exclusion from the definition of non-debt liabilities for preference shares should be expanded so it applies to preference shares that are not pro rata with shareholding. They pointed out that determining whether preference shares are a liability or not for financial statement purposes can be complex.

PwC supported the exclusion from non-debt liabilities for certain shareholder funding arrangements.

Comment

An amount will only be a non-debt liability if it is a liability in the financial statements. Generally preference shares will be a liability in the financial statements if they are redeemable in cash at the option of the holder or at a specified time. In that case, they are in a commercial sense a liability, and there is prima facie no reason not to treat them as such under the non-debt liability proposal. Non-debt liability treatment should only be reversed where there are other funding arrangements between the company and the shareholder that support treating the preference shares as equity. The nature of these arrangements should be the same as if the preference shares were an interest free loan. That is the effect of the Bill as introduced.

The complexity of determining whether preference shares are a liability or not for financial statement purposes does not seem relevant to the issue. The cost of making this determination has to be incurred for financial statement purposes, so there is no additional cost involved in using that determination under the thin capitalisation rules. At the margin, any complexity may mean that there are differences of opinion between advisors or over time. These kinds of issues are difficult to avoid, and not a strong argument in favour of abandoning a distinction which should generally be predictable enough.

Recommendation

That the submission in support of these exclusions be noted. That the submission in favour of excluding from non-debt liabilities preference shares which are not pro rata with shareholding be declined.

INFRASTRUCTURE PROJECT FINANCE

(Clauses 5, 17, 20, and 43(18))

Issue: Support for concessionary rule for infrastructure projects

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, Chapman Tripp, PwC)

Most submitters supported a concessionary rule that allows certain infrastructure projects that produce a public benefit to have more third party, limited recourse debt than would be allowed under the ordinary thin capitalisation rules.

Investment in infrastructure is essential for New Zealand's growth. *(Chartered Accountants Australia and New Zealand)*

Current tax rules unduly penalise participants in government infrastructure projects, which can result in increased costs for government and public sector entities. The infrastructure project finance exemption will help prevent project participants with a commercial level of debt from being penalised. This will help minimise infrastructure costs for the Government. *(Corporate Taxpayers Group)*

Comment

Officials note the support of the majority of submitters for a concessionary thin capitalisation rule for certain infrastructure projects.

Recommendation

That the submission be noted.

Issue: Opposition to concessionary rule for infrastructure projects

Submission

(New Zealand Council of Trade Unions)

One submitter said that the proposed concessionary rule for certain infrastructure projects is an unnecessary subsidy for those projects. This submitter said that the infrastructure projects that would receive the benefit of this rule are an expensive way to fund public infrastructure because private debt is more expensive than government debt.

This submitter considers that any competitiveness issue in the bidding process that results from the application of the thin capitalisation rules can be addressed by specifying maximum levels of debt in all relevant infrastructure projects.

This submitter also points to the failings of these infrastructure projects in New Zealand and overseas as a reason for why they should not be subject to a concessionary thin capitalisation rule.

Comment

Officials note that the Crown weighs up a number of factors when deciding how to fund an asset, but whether a specific asset could be funded in a more efficient way should not influence whether or not a concessionary rule should be provided.

Under current tax settings, infrastructure project participants using some structures are able to receive a deduction for all of their third party debt, while investors using other structures are limited in the amount of debt they can have by the thin capitalisation rules. This means that potential investors in an eligible infrastructure project are not always able to bid on a level playing field.

Officials consider that the proposed exemption for public project debt in eligible infrastructure projects is the best way to deal with this competitiveness issue. The alternative of limiting all eligible infrastructure projects to a lower proportion of limited recourse third party debt would force project participants to take on less debt funding than would be commercially efficient, which would in turn lead to an increase in the cost of the infrastructure project.

Recommendation

That the submission be declined.

Issue: Scope of rule – Central Government

Submission

(Chapman Tripp, Corporate Taxpayers Group, PwC)

The rule as drafted would apply only to infrastructure projects entered into with the Crown or with a public authority. The rule should be amended so as to apply to a wider range of infrastructure projects, including those entered into with local authorities, council controlled organisations, schedule 4A companies, and social housing providers.

Comment

Officials consider that the current definition of public project assets is sufficient. If, in the future, it becomes clear that some infrastructure projects are established that should receive the benefit of this rule but are not covered by the definition, the definition can be reviewed.

Recommendation

That the submission be declined.

Issue: Scope of rule – Determination power

Submission

(Corporate Taxpayers Group, PwC)

If the rule is not expanded so as to include infrastructure project contracts concluded with local authorities, council controlled organisations and social housing providers, Inland Revenue should have a determination power that would give them the flexibility to allow these infrastructure projects to still receive the benefit of this rule, provided that the infrastructure project was in the public interest. *(Corporate Taxpayers Group, PwC)*

Alternatively, such a discretionary power could instead be held by the Treasury. *(Corporate Taxpayers Group)*

Comment

Officials do not consider that a determination power is necessary. Officials consider that the scope of this concessionary rule should be fixed by Parliament. If changes to the scope of this rule are necessary, those changes should be required to go through the ordinary parliamentary process.

Recommendation

That the submission be declined.

Issue: Scope of rule – management phase

Submission

(Chapman Tripp, Corporate Taxpayers Group)

The rule as drafted requires the persons performing the contract to both construct or upgrade the public project assets, and operate or maintain the assets in New Zealand. Some infrastructure projects entered into by the Government comprise only a construction phase. These infrastructure projects should also get the benefit of this rule. *(Chapman Tripp, Corporate Taxpayers Group)*

Consideration should also be given to the fact that Government may be shifting to a delivery model for infrastructure projects that only includes a construction phase, meaning that future projects are unlikely to have a management phase. *(Chapman Tripp)*

If these submissions are not accepted, the legislation should be amended so that contracts that require the persons performing the contract to manage the assets in New Zealand are eligible, in addition to contracts that require the assets to be operated or maintained. *(Corporate Taxpayers Group)*

Comment

The rule is only intended to apply to infrastructure projects of at least 10 years in length. Any infrastructure project that is only a contract to construct an asset is not intended to receive the

benefit of this rule. Officials consider that short term projects that only require the construction of a public asset do not require a concessionary thin capitalisation rule.

Recommendation

That the submission be declined

Issue: Public project debt - security requirement

Submission

(Corporate Taxpayers Group)

The current definition of public project debt requires the debt to be secured against either public project assets, or income derived from public project assets. The definition of “public project debt” should not include any reference to the security provided for the debt. Instead, any debt that has a nexus with an eligible infrastructure project should be included in the special thin capitalisation calculation.

If this is not accepted, Inland Revenue needs to clarify how a person involved in an eligible infrastructure project needs to treat debt that is not public project debt for the purpose of the thin capitalisation rules.

Comment

The submitter is correct that the definition of public project debt is intended to be a gateway that captures all debt related to the eligible infrastructure project. Officials considered that all debt that was connected with an eligible infrastructure project would have some recourse against the project.

Based on the submission that it is possible that debt that will be applied to an eligible infrastructure project can, in certain circumstances, not have any recourse against the project, officials consider that the rule should be amended so that the requirement that public project debt must have recourse that is related to the project is removed.

Widening the definition of what constitutes public project debt will ensure that the rule works as intended. All debt that is intended to receive the benefit of this rule would have been included in the definition of public project debt as originally drafted. However some debt that is used as a part of an eligible project, but is not intended to receive the benefit of the rule, would not have come within this definition. Widening the scope will allow this debt to be appropriately dealt with by the special infrastructure rule, as opposed to the ordinary thin capitalisation rules.

Recommendation

That the submission be accepted.

Issue: Limited recourse debt

Submission

(Corporate Taxpayers Group)

All public project debt that is not recourse debt or public project participant debt should be limited recourse debt.

The current definition of limited recourse debt only includes debt that has security against either interests in public project assets, or income derived from these public project assets. There are two problems with this:

- Public project assets are generally owned by the Crown, so the taxpayer applying the rule will not have an interest in the assets.
- Debt should be allowed that has security against income derived from the project, not the public project assets.

The concept of limited recourse debt should be more widely defined so that it only excludes public project debt that has recourse that does not relate to the infrastructure project. The current definition of what constitutes “limited recourse” is too narrow and would exclude debt that in effect only has recourse against assets and income related to the project.

The submitter has provided some suggested drafting that would put this into effect.

rec[course] debt is the amount of all public project debt that is not public project participant debt and for which any security provided to the creditor does not relate only to the project:

limit[ed recourse] debt is the amount of all public project debt that is not public project participant debt and is not rec debt:

Alternatively, the definition of “limited recourse debt” should be amended so as to allow for all forms of security that are commonly provided in relation to eligible infrastructure projects. The common security interests that are not covered by the rule as drafted include assets and equity interests in a project Special Purpose Vehicle (SPV), where the activities of the SPV only relate to the project.

In addition, the reference to income derived from a public project asset in the definition of “limited recourse debt” should instead refer to income derived from the project.

Comment

Officials agree with the submitter’s point and consider that their alternative definition of recourse debt has merit. Any debt that has a nexus with an eligible infrastructure project, but has security that is not related to that project, should not receive the benefit of the proposed concessionary rule. If debt that had recourse against assets that do not relate to the project was allowed to get the benefit of this rule, then it is possible that the project participants could over-allocate debt into the New Zealand-based infrastructure project.

Officials therefore consider that the definition of recourse debt be amended in a manner similar to what is proposed by the submitter

If a definition similar to what is proposed by the submitter is adopted, there will no longer be a specific reference to income derived from a public project asset in the definition of recourse and limited recourse debt.

Recommendation

That the submission be accepted subject to officials' comments.

Issue: Excess debt

Submission

(Corporate Taxpayers Group)

The restriction on how much debt can receive the benefit of the proposed exemption should be removed so that all debt related to an infrastructure project covered by this rule would be deductible, unless it is either on non-limited recourse terms, or is public project participant debt.

In addition, a safe harbour should be introduced that would allow a taxpayer to avoid the apportionment formula in the rule, provided that the project is funded solely by limited recourse debt that is not public project participant debt. The submitter also recommends granting the Commissioner of Inland Revenue a determination-making power to approve certain project debt facilities so that no deductions are denied.

This is because the value of public project assets as defined does not include all relevant assets. Instead, the effect of the rule is to effectively compare a legal amount of debt with an accounting value of a financial asset that is an estimate of the present value of the cash flows that are expected to be derived from the project. This accounting valuation of the financial asset associated with the project can underrepresent the real value of the assets associated with the infrastructure project.

If the submission to remove excess debt from the rule is not accepted, then the definition of what constitutes excess debt should be amended to mean one of:

- Debt that exceeds the aggregate estimated construction costs of the public project assets; or
- Debt that exceeds 100% of the total assets held by the contractor at the relevant time for the purpose of the project.

Comment

Officials accept the submitter's submission that all debt that is on limited recourse terms and is not public project participant debt should be deductible. As such, officials consider that a limit on how much debt can be deductible under this proposed rule should be removed.

If excess debt is removed from the apportionment formula, officials consider that a safe harbour that would allow a taxpayer to avoid the apportionment formula if the only type of debt they have is limited recourse debt that is not project participant debt is unnecessary. If this is the only type of debt that a taxpayer has, then the apportionment formula will result in zero interest deductions being denied.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Public project participant debt (FE 4B (3))

Submission

(Chapman Tripp, Corporate Taxpayers Group)

The definition of public project participant debt is unnecessarily complex and should be simplified so that it can be more easily understood and applied by taxpayers. In addition, a detailed example should be provided in the commentary that clearly illustrates when an investor will be considered to have lent money in its capacity as a third party lender. *(Corporate Taxpayers Group)*

Further clarity is required around what form of related party debt will be deductible, as the rule as currently drafted is uncertain in its application. At a minimum, non-proportionate shareholder debt should be deductible. *(Chapman Tripp)*

Comment

Officials agree that complexity is to be avoided and aim to achieve this. The definition was drafted with the intention of ensuring that taxpayers could not abuse the rule and treat debt that is effectively a substitute for equity as if it were third party, limited recourse for the purpose of the thin capitalisation rules. Officials believe that the definition of public project participant debt can be redrafted in a way so as to be easier to understand and still accomplishes this purpose.

Officials consider that, in general, non-proportionate shareholder debt should be deductible under this rule. However, there may be some specific situations where some project participants are able to provide debt that is not in proportion to their interest in the project, but that is still effectively a substitute for equity. Officials consider that such debt should still come within the definition of "public project participant debt". A clear example will be provided in the Tax Information Bulletin (TIB) in order to illustrate what sort of participant debt will be considered a substitute for equity.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Debt applied to assets used in the project

Submission

(Corporate Taxpayers Group)

The definition of "public project debt" in s FE(4)(2)(a) requires that the debt is applied to the project to give rise to public project assets. Officials should confirm that this definition does not prevent debt from being applied to other assets required to carry out the project.

In addition, the definition of “public project debt” should be amended so that it only looks at the purpose for which the debt is drawn down for. All debt that is drawn down for the purpose of the project should be considered “public project debt”. This would prevent the need for a prescriptive definition that appropriately captures all relevant debt.

Comment

Officials consider that the definition of “public project debt” already allows for debt that is applied to assets that are used to carry out an infrastructure project. The debt must simply be used in a way that gives rise to public project assets, even if that way is in an indirect fashion.

Officials consider that the test for whether debt is “public project debt” should not be based solely on the purpose for which the debt is drawn down for. The various requirements in the definition of “public project debt” are necessary in order to ensure the integrity of the proposed rule.

The Specialist Advisor to the Finance and Expenditure Select Committee (Specialist Advisor) has suggested that the definition of “public project debt” be amended to allow for debt that is applied to the project so as to give rise to income derived from the project. Officials agree with this suggestion.

Recommendation

That the submission be accepted, subject to officials’ comments.

Issue: Debt refinancing

Submission

(Corporate Taxpayers Group)

It is possible that the definition of public project debt does not cover the refinancing of debt that was originally valid public project debt. The submitter states that it is common for senior bank debt facility refinancing to occur every 5 to 7 years for relevant infrastructure projects and that this debt should be included in the definition of “public project debt”.

Comment

Officials agree that the definition of “public project debt” should be amended so that debt used to refinance existing “public project debt” is also included in the definition.

Recommendation

That the submission be accepted.

Issue: On-lending funds to persons not associated with the project

Submission

(Corporate Taxpayers Group)

The restriction on “public project debt” not being lent to a person not associated with the project is too restrictive. It is possible for third party funds to be drawn down on pre-set dates, but the timing of the construction does not necessitate the payment of those funds immediately.

As a result, there will be a legitimate business reason for funds that will eventually be applied to a relevant project to be on-lent to a third party, such as a financial institution, before the funds are eventually applied directly to the project.

Comment

Officials consider that such on-lending of funds that will eventually be applied to the infrastructure project should not invalidate that debt from being public project debt.

Officials consider that the provision should be amended so as to explicitly carve out on lent funds that are deposited with a registered bank, except for funds that are not intended to be used in performing the project.

Recommendation

That the submission be accepted.

Issue: Rule should be optional

Submission

(Corporate Taxpayers Group)

As the rule is intended to be concessionary to taxpayers investing in eligible infrastructure projects, these taxpayers should have the option of applying the ordinary thin capitalisation rules if they want. The rule as currently drafted could result in a greater level of interest deductions denied than under the ordinary thin capitalisation rules in certain circumstances.

Comment

Officials consider that the exemption should never result in a worse outcome for eligible taxpayers when compared to the ordinary thin capitalisation rules. However, officials consider that providing an election for an infrastructure project as to whether the proposed concessionary rule or the ordinary thin capitalisation rules will apply is acceptable, provided that the election is a one-off decision for each excess debt entity that can only be taken before the first thin capitalisation calculation is undertaken for the infrastructure project by that entity.

For existing infrastructure projects, the election will need to be exercised at the time of the first thin capitalisation calculation after the rule comes into effect.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Allow investor to divest interest to a separate investor

Submission

(Corporate Taxpayers Group)

The rule as drafted prevents the investor from disposing of the public project assets within 10 years from the beginning of the contract, except to the public authority, or to another person performing the contract.

It should be clarified in a TIB example that the legislation allows one investor to sell their interest in an infrastructure project to a new investor.

Comment

Officials consider that the Bill already allows for an investor to dispose of their interest in the project to another investor. The meaning of "another person performing the project" includes new investors who will be performing the project in the place of the participant selling their interest in the project.

However, officials do consider that the wording in the draft legislation should be amended to clarify that public project assets can also be disposed of to the Crown, in addition to a public authority.

Recommendation

That the submission be declined.

Issue: Taxpayers within scope (FE 7B(1)(a))

Submission

(PwC)

The rule as drafted would only apply to a company controlled by a group of non-residents acting together. This restrictive requirement should be relaxed.

Comment

The rule as drafted would not apply to a New Zealand company controlled by a non-resident owning body. Instead, the rule will only apply to excess debt entities that are not controlled by a non-resident owning body.

All persons who will foreseeably be involved in eligible infrastructure projects are covered by the rule. The rule as drafted would only apply to entities that are controlled by a single non-

resident, partnerships entered into by non-residents, and New Zealand resident entities subject to the outbound thin capitalisation rules.

Recommendation

That the submission be declined.

Issue: Exclude interest expenditure on public project debt from ordinary thin capitalisation rules (FE 7B(6))

Submission

(Corporate Taxpayers Group)

The rule as drafted excludes public project debt and public project assets from being taken into account in a separate thin capitalisation calculation. This exclusion needs to be extended to the interest expenditure on that debt as well.

Comment

Officials consider that the carve out of public project debt from use in other thin capitalisation calculations means that any interest related to that debt is similarly carved out.

For clarity, officials consider that the legislation should be amended to specifically carve out interest on public project debt from other thin capitalisation calculations.

Recommendation

That the submission be accepted.

Issue: Drafting issues

Submission

(Corporate Taxpayers Group)

The “Meaning of public project participation debt” title in section FE 4B should instead read “Meaning of public project participant debt”.

“Is not a source of funds” in section FE 4B(2)(c) should be “provides funds” in order to be consistent with the other thin cap legislation.

The section FE 4B (2) definition of “public project debt” refers to an excess debt entity’s proportion of a loan. This is unnecessary as section HG 2 already deals with a partner in a partnerships proportion of a loan. Using the wording contained in FE 4B(2) of “the excess debt entity’s proportion of the loan” instead of relying on section HG 2 is inconsistent with the rest of the thin capitalisation legislation.

Officials note that s FE 7B(2)(b) should also be amended so as to remove the reference to an excess debt entity's proportional interest in the public project assets, so as to be more consistent with section HG 2 and the rest of the thin capitalisation rules.

Comment

Officials agree that all of these drafting issues should be addressed by amending the legislation.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Threshold debt amount

Submission

(Matter raised by officials)

The "threshold debt amount" of an excess debt entity, which is defined in s FE 7B(4)(c)(i) should be altered so as to be consistent with the definition of the entity's debt percentage, as provided by FE 7B(2). This will allow assets used in performing the project to also be used in determining how much debt would be denied under the special infrastructure project rule.

Recommendation

That the submission be accepted.

Issue: Non-debt liabilities

Submission

(Matter raised by officials)

All of the non-debt liabilities of an excess debt entity that relate to a public project should be included in the calculation of that excess debt entity's debt percentage. In addition, all of those non-debt liabilities should also be excluded under s FE 7B(6) from being taken into account for the rest of the thin capitalisation rules.

Recommendation

That the submission be accepted.

Issue: Disposing of asset to the Crown

Submission

(Matter raised by officials)

Section FE 4B(1)(b) allows a public project asset to be disposed of within 10 years from the beginning of the project to a public authority. Officials consider this should be amended to also include “the Sovereign in right of New Zealand”.

Recommendation

That the submission be accepted.

OTHER THIN CAPITALISATION

Issue: Non-proportionate shareholder debt

Submission

(Chapman Tripp)

The Bill contains an amendment to reduce the 110% worldwide debt threshold to 100% for an entity controlled by a group of non-residents acting together. Under the proposed amendment, if such an entity exceeds the 60% safe harbour, any owner-linked debt will be non-deductible.

We do not agree with the proposed amendment in respect of non-proportionate shareholder debt. In this scenario the shareholder is effectively taking on the role of third party lender. Shareholder debt in this situation should be considered analogous to third party debt and should remain deductible (even above 60% gearing). Any arm's length debt should remain deductible above the 60% safe harbour on the basis that these investors will not have the benefit of a worldwide group test to reflect an appropriate industry debt level.

Comment

This position was set when these rules were introduced as the same issue can arise with a 110% threshold, albeit it arises earlier with a 100% threshold. While holding debt in proportion to shareholding is an indication that this debt may be in substitution for equity this is not the only way to achieve this effect. Allowing a borrower to have over 60% debt and the ability to have debt from shareholders would increase the risk of a company having high levels of debt in substitute for equity.

Recommendation

That the submission be declined.

Issue: De minimis threshold for inbound thin capitalisation rules should include owner-linked debt

Submission

(Chapman Tripp, Corporate Taxpayers Group)

We support the extension of the de minimis threshold so that it applies to inbound entities. However, we submit that the de minimis threshold should include owner-linked debt as otherwise the de minimis threshold would be very limited in application. The de minimis threshold should instead apply to all cases where the inbound thin capitalisation rules apply. This would be consistent with Australia's de minimis threshold which is a flat A\$2 million regardless of whether any lending is with a related party. *(Chapman Tripp)*

Section FE 6(3)(ac) provides a de minimis for a person subject to the outbound thin capitalisation rules. The Bill proposes to extend this to persons subject to the inbound thin capitalisation rules but only if they have no "owner-linked debt". The proposed related party debt restriction is likely to make the de minimis very limited in application. It would be

appropriate to extend the de minimis to inbound investment without the owner-linked debt restriction on compliance cost saving grounds. In Australia a flat \$2 million de minimis applies, regardless of whether any lending is related party debt. (*Corporate Taxpayers Group*)

Comment

The de minimis applies consistently with the existing outbound de minimis in that it fully applies up to \$1 million then diminishes up to \$2m million. The purpose of this is to remove the disincentive to have only a small amount of interest above the \$1 million threshold and therefore have the de minimis not apply at all.

Unlike the \$10 million de minimis in sections GC 16(1)(a) and GC 18(1)(a) which apply to the loan principal this de minimis applies to interest. At an interest rate of 5% the amount of the loan(s) may be up to \$20 million. Officials consider at this level of related party lending it is appropriate for the thin capitalisation rules to apply as the compliance costs of applying the rules will become smaller relative to the potential tax effect of the rules applying.

This de minimis does not apply to the inbound rules when the group has owner-linked debt. The thin capitalisation rules consider the level of debt rather than the price of that debt. When a group has owner-linked debt this increases the risk that a group has included higher levels of debt for tax purposes compared with a group that has entirely third party debt. As the de minimis does not currently apply at all to the inbound rules the proposals in the Bill result in a more taxpayer favourable treatment than under the current legislation.

Recommendation

That the submission be declined.

Issue: Non-residents acting in concert: related-party debt

Submission

(*Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group*)

We support the proposed amendment, sections FE 5(1)(ab) and FE 6(3)(e)(iii), to amend the rules for entities controlled by a group of non-residents acting together. (*CA ANZ*)

The group is supportive of the proposal to amend the way the thin capitalisation rules apply to “non-resident owning bodies” so if such a firm exceeds the 60% safe harbour, any owner-linked debt in excess of 60% will be non-deductible. (*Corporate Taxpayers Group*)

Comment

Officials note the support.

Recommendation

That the submission be noted.

Issue: Group acting in concert

Submission

(Corporate Taxpayers Group)

The group does not support the inclusion of new section FE 5(6) for the following reasons:

- It is an inherently uncertain rule. What does it mean to “act in concert”? “Act in concert” is not a defined term. The concept of acting in concert was rejected when the thin capitalisation rules were amended in 2012. Without further guidance it is completely meaningless and drives unnecessary complexity into the rules.
- Perhaps more importantly section FE 5(6) is not required. As noted above, the issue to be addressed only arises when the membership of the worldwide group is determined under section FE 31D. Section 31D only applies when the “ordinary” thin capitalisation rules do not apply. It is only entities controlled by a non-resident owning body (i.e. entities that fall into section FE 2(1)(cb) that use FE 31D to determine the make-up of their worldwide group, and then it is only those entities that should be subject to this proposals.

Comment

“Act in concert” is an existing concept used in the thin capitalisation rules in sections FE 1(1)(a)(iii), FE 2(1)(d)(iii) and FE 26(7)(b) which each relates to the use of trusts. This was explained in Tax Information Bulletin Volume 26, Number 7 August 2014 as:

As with companies, the thin capitalisation rules apply to trusts settled by entities acting in concert. This is important to ensure the rules cannot be easily circumvented through the use of trusts. However, the rules for determining when a group of entities appear to be acting together used for companies (described in the section *non-resident owning body*) cannot be used for trusts. Instead, the rules apply to a trust settled by a group “acting in concert”. This is because, for example, it is not sensible to refer to settlements made in proportion to debt extended to a trust because rights to income from a trust generally do not depend on the amount a person has settled on it.

The proposed changes to sections FE 5 and FE 6 separate taxpayers who are controlled by a group acting in concert from other taxpayers covered by the thin capitalisation rules so that a 100% worldwide debt percentage can be applied instead of the typical 110%.

The changes to sections FE 5 and FE 6 were not intended to change the scope of who is acting in concert for the purpose of the interest apportionment rules, merely to apply a 100% percentage to taxpayers who were already treating their New Zealand group as their worldwide group. The provision that achieves this is section FE 31D and officials recommend the reduction in debt percentage to 100% of the worldwide group should cross-reference to this provision to ensure that the scope is unchanged.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Grandparenting of non-residents acting in concert

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Powerco)

Submitters support the five year grandparenting of existing arrangements under proposed section FZ 8 on the basis that they were agreed under the existing tax regime. This will result in a fairer and more equitable outcome for taxpayers.

However, some submitters considered the grandparenting provision should include the option to assess the grandparented debt percentage up until the effective date of the changes. This would allow the preservation of the positions being taken immediately before the law is actually passed by Parliament in its final form, which gives effect to the intention of the grandparenting.

By contrast, only allowing assessment of the debt percentage on or prior to the date of introduction to Parliament appears to assume that taxpayers are likely to change their debt levels following introduction of the Bill. Given that the Bill is still subject to further changes as part of the Parliamentary process, the Group does not consider that this is a realistic assumption. Further, the existing and newly proposed specific anti-avoidance rules in section FE 11 and section GB 51B should deal with any avoidance concerns that Officials might have with regard to grandparenting positions taken between the introduction of the Bill and the date of enactment. *(Corporate Taxpayers Group)*

Without legislation taxpayers have not been in a position to reduce their debt to within the new reduced threshold. It is consistent with previous legislative reform in this area that taxpayers are given an opportunity to reset their gearing levels to fall within the new rules. The transition date should apply from the first measurement date after the corresponding Act is passed or the measurement date preceding the application date. *(PowerCo)*

Comment

The Bill includes, at the option of the borrower, two measurement dates for the grandparenting provision: either the introduction date of the Bill (6 December 2017) or the borrower's thin cap calculation date immediately before this date. A measurement date for the date of enactment of the Bill was not included as this would create an incentive for any borrower covered by the proposed law change to increase their level of related party borrowing, up to the current 110% limit, prior to enactment of the Bill so they could maintain this higher level of debt for the next five years.

Officials consider the two possible measurement dates should accurately reflect the related party debt proportion of borrowers affected by the proposed law change.

Recommendation

That submitters' support for the grandparenting be noted but that the submission to amend the transition date be declined.

Issue: Asset valuation

Submission

(Chartered Accountants Australia and New Zealand)

We support the proposal to allow taxpayers to use the net current valuation method when a valuation from an independent valuer has been received or the valuation methodology, assumptions and data have been approved by an independent valuer.

Comment

Officials note the support.

Recommendation

That the submission be noted.

Issue: Assets not recognised for financial reporting purposes

Submission

(Corporate Taxpayers Group)

The asset measurement rules should be amended to allow assets that are not recognised for financial reporting purposes to be included in total assets for thin capitalisation purposes, where an independent valuation of that asset can and has been obtained. Specifically, we are advocating for the recognition of intangible assets that are not able to be recognised under existing financial reporting standards.

Business models and operators have changed significantly in the last few decades, such that traditional accounting measures of assets do not necessarily reflect the value of a company or provide an indication of likely cash flow to be generated. The reality is that a third party lender would look to more than just the balance sheet of a business when determining how much to lend, such as forecasted future income and “off balance sheet” assets like licences. As such, it would be appropriate to include the value of such assets for the purposes of the thin capitalisation rules.

If this is not accepted, then at a minimum interest paid on non-recourse third party debt supporting assets where a third party valuation is available to support should be allowed. What the thin capitalisation regime is seeking to do is ensure that the level of debt borne by the New Zealand operations is appropriate and not excessive. If a third party would be prepared to lend against an asset then such debt is not excessive as it is an arm’s length amount. We should not be denying interest on such funding depending on the accounting treatment.

Comment

There can be considerable subjectivity in the valuation of intangible property that is not able to be recognised under financial reporting standards, even when an expert valuer is involved. Allowing the inclusion of such assets when they are not recognised under existing financial reporting standards would create an incentive for taxpayers to (sometimes substantially) increase

the value of intangible assets when they were approaching or over the thin capitalisation threshold (or the equivalent test in the restricted transfer pricing rules).

Recommendation

That the submission be declined.

Issue: Drafting of thin capitalisation rules

Submission

(Corporate Taxpayers Group)

Following numerous rounds of amendments to the regime, the thin capitalisation rules have now become extremely complicated and difficult to understand. Subpart FE of the Act should be renumbered and rewritten to allow the rules to be more easily understood.

Comment

The submitter's suggestion would require significant resources that cannot be committed as part of the select committee process of this Bill. Officials will consider this submission for future inclusion on the tax policy work programme.

Recommendation

That the submission be declined.

Issue: Interest carry forward rule

Submission

(PwC)

An interest carry forward rule should be introduced to offset and balance the volatility and uncertainty that arises as a result of the proposed legislation.

Taking non-debt liabilities into account in calculating an entity's capacity for debt will introduce potentially material volatility and uncertainty to that entity's thin capitalisation calculations. This uncertainty will be compounded due to the currently drafted thin capitalisation anti-avoidance legislation.

This volatility is a similar concern to that recognised in the Bill Commentary as a problem with an EBITDA-based test and that taxpayers should be afforded protection from such unpredictability. Given the volatility is similar to that under an EBITDA-based test, protection similar to that suggested by the OECD (that is, the ability to carry forward denied interest deductions) should be adopted. Such a mechanism is intended to smooth out the effect of such volatility over subsequent income years.

Comment

An EBITDA test compares earnings to interest. This test will be volatile, particularly for taxpayers near the upper limit, as very few businesses will be able to accurately forecast their earnings a year in advance.

These concerns are not as significant with New Zealand's thin capitalisation test which compares debt to assets (proposed to be assets minus non-debt liabilities). While there will be some difficulty in being 100% accurate in forecasting assets and non-debt liabilities this should be much easier than forecasting earnings. To the extent there is difficulty in forecasting debt and assets, this has always been a feature of New Zealand's thin capitalisation rules.

The changes to the thin capitalisation rules will not necessarily increase volatility as in some instances a non-debt liability will be matched by a corresponding asset so a change in one value will be matched by an equal change in the other so that excluding non-debt liabilities reduces volatility. The anti-avoidance rule will only apply where a taxpayer intentionally structures to avoid the application of the thin capitalisation rules and officials do not consider this can be treated as increasing volatility.

Recommendation

That the submission be declined.

Issue: Inbound de minimis

Submission

(Corporate Taxpayers Group)

In the proposed amended section FE 6(3)(ac)(i) the reference to "and not a party to a financial arrangement..." should not include the word "not".

Comment

This amendment is intended to extend the existing outbound de minimis to persons subject to the inbound de minimis unless they have owner-linked debt. When section FE 6(3)(ac)(i) applies the de minimis does not; therefore the amendment to this subparagraph should remove inbound persons without owner-linked debt from its existing scope.

A person with owner-linked debt is a party to a financial arrangement that is removed under section FE 18(3B) therefore a person without owner linked debt would not be a party to such an arrangement which means they would satisfy that portion of the amended section and therefore be ineligible for the de minimis. Therefore, the submitter is correct that the amendment will not achieve the intended outcome.

However, current drafting, even with the word "not" removed, as the submitter suggests, would not achieve the intended policy outcome. This is because the amendments to section FE 6(3)(ac)(i) remove the reference to "not [being] an excess debt outbound company". The consequence is the de minimis would be available to all excess debt entities except for natural persons or trustees described in section FE 2(1)(g) with owner-linked debt.

Officials recommend section FE 6(3)(ac)(i) is amended so that the de minimis is available to any person unless they are subject to the inbound thin capitalisation rules and they have owner-linked debt.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Definition of assets

Submission

(Corporate Taxpayers Group)

Asset, as used in proposed section FE 16(1BAA), is not a defined term. It could be made clearer if “asset” is only intended to assets which can be recognised for financial reporting purposes.

Comment

While “asset” is not a defined term for the purpose of the thin capitalisation rules it is already used in existing section FE 16(1) which proposed section FE 16(1BAA) provides how that asset may be valued. Furthermore, existing section FE 16(2) states that total group assets must be calculated under generally accepted accounting practice. This amendment is not intended to change the definition of “asset” that already applies to the existing section.

Recommendation

That the submission be declined.

Issue: Frequency of asset valuation

Submission

(Corporate Taxpayers Group)

It should be clarified that taxpayers do not need to have assets valued annually to apply the net current value in proposed section FE 16(1BAA). For example, a new valuation could be required where there is an impairment event for financial reporting purposes, or the taxpayer is seeking to increase the value from a previous valuation.

Comment

This section provides how a valuation is to be determined but does not provide any guidance on how frequently that valuation must be undertaken. Officials consider it would be impractical to require a valuation each time a thin capitalisation calculation is undertaken. Conducting a valuation each time there is an impairment event for financial reporting purposes or if the taxpayer is seeking to increase the value from a previous valuation would be consistent with the policy intent and officials consider this can be achieved under the current drafting in the Bill.

Recommendation

That the submission be noted.

Issue: Valuation of unique assets

Submission

(Corporate Taxpayers Group)

Guidance on section FE 16(1BAA) is required in the situation where a taxpayer has a very unique asset. It may be difficult to find an expert in the valuation of a unique asset (but it can be valued by a valuation expert)

Comment

This section requires the valuation to be done by an independent person who is an expert in the valuation of such assets. In the case of a particularly unique asset an experienced valuer may be best placed to conduct that valuation even though they have not valued an identical asset before. This would be available under the proposed requirement. If a valuer was an expert in their field but had no experience of such assets, for example getting a valuation on intellectual property from a person who specialised in valuing real estate this would not meet the proposed requirement.

Recommendation

That the submission be noted.

Issue: Independent expert valuations of assets

Submission

(Corporate Taxpayers Group)

The concept that a valuation must be done by “an independent person who is an expert” needs to be refined or otherwise clarified in guidance. “Independent” and “expert” are too vague.

Who is “independent” (this is only targeted at excluding employees / contractors of the taxpayer). A person can be either a business or an individual. A professional services firm may provide multiple types of services / have multiple supplier/customer relationships with a taxpayer, it should still be viewed as independent from the taxpayer for the purposes of this rule. To be an “expert”, this should be the valuation service provider holding themselves out as an expert. There are not professional bodies or relevant qualifications for all types of assets.

Comment

It would be difficult to define what is “independent” or an “expert” as this will be very fact specific to an individual valuation. Independence suggests the valuer has applied an objective approach to the valuation. This would not be met if people relying on that valuation, such as the taxpayer or the Commissioner, believe that the valuer may have been influenced by other

parties. Being an expert will also need to be determined on a case-by-case basis taking relevant factors such as qualifications, experience in valuing similar (but not necessarily identical) assets and membership of a relevant professional body if applicable.

Recommendation

That the submission be noted.

Issue: Support for anti-avoidance rule

Submission

(Chartered Accountants Australia and New Zealand)

We support the proposal to introduce section GB 51B, an anti-avoidance rule where a taxpayer enters into a transaction near a measurement date with the purpose or effect of manipulating the thin capitalisation rules.

Comment

Officials note the support.

Recommendation

That the submission be noted.

Issue: Anti-avoidance rule scope

Submission

(Corporate Taxpayers Group, KPMG, PwC)

The application of the anti-avoidance rule in section GB 51B(1)(a) is too broad, especially due to the inclusion of “or would have”. What is this intended to capture? Would taking a legitimate financial reporting position satisfy this? *(Corporate Taxpayers Group)*

Further clarity is needed on the intended application of proposed section GB 51B. Given the enhanced scope for changes in loan values to be disregarded for thin capitalisation purposes, clarity is needed on the circumstances in which the Commissioner will seek to apply new section GB 51B. *(KPMG)*

We appreciate the need for anti-avoidance rules to be appropriately general in nature so as to capture tax outcomes which contradict policy rationale. However, the proposed rule as currently drafted is far reaching and could be erroneously applied to challenge tax outcomes that are supportable by ordinary commercial arrangements and not motivated at all by thin capitalisation implications, including but not limited to revolving credit, working capital and other short-term funding facilities.

The current anti-avoidance provision in the thin capitalisation regime should be sufficient.

If the proposed provision is maintained, at a minimum, it should include a safe harbour time frame beyond which an increase or decrease in a value would not be considered to have the purpose or effect of defeating the intent or application of the thin capitalisation rules. Allowance should also be made for immaterial movements in the values.

The proposed provision, if enacted, will need to be accompanied by significant Inland Revenue guidance on its intended application. The proposed provision should not capture an increase or decrease in value that is attributable, co-incidentally or otherwise, to a seasonal factor, one-off transaction or standard end-of-year procedures. (*PwC*)

Comment

The proposed anti-avoidance rule will operate very similarly to a number of existing anti-avoidance rules in other parts of the Income Tax Act. Like other such rules, whether this anti-avoidance rule applies will need to be considered on a case-by-case basis. The types of transactions identified by the submitters such as revolving credit, working capital and other short-term facilities will not trigger the anti-avoidance rule merely because they occur near a balance date. What is crucial is whether the transaction was for the purpose or effect of avoiding the thin capitalisation rules.

Where particular safe harbours are inserted into an anti-avoidance rule this risks sanctioning an acceptable level of avoidance. For example if the rule stated that it did not apply to any transaction more than a month from a balance date, this would mean it would not apply if a taxpayer deliberately had less than the required level of equity for the measurement period but repaid debt one month and one day prior to the balance date. While this would mean the rule applied to the most blatant transactions such as those entered into then unwound the following day, it would allow many other undesirable transactions to go unchallenged.

Recommendation

That the submission be declined.

Issue: Anti-avoidance rule dominant purpose

Submission

(Corporate Taxpayers Group)

The anti-avoidance rule in section GB 51B applies if an arrangement has an effect of defeating the intent and application of subpart FE. This should be a dominant purpose test.

Comment

The anti-avoidance rule can apply when an arrangement, action or omission has a purpose or effect of defeating the intent and application of the thin capitalisation rules. As this is not a dominant purpose test it means it can still apply when a taxpayer has more than one purpose for their action with only one of these purposes being tax avoidance.

Taxpayers who have entered into avoidance arrangements will almost always argue that the arrangement was entered into for commercial purposes and that tax avoidance was not their

intention or was merely incidental. Inserting a dominant purpose of tax avoidance is a much higher threshold, particularly on a provision that is aimed at a taxpayer's balance sheet.

Of the existing anti-avoidance rules, many of which are in subpart GB, the most common approach is to be triggered by a purpose or effect of the arrangement. Officials see no reason why this particular anti-avoidance rule should have a higher threshold than that applying to other areas of the Income Tax Act.

Recommendation

That the submission be declined.

Issue: Owner-linked debt when the borrower is a trust

Submission

(Chartered Accountants Australia and New Zealand)

We support the proposal to amend section FE 18(3B) to ensure the rules operate clearly in relation to trusts.

Comment

Officials note the support.

Recommendation

That the submission be noted.

Issue: Worldwide group debt percentage and on-lending concession

Submission

(Bell Gully)

The thin capitalisation rules should provide express guidance as to the make-up of residual debt that remains after applying the on-lending concession in section FE 13 so that the worldwide group test in section FE 18 can be applied with certainty. The passage of the Bill provides an opportunity to correct this omission given that the Bill already contains corrective changes to section FE 18.

The issue, broadly, is:

- The on-lending concession effectively allows a deduction for interest on notes issued by a securitisation trust (Trust) to the extent they fund financial arrangements with non-associated borrowers.
- After applying the on-lending concession, the Trust's assets and debt for thin capitalisation purposes consist (respectively) of non-financial arrangement assets and notes funding those assets.

- When applying the worldwide group test to the residual debt and asset position, it is necessary to identify what proportion of the debt is related party debt (such debt being excluded from the calculation of the worldwide group debt percentage).
- However, the statutory provisions provide no guidance as to the split of the residual debt amount (after applying the on-lending concession) between related party and third party components. This makes the worldwide group test difficult to apply.
- A reasonable approach might be to apply the same percentage split of the total third party versus related party notes to the residual debt amount. However, the statutory provisions provide no express support for this, and other allocations could be adopted (e.g. all related party debt, or all third party debt).

Comment

Due to the fungibility of money, when a borrower has a mixture of third party and related party funding, it is not possible to determine which specific source of funding has been allocated between the on-lent funding and the residual application of funds. Officials agree that apportioning the residual between third party and related party debt in the same proportions as before the on-lending concession is applied would be appropriate and recommend changes to FE 18 to achieve this.

Recommendation

That the submission be accepted.

Permanent establishment anti-avoidance rule

OVERVIEW

The Bill proposes a new anti-avoidance rule for large multinationals (with over €750m of consolidated global turnover) that structure to avoid having a permanent establishment (PE) and therefore a taxable presence in New Zealand.

The proposed rule will deem a non-resident entity to have a PE in New Zealand if a related entity carries out sales-related activities for it here under an arrangement with a more than merely incidental purpose of tax avoidance (and the other requirements of the rule are met). This PE will be deemed to exist for the purpose of any applicable double tax agreement (DTA), unless the DTA incorporates the OECD's latest PE article.

In addition, under the proposed amendments an amount of income will be deemed to have a source in New Zealand if that income can be attributed to a PE in New Zealand. If a New Zealand DTA applies to the non-resident, the definition of a PE in that DTA will apply for this purpose. If no New Zealand DTA applies to the non-resident, then a new domestic law definition of a PE will apply.

The Bill also proposes deeming an item of income to have a New Zealand source under our domestic legislation if New Zealand has a right to tax that item of income under a DTA.

The new source rules aim to both simplify the test for determining whether an item of income has a source in New Zealand, and ensure that all items of income New Zealand is entitled to tax under a DTA will be taxable under domestic law.

Submitters were generally supportive of the proposed PE anti-avoidance rule, but they were concerned about some aspects. Several submitters argued that the rule should not override New Zealand DTAs. Other submitters were concerned about its effect on foreign direct investment. The majority of the submissions requested amendments to clarify or narrow the scope of the proposed rule. Submitters also wanted detailed guidance to be provided about its application.

The proposed changes to the source rules attracted fewer submissions. The main concern was that the rules could apply too broadly. There was also some concern about introducing the rules given that they were not part of the OECD's BEPS recommendations.

GENERAL

(Clause 34)

Issue: General support for the rules

Submission

(Chartered Accountants Australia and New Zealand, EY)

The above submitters generally support the introduction of the PE avoidance rules to protect New Zealand's tax base.

However, the submitters had some concerns about the specific features of the amendments. The specific concerns are addressed below.

Recommendation

That the submission be noted.

Issue: Proposed rules will have a detrimental effect on foreign direct investment

Submission

(Deloitte, Corporate Taxpayers Group, PwC, Chartered Accountants Australia and New Zealand)

The proposed rules will materially impact on the perceptions of New Zealand as an attractive and easy place to do business. If the proposed changes proceed, there is a risk that multinational groups will cease to operate in New Zealand. Further, if other countries adopt similar positions in their domestic legislation, many New Zealand exporters may find themselves with PEs overseas that they do not currently have. As a result, those exporters will pay tax overseas, thereby reducing the tax they pay in New Zealand.

Comment

There will be additional tax and compliance costs for some investors, but these are necessary to address the policy issues. Officials have used consultation to refine the proposals, minimise unintended impacts, and better target the BEPS concerns. This should reduce the additional compliance costs, although it will not eliminate them.

The higher tax payments resulting from the proposed measures may make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. But 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. It also erodes the integrity of the system.

New Zealand is also undertaking these BEPS measures in line with most other OECD countries and the expected tax revenue increase is expected to be relatively small (compared with the total

corporate tax base). 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.

Officials also consider that it is 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.

Given New Zealand's size, whether or not other countries adopt similar BEPS measures is unlikely to be materially influenced by our proposals. For example, Australia and the UK had already introduced their diverted profits taxes (DPT) prior to the introduction of the BEPS Bill.

Recommendation

That the submission be declined.

Issue: Clear guidance should be provided in the Officials' Report

Submission

(KPMG)

The Bill Commentary does not provide sufficient guidance on two aspects of the deemed PE rule. As such, the Officials' Report should provide clear guidance of the following:

- determining whether an activity is sufficiently connected to a sale in New Zealand; and
- if so, determining whether that activity is preparatory or auxiliary.

Comment

The purpose of the Officials' Report is to advise the Committee on the submissions received on the Bill. Accordingly, it is not an appropriate vehicle for detailed general guidance on the application of the proposed provisions. It is also not appropriate to pre-empt Parliament's decision on whether to enact the measures.

Officials do recognise the importance of providing guidance on the PE anti-avoidance rule. This will be provided in a Tax Information Bulletin on enactment of the Bill.

Recommendation

That the submission be declined.

Issue: The proposed PE anti-avoidance rule is misconceived

Submission

(Chapman Tripp)

The proposed PE anti-avoidance rule is misconceived. It does not make sense to describe a multinational as “avoiding” a New Zealand PE when it sets up a legal entity here (subsidiary) that is resident in New Zealand and fully within the New Zealand tax net. This illustrates that any “PE avoidance” is, in reality, a transfer pricing issue as to the appropriate level of reward earned by the New Zealand subsidiary for New Zealand based activities.

Comment

The issue that section GB 54 is aimed at is the ability for a non-resident to avoid New Zealand tax on its sales to New Zealand customers through structures that prevent a PE from arising in respect of those sales. Where a non-resident incorporates a subsidiary to carry on sales support services, that subsidiary may not give rise to a PE for the non-resident. Accordingly, the non-resident’s sales are still not subject to New Zealand taxation despite the presence of the New Zealand subsidiary. Further, it is the presence of the subsidiary in New Zealand that allows the non-resident to avoid having a PE in law, even though one exists in substance. Therefore, the existence of a subsidiary in New Zealand, rather than preventing PE avoidance, in fact enables it in the kinds of arrangements we are concerned about.

In relation to transfer pricing, officials understand the submitter’s point to be that the correct application of transfer pricing principles to the arrangement between the non-resident and its New Zealand subsidiary should result in the correct amount of tax being payable in New Zealand. As a result, the PE anti-avoidance rule is unnecessary.

In response, officials note that the principles underlying transfer pricing and PE profit attribution, while similar, are not the same. The transfer pricing rules seek to determine an arm’s length price for transactions between related entities. The PE profit attribution rules seek to determine what part of an enterprise’s overall profit should be attributed to a PE in a particular country. The OECD guidance is clear that profit may still be attributable to a PE even after the correct application of the transfer pricing rules to any dependent agent (depending on the circumstances). In addition, deeming a PE to exist will allow Inland Revenue to charge NRWT on any royalties paid by the non-resident that relate to its New Zealand sales. This will not be possible under the transfer pricing rules.

Accordingly, application of the transfer pricing rules alone would not produce the appropriate amount of tax for New Zealand in many cases where a PE is being avoided

Recommendation

That the submission be declined.

Issue: Treaty override

(Clauses 4, 34)

Submission

(Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, KPMG, New Zealand Law Society, Russell McVeagh)

The proposed PE anti-avoidance rule would unilaterally override New Zealand's DTAs. It would be inconsistent with article 27 of the Vienna Convention on the Law of Treaties, which provides that a party may not rely on its internal law as justification for failing to perform a treaty (*Russell McVeagh*).

This override would include DTAs with countries that have made a conscious decision not to adopt Article 12(1) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which prevents PE avoidance. The proposed rule effectively legislates into our domestic law the same outcomes that would arise under the MLI but for countries who have either not signed up to it or have not agreed to certain PE amendments.

This is an inappropriate treatment of New Zealand's DTA partners and will likely result in protracted and costly disputes with other competent authorities.

Further, there is concern that implementing unilateral measures outside of the OECD's BEPS Action Plan will lead to a real risk of double taxation. It may also cause our treaty partners to respond in kind, increasing the foreign tax payable by New Zealand businesses and thus reducing the New Zealand tax (as New Zealand would give a credit for the foreign tax).

The UK and Australian PE avoidance rules are different from proposed section GB 54, in that they arguably impose a different kind of tax that is not covered by DTAs.

The PE avoidance changes would be best achieved by bilateral negotiation where New Zealand is able to benefit from the negotiation.

Alternatively, the PE anti-avoidance rule should be amended to reflect bilaterally negotiated treaty provisions (*New Zealand Law Society*).

Comment

The OECD's Commentary to the Model Tax Convention (the OECD Commentary) states that, as a general rule, there will be no conflict between domestic anti-avoidance provisions and the provisions of a DTA. It also confirms that states are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that this should not be lightly assumed).

The proposed PE anti-avoidance rule is an anti-avoidance measure that only applies if there is a more than merely incidental purpose of tax avoidance. Accordingly, it should not conflict with New Zealand's DTAs in the vast majority of cases.

The proposed PE anti-avoidance rule is also broadly consistent with the OECD's recommended BEPS measures to prevent PE avoidance, which are contained in article 12(1) of the MLI (and now form part of the OECD Model Convention). An important difference is that the OECD's PE avoidance provision only applies in respect of a DTA if both countries agree (as the OECD

cannot force countries to adopt its recommendations). However, proposed section GB 54 will apply unilaterally to our DTAs.

We consider that the PE anti-avoidance rule should expressly override our DTAs. This is to simplify the application of the rule. Otherwise, it would be necessary to show that the application of the rule was consistent with a DTA in each particular case. This would be a time-consuming and resource intensive exercise. It would significantly undermine the practical effectiveness of the rule. We also note that both the UK and Australian PE anti-avoidance rules override their DTAs. The UK and Australia defend their rules on the basis that they are the kind of domestic anti-avoidance provisions permitted by the OECD Commentary.

Further international treaties only have legal effect in New Zealand (and other countries) to the extent they are incorporated into domestic legislation. It is not illegal for New Zealand to “override” its DTAs under domestic legislation, given that the DTAs only have legal effect to the extent provided for under that same domestic legislation.

We also consider that the PE rule should apply in respect of DTAs where the other country has elected not to include the widened PE definition from the MLI. The existing position is that anti-avoidance rules are generally consistent with DTAs. We do not consider that a country’s decision not to adopt the widened PE definition in the MLI changes this principle. In particular, we do not consider that such a decision evinces a common intent that a DTA can now be abused by the taxpayer of either jurisdiction.

We also note that the widened PE definition will be added to the OECD Model Convention, and so represents what the OECD considers to be the current best practice. Countries may also not want to adopt such a provision multilaterally under the MLI, but may be happy to agree to such a provision in bilateral negotiations with New Zealand (such as Australia). Accordingly, the decision not to adopt the widened PE definition under the MLI does not mean that the other country objects to such a provision in their DTA with New Zealand.

It would be very time consuming, however, for New Zealand to renegotiate all of its DTAs to include the OECD’s new PE provision. In fact, the OECD introduced the MLI because it recognised that bilateral renegotiation of DTAs would be too time consuming. Therefore, bilateral renegotiation is not a practical solution to the problem of PE avoidance.

In relation to double taxation, officials consider that the risk to be low, given the OECD’s statements that anti-avoidance rules (such as proposed GB 54) should be consistent with DTAs in the vast majority of cases. Further, the risk should only fall on taxpayers who try to avoid New Zealand tax. Finally, while undesirable, the risk of double taxation can also be seen as a disincentive to entering into PE avoidance arrangements (which we note are typically designed to achieve double non-taxation).

Australia’s PE anti-avoidance rule (the MAAL) is part of its income tax system, just like New Zealand’s proposed PE anti-avoidance rule (the MAAL is included in Part IVA of Australia’s Income Tax Act 1936). The MAAL relates to income tax, and does not impose a separate tax. Accordingly, the MAAL’s DTA override is directly comparable to proposed section GB 54. The UK diverted profits tax is stated to be a separate tax, however it is generally calculated under the same provisions as the UK’s income taxes. We note that DTAs also apply to taxes that are substantially similar to income taxes.

Recommendation

That the submission be declined.

Issue: Royalties and the deemed PE source rule

Submission

(KPMG, PwC)

The Government should consider whether potential double withholding tax on royalties attributed to a deemed PE is appropriate policy (*PwC*).

Proposed section YD 4(17C) deems income to have a New Zealand source if it is attributable to a PE in New Zealand.

As acknowledged by the Bill Commentary that, if a non-resident has a PE in New Zealand under the deemed PE anti-avoidance rule in proposed section GB 54, New Zealand could impose NRWT on royalty payments made by that non-resident to another non-resident.

Using the Australia/New Zealand DTA as an example, NRWT could be imposed under article 12(5), which states that royalties would be deemed to arise in New Zealand if a non-resident has a PE in New Zealand and the royalties are deductible in determining the profits attributable to the PE. This raises a broader concern that the proposed changes increase the risk of unintended consequences, such as double taxation.

Comment

It is important for royalties connected with a deemed PE under section GB 54 to be subject to NRWT. This is because many PE avoidance arrangements involve the payment of large royalties, which shift most of the profits from the sales into a low or no tax jurisdiction (with which New Zealand does not have a DTA). If these royalty payments were not subject to NRWT under proposed section GB 54, then the section would not be effective in preventing the avoidance of New Zealand tax.

It is true that double tax may arise as a result of section GB 54, as the other country may also charge withholding tax on the royalty and may not give a tax credit for the Zealand NRWT. Double taxation is undesirable. However, we consider that the risk of it occurring in this case is necessary for proposed section GB 54 to achieve its policy objective. In addition, we note that the risk should fall only on taxpayers who try to avoid New Zealand tax. In this regard, the royalty payment is often not subject to any foreign tax under the kinds of PE avoidance arrangements we are concerned about. This means that double tax would not arise for these arrangements. Finally, the risk of double taxation can also be seen as a disincentive to entering into PE avoidance arrangements (which we note are typically designed to achieve double non-taxation).

Recommendation

That the submission be declined.

Issue: Scope of the PE anti-avoidance rule

Submission

(Corporate Taxpayers Group)

If the PE anti-avoidance rule does proceed, the scope of the rule must not be widened. In particular:

- the focus of the rule should be on artificial arrangements that have a purpose of altering the incidence of tax and that purpose is more than merely incidental; and
- the application of the rule should be limited to “large multinational groups”.

Comment

Officials have no intention of widening the PE anti-avoidance rule beyond its current scope. The submission does not request a change to the Bill.

Recommendation

That the submission be noted.

APPLICATION OF THE RULE

(Clause 34)

Issue: Consolidated group turnover threshold is appropriate

Submission

(Chartered Accountants Australia and New Zealand)

The proposed threshold of consolidated group turnover (over €750 million) is sensible because the rule is complex and could be difficult for smaller entities to monitor.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: Threshold may still result in rule applying to smaller New Zealand resident entities

Submission

(Chartered Accountants Australia and New Zealand)

Proposed section GB 54 will still apply to smaller New Zealand resident entities that have overseas ownership where the turnover for the total group exceeds the threshold (€750 million of consolidated group turnover). We understand that the EU has estimated that there may be up to 6,000 such multinationals globally. A large number of these will have a presence in New Zealand, but this presence will often be small. There is, therefore, an additional compliance cost for overseas owned businesses that may have relatively small New Zealand operations.

Comment

The rule only applies if the non-resident has a related party in New Zealand that carries on sales-related activities. The existence of such a related party implies a material level of economic activity in New Zealand. Accordingly, the requirement for a related party has the practical effect of requiring a more than minimal level of economic activity in New Zealand. In addition, we would not expect the rule to impose significant compliance costs on a non-resident, unless their current structure has been entered into for a purpose of avoiding tax.

Recommendation

That the submission be declined.

Issue: Application dates unclear

(Clauses 2, 4, 34, 46, and 47)

Submission

(Corporate Taxpayers Group, EY, New Zealand Law Society, PwC)

The application dates for sections GB 54 and YD 5B are unclear and should be explicitly referred to in the legislation to address any confusion. In addition, it is not clear when the proposed amendments to section BH 1 (clause 4) and section YD 5 (clauses 46 and 57) are to take effect.

These provisions should apply for income years starting on or after 1 July 2018. This would make their application dates consistent with the dates for the other PE related amendments.

Comment

Officials agree with these submissions. Proposed sections GB 54 and YD 5B, and the amendments to sections BH 1 and YD 5, should apply for income years beginning on or after 1 July 2018.

Recommendation

That the submission be accepted.

Issue: Proposed application dates do not allow sufficient time for multinationals to restructure

(Clauses 3, 34)

Submission

(Corporate Taxpayers Group, New Zealand Law Society)

In the Commentary to the Bill, the Government implicitly encourages taxpayers to restructure their New Zealand operations. However, the proposed application dates in the Bill do not recognise that restructures, particularly in the context of large multinationals, generally take a reasonable amount of time and resources to implement.

The Bill should contain provisions for transitional periods to be implemented alongside the proposed new rules. Alternatively, the proposed application dates should be delayed to give multinationals an opportunity to restructure, rather than expecting them to effectively start restructuring into an environment where there is yet no certainty on the applicable rules. *(New Zealand Law Society)*.

Comment

We do not consider that the problem of the current ability for multinationals to avoid having a PE should be allowed to persist for future income years. This is especially the case given that proposed section GB 54 only applies to avoidance arrangements.

However, applying the new rule to multinationals that are already in the process of restructuring in response to it may not be the best use of the Commissioner's resources. Accordingly, Inland Revenue will take any current restructuring process into account when it investigates or assesses a multinational following the introduction of the proposed rule.

Recommendation

That the submission be declined, subject to Officials' comments.

ROLE OF THE FACILITATOR

(Clause 34)

Issue: Support for non-resident supply of goods or services to New Zealand rule

Submission

(Chartered Accountants Australia and New Zealand)

The criterion that a non-resident must make a supply of goods and services to a person in New Zealand, either directly or under an arrangement that includes the intermediary on-supplying the goods to another person in New Zealand is appropriate.

The submitter understands from the Commentary to the Bill that the proposed amendment is intended to include (but not be limited to) situations where the non-resident's sale to the third party is wholly dependent on the customer agreeing to purchase the goods. This is appropriate.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: Introducing the concept of a 'facilitator' is a good step forward

Submission

(Dr Victoria Plekhanova)

The introduction of the concept of a 'facilitator' is a good step forward towards the protection of the New Zealand corporate tax base from erosion.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: The proposed PE rules should be consistent with the OECD Action Plan

Submission

(Russell McVeagh)

The proposed PE anti-avoidance rule applies when a non-independent facilitator in New Zealand brings about the supply by a non-resident to New Zealand customers (proposed paragraphs GB 54(1)(a) – (c)).

These provisions should be made consistent with Action 7 of the OECD Action Plan and article 12(1) of the MLI. This means that the facilitator should be required to "habitually conclude contracts, or habitually play the principal role of leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" before a PE can arise. Otherwise, the proposed PE avoidance rule will be much broader than the OECD's measure.

Comment

Proposed paragraphs GB 54(1)(a) – (c) are wider than the OECD’s test in article 12(1) of the MLI. However, the proposed PE anti-avoidance rule in section GB 54 is subject to several other requirements. In particular, the arrangement must have a more than merely incidental purpose of tax avoidance. This requirement is not included in article 12(1) of the MLI and it significantly narrows the scope of s GB 54. We expect the PE anti-avoidance rule in s GB 54 (including all of its requirements) and article 12(1) of the MLI will have a broadly similar scope, although there will be differences in some cases. Therefore, the wording in article 12(1) together with the other requirements of s GB 54 would excessively narrow the scope of the proposed rule.

Recommendation

That the submission be declined.

Issue: Facilitator rule should cover sales only

Submission

(Chartered Accountants Australia and New Zealand)

The rule that the facilitator in New Zealand must carry on an activity for the purpose of bringing about the supply should cover sales only, and not extend to activities that do not relate to a specific sale such as warehousing, marketing, and advertising.

The legislation excludes preparatory or auxiliary activities and the distinction is clearly articulated in the Commentary to the Bill. The Commentary to the Bill states that “only activities designed to bring about a particular sale to an identifiable person should potentially result in a deemed PE.” We therefore believe the rule is sufficiently targeted to the activities it intends to catch.

Comment

We agree with the submitter’s interpretation of the relevant provisions and the policy intent. We note that no amendment is requested by the submitter.

Recommendation

That the submission be noted.

Issue: The legislation should further clarify the kind of activities intended to be caught by the rule

Submission

(PwC)

The legislation is still unclear as to the kind of activities that need to be carried on by a facilitator before proposed section GB 54 may apply.

The Bill Commentary is helpful in acknowledging that:

- Only activities designed to bring about a particular sale to an identifiable person could potentially result in a deemed PE.
- Activities which do not relate to a particular sale (such as advertising and marketing) would not be sufficient to trigger a deemed PE.
- After sale activities (i.e. technical support) would not trigger a deemed PE, given they have occurred after the supply has been made.
- Ordinary distributor arrangements are not within the scope of the proposed rule.

However, the draft legislation does not adequately reflect this policy intention (with the exception of the final point above). The legislation should be narrowed to more clearly reflect what the Commentary states to be the intended effect.

Comment

It is not feasible to individually address in the legislation all the multifarious circumstances in which the proposed rule may or may not apply. Instead, the legislation attempts to set out clear and easily understandable principles that can be applied to determine whether an activity is inside or outside the scope of the rule. Officials intend to provide guidance on how these principles apply (including specific examples) shortly following enactment of the Bill.

In relation to the specific issues raised in the submission (excepting the last point):

- In proposed section GB 54(1)(a), the legislation refers to a specific supply which is made under an arrangement to a recipient. This supply is defined as the “facilitated supply”. Under proposed section GB 54(1)(b), the facilitator needs to carry out an activity for the purpose of bringing about the facilitated supply to the recipient. We consider the reference to the “facilitated supply” means that a particular supply is being referred to.
- For section GB 54 to apply, the particular supply must be made to a recipient under a single arrangement. This means the recipient must be identifiable. However, where an intermediary is involved, it is not clear that the final recipient must be identifiable to the facilitator. Accordingly, we recommend that section GB 54(1)(a)(ii) be amended so that the recipient of the supply be known to the facilitator at the time the non-resident’s supply is made to the intermediary.
- The facilitated supply and the facilitator’s activity must be made under the same arrangement. An activity that did not relate to a particular facilitated supply (such as advertising or marketing) would not be made under the same arrangement as the facilitated supply itself. In addition, there would not be an identifiable recipient of the supply. Accordingly, these activities would not trigger a deemed PE under the current drafting.
- After sales activities would occur after the sale. While the promise to provide the after sale support may have helped convince the recipient to acquire the goods or services, the actual activity of providing the after sale services would not be for the purpose of bringing the prior sale about. Accordingly, after sale activities would not trigger a deemed PE under the current drafting.

Recommendation

That the submission be accepted in part, by amending section GB 54(1)(a)(ii) so that when an intermediary is involved, the recipient of the supply must be known to the facilitator at the time the non-resident's supply is made to the intermediary.

Issue: Does the facilitator include employees visiting New Zealand?

Submission

(PwC, EY)

Is the facilitator (proposed section GB 54(1)(b) intended to capture employees of the non-resident visiting New Zealand? The submitters assume not, as the non-resident would not have a PE if the OECD's expanded PE definition was applied instead.

In particular, section GB 54(1)(b) should not apply to "fly in, fly out" arrangements, where non-residents do not have any permanent presence in New Zealand (either directly or through a related party) but instead send personnel to New Zealand on temporary trips.

Comment

There is no black letter rule in DTAs which provides that fly in, fly out employees or representatives cannot give rise to a PE for a non-resident (we note there is no requirement in our DTAs for a dependent agent's activities to be connected with a fixed and permanent place in New Zealand in order for them to give rise to a PE). Whether a PE arises is always a question of fact and circumstance. There may be some circumstances in which a fly in, fly out employee or representatives does give rise to a PE. Fly in, fly out employees and other representatives of the non-resident should therefore not be automatically excluded from section GB 54. Otherwise, a PE could still be avoided in a fly in and fly out arrangement.

The specialist advisor to the Finance and Expenditure Select Committee (Specialist Advisor) has suggested we clarify proposed section GB 54(1)(a) by stating that the facilitator includes an employee of the non-resident. We agree with this suggestion.

Recommendation

That the submission be declined. However, proposed section GB 54(1)(a) should be amended to provide that the facilitator includes an employee of the non-resident.

Issue: Physical location of the facilitator

Submission

(EY)

Proposed section GB 54(1)(b) should clarify that the facilitator must be physically located in New Zealand when the activities are performed. The current wording could be interpreted to

mean that a facilitator could carry on activities remotely and still be caught by the section. We recommend the wording in the section is aligned to that in the Commentary.

Comment

Section GB 54(1)(b) requires that the facilitator carries out the facilitation activities in New Zealand. This requires the facilitator to have a presence in New Zealand in order to carry out the activities here. If the facilitation service was carried out remotely, for example over the internet from Australia, then we consider the activities would not be carried out in New Zealand. Instead they would be carried out in Australia, as this is where the personnel actually carrying out the activity would be located.

We also note that the reference in section GB 54(1)(b) to activities carried on in New Zealand is similar to the reference to a business being carried on in New Zealand in section YD 5(2). There is overseas case law that the relevant business activities actually need to be physically carried out in the relevant country – it is not enough if all the of the business activities are carried on remotely (*Grainger v Gough* [1896] AC 325; *McDermott Industries (Aust) Pty Ltd v FCT* 2005 ATC 4398). Finally, section YD 5(3) also refers to business activities carried out in New Zealand (with no reference to the physical location of the taxpayer). It is clear in this context that the business activities must actually be performed in New Zealand. Accordingly, it would be inconsistent with the application of other, similar provisions if remote activities were treated as carried on “in New Zealand” under section GB 54(1)(b).

In addition, the intention is for section GB 54(1)(b) to apply both where the facilitator is located in New Zealand (e.g. a New Zealand incorporated company), and where the facilitator is a non-resident with a New Zealand presence (e.g. a branch). If the provision required the facilitator to be physically located in New Zealand, the application of the rule could be unclear where the facilitator was a foreign company operating through representatives in New Zealand.

Recommendation

That the submission be declined.

Issue: Criterion for commercial dependence of non-resident is appropriate

Submission

(Chartered Accountants Australia and New Zealand)

We support the criterion that the facilitator will be commercially dependent on the non-resident if it derives 80% of its income from the non-resident (proposed section GB 54(c)(ii)). This test will be easier to apply than a more subjective test of “commercial dependence” and this will reduce compliance costs for businesses.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: The facilitator should not include commercially dependent entities, or the measurement should be clarified

Submission

(Chapman Tripp, EY, New Zealand Law Society)

The facilitator should not include commercially dependent but non-associated entities.

A test that is based on the facilitator's income will be difficult for the non-resident to apply. The facilitator's income could vary due to decisions or circumstances made outside the control of the non-resident. It would be unfair for a non-resident's tax position to be affected by decisions made by unrelated parties.

Alternately, more clarity should be provided about the test, such as the time period over which it should be measured. The time period should be set to equal the life of the facilitator's business thus far, so that facilitators that are truly independent when considered over the long run are not inadvertently included *(New Zealand Law Society)*.

In addition, there should be protection for the non-resident if the facilitator provides inaccurate information or fails to provide the information in time *(EY)*.

Comment

It is important that facilitators include commercially dependent entities. Otherwise, a non-resident could continue to avoid a PE in New Zealand by substituting a wholly-owned subsidiary for a nominally independent facilitator that is under the non-resident's de facto control.

Officials consider that the 80% test is an appropriate threshold to measure commercial dependence. We would not expect facilitators to fall in and out of the threshold in the ordinary course of their business.

In addition, the presence of an associated or commercially dependent facilitator is only one of several requirements that must be met in order for proposed section GB 54 to apply. In particular, the facilitator must be part of an arrangement with a more than merely incidental purpose of tax avoidance. This requirement would not be met where the facilitator was engaged for commercial purposes only.

Officials therefore consider the commercial dependence provision should remain. However, we agree that the period over which the 80% test is to be measured be specified. We recommend that the 80% test should be required to be met for the current income year and the previous income year. This should prevent facilitators from accidentally meeting the commercially dependent test due to unusual circumstances in a particular year, and so give more certainty about the test's application. Requiring the test to be met for the previous income year will also put the non-resident on notice that the facilitator may be commercially dependent on it in the current income year.

Further, it means that a facilitator will not be commercially dependent in its first year of operation. This is appropriate, as a facilitator will be are trying to establish its client base in its first year and might have only a single client during this period.

Recommendation

That the submission be accepted in part, by requiring that the 80% test in proposed section GB 54(1)(c)(ii) be required to be met for both the current income year and the previous income year.

Issue: The 80% assessable income test should be a necessary but not sufficient criterion in the commercially dependent test for a facilitator

Submission

(Chapman Tripp)

Section GB 54 is intended to reflect the dependent agent PE provision in DTAs, with a similar “independent agent” provision. However the OECD’s independent agent exclusion is more flexible and permits an agent to be independent even where it has only one principal. Accordingly, proposed section GB 54 should allow an agent to demonstrate that it is not commercially dependent even if it derives more than 80% of its income from the non-resident.

Comment

Determining whether an agent is commercially dependent is inherently subjective and uncertain. For this reason, the decision was made to use the 80% test. Allowing an agent to demonstrate that it is not in fact commercially dependent would re-introduce that subjectivity and uncertainty. The divergence from the OECD’s test for independence in this regard is deliberate and desirable in officials’ view.

Officials also note that the facilitator must be part of an arrangement that has a more than merely incidental purpose of avoiding tax in order for s GB 54 to apply (amongst other requirements). This requirement is not present in the DTA’s test for a dependent agent.

Recommendation

That the submission be declined.

PURPOSE OF AVOIDANCE TEST

Issue: More than merely incidental purpose criterion is appropriate

Submission

(Chartered Accountants Australia and New Zealand)

The proposal that an arrangement must have a more than merely incidental purpose of avoidance is appropriate, as it is an anti-avoidance rule.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: Proposed purpose of avoidance test too broad

Submission

(Chapman Tripp, New Zealand Law Society)

The purpose of avoidance test in proposed paragraphs GB 54(1)(h) and (i) is too broad and could catch ordinary commercial arrangements.

Comment

The test requires a more than merely incidental purpose of tax avoidance. This is a common test appearing in other specific anti-avoidance tests throughout the Act (e.g. section GB 35(2)). It is also a component of the general anti-avoidance test in section BG 1. There is a significant body of case law on the merely incidental test. This has typically required a degree of artificiality and contrivance before the test can apply (see the decision of Woodhouse P in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA)). In particular, the test has not been held to apply to ordinary commercial arrangements (i.e. arrangements undertaken for commercial purposes). Accordingly, officials do not agree that the purpose of avoidance test would capture ordinary commercial arrangements.

The test may apply to tax avoidance arrangements that have been adopted by numerous taxpayers, and so may have come to be viewed as ordinary in certain quarters (for example, the conduit tax arrangements adopted by several banks and subsequently found to be tax avoidance by the courts). However, the application of the test to such arrangements is appropriate in officials' view.

Recommendation

That the submission be declined.

Issue: The phrase “merely incidental” needs legislative clarification

Submission

(KPMG)

The meaning of the phrase “merely incidental” needs to be clearly established in the legislation.

The case law on the phrase “merely incidental” for section BG 1 is intended to apply to the test in proposed section GB 54. Based on case law, in practice, this test considers whether there are sufficient commercial reasons for the arrangement so that its tax effects are consequential on those reasons being achieved. It is not a test of whether the tax “avoided” is an absolute large number or not. We consider this should be made explicit in the legislation.

Comment

The phrase “merely incidental” has been subject to a large body of case law and has been extensively interpreted by judges. Officials do not want to upset that previous case law by introducing legislative elements to the test.

Under this case law, the size of the tax benefit achieved under the arrangement will not on its own establish whether a tax avoidance purpose is merely incidental. Nevertheless, it may be a strong evidential factor a court will consider in reaching a view on whether a tax avoidance purpose is more than merely incidental. If the tax benefits are very large, it may be difficult to establish that the tax benefits follow naturally from, or are necessarily and concomitantly linked to, some other purpose (*Hadlee v Commissioner of Inland Revenue* [1989] 2 NZLR 447 (HC) at [470]; *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 at [597]).

Accordingly, the significance of the amount of tax avoided has been appropriately considered under the existing case law.

Recommendation

That the submission be declined.

Issue: Parliamentary contemplation test should apply

Submission

(Chapman Tripp)

The parliamentary contemplation test should be retained for proposed section GB 54. There is no principled reason why, if a taxpayer can successfully show that their arrangement uses tax provisions in a way that was contemplated by Parliament, they should still be caught by section GB 54. There is no risk to the revenue of retaining the parliamentary contemplation limb, as the taxpayer has the legal onus of showing that their arrangement is not tax avoidance.

The parliamentary contemplation limb is critical in determining what is, and what is not, tax avoidance. Without that test, the avoidance test will become even more uncertain than it currently is – the relevance of existing case law on avoidance will often be unclear, as particular

statements by the courts could be interpreted to apply only to the parliamentary contemplation limb, or only to the merely incidental limb, or to both limbs.

Comment

The parliamentary contemplation test provides that an arrangement must use the relevant tax provisions in a manner not contemplated by Parliament before it can be a tax avoidance arrangement. If an arrangement does use the provisions in a manner not contemplated by Parliament, then the arrangement will be subject to the general anti-avoidance test (GAAR) in section BG 1 only if it also has a more than merely incidental purpose of tax avoidance. Accordingly, the parliamentary contemplation is the first part of the two part test which determines whether section BG 1 applies.

The parliamentary contemplation test arises out of the need to reconcile Parliament's purpose for the specific tax provisions (which may have been intended to confer a benefit in the circumstances) with its purpose for section BG 1 (see *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115 at [102]). The proposed PE anti-avoidance rule is a specific anti-avoidance provision, rather than a GAAR. The circumstances in which the PE anti-avoidance rule applies have been carefully circumscribed and the intention is simply for the rule to apply, when the specified criteria are met. Given this, there is no need or scope for the reconciliation of the PE anti-avoidance rule with any other provisions in the Act in terms of Parliament's purpose. Accordingly, retaining the parliamentary contemplation test would not be appropriate.

Recommendation

That the submission be declined.

Issue: Parliamentary contemplation test could still apply

Submission

(Chartered Accountants Australia and New Zealand, KPMG)

There remains a risk that the parliamentary contemplation test could still apply when arrangements are considered under proposed section GB 54.

If the intention is for the parliamentary contemplation test to be excluded, this should be clear in the legislation.

Comment

The parliamentary contemplation test is related to the definition of "tax avoidance arrangement" or "tax avoidance" used by section BG 1. Officials consider that by avoiding these definitions, it should be sufficiently clear that the parliamentary contemplation test is not intended to also apply. This intent is also buttressed by the Commentary, which makes it clear that the parliamentary contemplation test is not to apply.

In addition, as discussed above, there is no need or scope for the reconciliation of the PE anti-avoidance rule with any other provisions in the Act in terms of Parliament's purpose.

Accordingly, the parliamentary contemplation test is not appropriate in the context of section GB 54.

Recommendation

That the submission be declined.

Issue: Purpose of avoidance test should use similar wording to section BG 1

Submission

(Russell McVeagh)

The PE anti-avoidance test in proposed section GB 54(1)(h) should be drafted more consistently with the definition of tax avoidance arrangement in the existing GAAR (section BG 1), with the modification that in considering whether a purpose or effect of tax avoidance is more than incidental, it is permissible to consider any avoidance of foreign tax as well as New Zealand tax. Otherwise, there is no justification for not using the existing anti-avoidance drafting that has been interpreted by the courts.

Comment

As noted above, sections GB 54(1)(h) and (i) deliberately do not use the definition of a “tax avoidance arrangement”. This is so the parliamentary contemplation component of the section BG 1 anti-avoidance test does not apply. The reasons for this are set out in our response to Chapman Tripp’s submission on the issue. In addition, the other specific anti-avoidance provisions of the Act which refer to a more than merely incidental purpose generally do not use the phrase “tax avoidance arrangement” (see, for example, sections HA 41(8), GB 31(1), GB 35(2) and GB 42(2)).

Section GB 54(1)(i) refers to a more than merely incidental purpose of tax avoidance. This concept has been extensively considered by the courts in relation to section BG 1 and its predecessors. Officials expect this case law to be equally applicable under section GB 54(1)(i).

Recommendation

That the submission be declined.

Issue: Avoidance test should require further indicia of avoidance

Submission

(EY, KPMG, Chartered Accountants Australia and New Zealand)

Some of the uncertainty in the merely incidental test could be addressed by including the requirements contained in the UK’s or Australia’s DPT.

In particular, the DPT does not apply where:

- there is a similar tax result in the foreign jurisdiction (the applicable foreign tax rate is greater than 80% of Australia’s corporate tax rate); or
- the Australian activity is sufficiently remunerated; or
- there is sufficient economic substance to the arrangement.

These tests are more straightforward indicators of whether the rule should apply or not. Without such indicia there is a risk of the rule applying more widely than intended.

Comment

Officials do not recommend introducing specific criteria which must be met before the purpose of avoidance test is met. The PE anti-avoidance rule in both the UK and Australia do not require such additional criteria in their purpose of avoidance limbs (although the UK rule includes additional criteria in an alternative limb to its main avoidance test).

The anti-profit shifting rules in the Australian and the UK DPTs do require that the arrangement lacks economic substance, or that the non-resident is subject to less taxation in its home jurisdiction than the source jurisdiction in relation to the arrangement.

We prefer not to introduce further requirements such as these because it can be difficult to determine whether the non-resident does face a lower tax impost in their overseas jurisdiction – as this could be affected by matters such as the availability of tax losses or credits and special tax relief. In addition, officials would still be concerned if a PE (and therefore tax) was being avoided in New Zealand, even if the non-resident did face a similar tax impost in its home jurisdiction. In this regard, taxpayers often prefer to pay tax in their home jurisdiction – for example, Australia’s imputation system incentivises companies in Australia to pay Australian tax, as the payment of Australian tax (unlike the payment of foreign tax) gives rise to franking credits which can be used by the company’s shareholders to offset the tax payable on dividends received. We therefore recommend against a requirement for the non-resident to be subject to a lower foreign tax impost.

In relation to the economic substance test, we expect this to already form part of the current purpose of avoidance test. Woodhouse P in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) commented on the relevance of economic substance to the merely incidental test at [535]:

When construing s 99 and the qualifying implementations of the reference in subs (2)(b) to “incidental purpose” I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the statute while in direct pursuit of tax benefits.

We prefer that the degree of economic substance of any arrangement be taken into account in this way, where it can be weighed against other factors, rather than being included as a strict black or white requirement. Including such an economic substance requirement would also further complicate the provision and require the repetition of much analysis relevant to the merely incidental test.

Finally, we note the requirement for the Australian entity to be sufficiently remunerated is a de minimis rule rather than an indicia of avoidance (it provides that the Australian group must

derive at least AUS\$25 million of annual Australian income for the DPT to apply). The desirability of a de minimis test is discussed elsewhere in this report.

Recommendation

That the submission be declined.

Issue: Savings provision for no avoidance in other country

Submission

(Chartered Accountants Australia and New Zealand)

The Government should consider introducing a savings provision to allow the non-resident to prove that there is no tax avoidance in the other country.

One of the criteria in the proposed rule (in proposed section GB 54(1)(h)) is that the arrangement has a purpose of avoiding foreign tax. We do not believe the existence of foreign tax avoidance should be the subject of dispute in New Zealand courts. An exception should be introduced that allows the non-resident to provide assurance that no tax has been avoided in the foreign country. The exception should specify what the non-resident would need to provide to confirm that no tax has been avoided.

Comment

Proposed section GB 54(1)(h) is not directed towards preventing foreign tax avoidance. It is directed towards preventing New Zealand tax avoidance only. The reference to foreign tax is only intended to prevent any argument that an arrangement's avoidance of New Zealand tax was only incidental to its avoidance of foreign tax. For this reason, the proposed section requires either the avoidance of New Zealand tax or the avoidance of *both* New Zealand tax and foreign tax.

Given this, it would not be appropriate to allow an exception to the rule where no foreign tax has been avoided.

Recommendation

That the submission be declined.

Issue: Avoidance of foreign tax

Submission

(KPMG)

The reference in proposed section GB 54(1)(h) to the avoidance of foreign tax does not make sense. In order to determine that foreign tax has been avoided, it is presumably necessary to consider whether the foreign country considers the arrangement to be tax avoidance. This is a potentially circular test – if there is foreign tax avoidance, it can be expected that this would be counteracted by the other country. If not, by definition, it is not tax avoidance but an expected

and allowed result. This illustrates the difficulty of the proposed rule, which substitutes New Zealand's view of what is acceptable for another country's view. For this reason, the issue of PE avoidance is better dealt with by explicit agreement with New Zealand's treaty partners.

Comment

The words "tax avoidance" are not used in section GB 54(1)(h) – the section only requires there to be an arithmetic reduction in foreign tax payable. Section GB 54(1)(h) has been drafted this way to specifically exclude any question of whether the reduction of tax is acceptable or not. Section GB 54(1)(h) therefore does not involve any question of whether that reduction in foreign tax (or New Zealand tax for that matter) is acceptable. Accordingly, it does not involve New Zealand substituting its view of what is acceptable from another country's view.

It is also worth noting that, if section GB 54 applies, it will only have effect in relation to New Zealand tax. It will not require, or otherwise affect, the payment of any foreign tax. Section GB 54 therefore prevents the avoidance of New Zealand tax only. The reference to foreign tax is only intended to prevent any argument that an arrangement's avoidance of New Zealand tax was only incidental to its avoidance of foreign tax.

Recommendation

That the submission be declined.

ADMINISTRATIVE MATTERS

Clause 34

Issue: Clarifying guidance required

Submission

(EY, PwC, KPMG, Deloitte)

It is very important for Inland Revenue to publish clarifying guidance and examples detailing the circumstances in which proposed section GB 54 is to be applied. This should make it clear that the rule is to be applied on a case by case basis, with careful attention paid to the particular circumstances of each non-resident.

Comment

Officials will provide detailed guidance in a Tax Information Bulletin shortly following enactment of the Bill, which will explain the rule's application. This guidance will address the examples contained in PwC's and KPMG's submissions. It will also cover which PE rule applies in which circumstances.

Recommendation

That the submission be accepted. The submission does not require any amendment to the Bill.

Issue: Guidance on attribution of profits to PEs

Submission

(Chapman Tripp, KPMG, New Zealand Law Society, PwC)

There is insufficient guidance as to how the PE profit attribution principles apply. Inland Revenue should provide detailed guidance on the method New Zealand will use to attribute profits to a PE. Although there is OECD guidance on the method of attribution of profits to PEs, it is not sufficient to rely on this guidance for the purposes of proposed section GB 54.

Comment

Officials agree that guidance should be provided as to the profit attribution principles New Zealand currently uses as New Zealand follows an earlier version of the OECD's current authorised approach. Shortly following enactment of the Bill, officials will publish appropriate guidance, including the parts of this OECD guidance which New Zealand currently uses. However, officials do not intend to provide detailed guidance given that New Zealand simply follows a version of the OECD's own detailed guidance on the attribution of profits.

Officials note that the OECD guidance on profit attribution should apply equally to formal PEs and deemed PEs under proposed section GB 54. Accordingly, officials do not consider that additional guidance needs to be provided on the attribution of profits in the context of section GB 54.

Recommendation

That the submission be accepted. The submission does not require an amendment to the Bill.

Issue: Compliance obligations for new rule

Submission

(EY)

When seeking to apply the new rules, the Commissioner should give weight to the compliance obligations for business. For a multinational business, changes to a domestic operating model is a highly significant exercise and may take a number of years. This is a particular issue for Australian-owned businesses, which will generally have a 30 June balance date, and so will be required to apply the new rule immediately.

Comment

Inland Revenue will take any restructuring process into account when it investigates or assesses a multinational following the introduction of the proposed rule.

Recommendation

That the submission be accepted, subject to officials' comments. The submission does not require an amendment to the Bill.

Issue: Post-implementation review

Submission

(PwC)

There should be a post-implementation review of the proposed PE avoidance rule within three years of its enactment. At that time, the Government should consider whether the proposed rule has resulted in unintended consequences for business and Inland Revenue, such as multinationals exiting their investments in New Zealand.

Comment

Officials will monitor the implementation of the proposed PE rule to determine whether it is achieving its intended purpose and whether it is having unintended consequences.

Recommendation

That the submission be accepted, subject to officials' comments. The submission does not request a change to the Bill.

OTHER MATTERS

(No specific clause reference)

Issue: Profit attribution

Submission

(PwC)

New Zealand's current approach to attributing profits to a PE should be reconsidered to better reflect the substance of the economic activity carried out in New Zealand.

New Zealand follows an earlier version of the current authorised OECD approach (AOA) to profit attribution. This earlier version only permits actual costs incurred by the non-resident to be attributed to a non-resident PE. The amount of profit subject to New Zealand tax can therefore be disproportionate compared to the economic activity of the PE because, for example, value attributed to intellectual property generated offshore may be taxed in New Zealand. This approach is also inconsistent with the proposed transfer pricing changes, which are intended to base the transfer pricing rules on economic substance rather than legal form.

Alternatively, Inland Revenue needs to assist taxpayers by releasing more detailed guidance in this area as to how the appropriate economic outcome can be achieved within the existing framework.

Comment

New Zealand's approach to the attribution of profits to PEs is consistent with the approach of Australia and the majority of OECD member countries, who have not adopted the AOA. This approach is embedded in our treaty network and accepted by all our treaty partners.

At an international level, different approaches to the attribution of profits take different views as to what constitutes economic activity. Each approach results in a proportionate outcome based on that view.

Under the New Zealand approach, economic activity includes the exploitation of intangible property in New Zealand and recognises the PEs ownership of the exploited intangible property, as appropriate. It does not tax overseas generated intangible property that has no connection to New Zealand. This is considered to be an appropriate and proportionate outcome for the New Zealand economic activity.

With respect to consistency, the attribution of profit to PEs and transfer pricing apply the arm's length principle to two fundamentally different constructs and therefore full alignment is not an objective, either domestically or internationally. We note, however, that the proposed transfer pricing changes will result in a closer alignment of these rules. This is because the proposed changes will allow certain inter-company contractual arrangements, which do not exist in a profit attribution scenario, to be set aside.

As discussed in our response to an earlier submission, Inland Revenue plans on publishing guidance on the attribution of profits to PEs.

Recommendation

That the submission be declined.

Issue: A DPT should not be dismissed

Submission

(New Zealand Council of Trade Unions)

DPTs have been implemented in Australia and the United Kingdom. They are levied at a penal rate and aimed at incentivising multinationals to pay the right amount of tax under the standard rules. The effect of the Bill should be monitored for a limited time and a DPT should be reconsidered if the legislation is not working.

Comment

The Government has not ruled out the adoption of a DPT in the future.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: A DPT should be adopted

Submission

(Public Health Association of New Zealand)

The Bill should mandate action on what is referred to in the UK and Australia as ‘diverted profits’. Although the idea of ‘diversion’ is euphemistic and the reality should be conceptualised as ‘tax avoidance’, an approach to this issue should be adopted similar to that adopted in both the UK and Australia in their DPTs. This is basically a rebuttable penalty approach to tax avoidance: that is, tax authorities may consider, on the basis of external evidence, that tax avoidance has occurred, but this assumption can be rebutted.

Comment

The Government has decided to adopt the measures in the Bill instead of a DPT. However the Government has not ruled out the adoption of a DPT.

Recommendation

That the submission be declined.

Issue: New Zealand should adopt a ‘facilitation from abroad’ rule

Submission

(Dr Victoria Plekhanova)

Proposed section GB 54 does not tackle a situation when a foreign firm is conducting or facilitating cross-border direct sales of goods and services to customers in New Zealand through its foreign subsidiary but not paying tax on income from these sales either in the country where the firm’s foreign subsidiary is incorporated (because the customers are in New Zealand) or in New Zealand (because sales were direct and were not facilitated in New Zealand).

If the Government is prepared to accept the political and (possibly) economic risks of overriding DTAs and wants to protect the New Zealand corporate tax base from BEPS activities, section GB 54 should include a ‘facilitation from abroad’ rule. Under this rule, a direct cross-border supply of goods or services to the recipient or the intermediary in New Zealand should be deemed as a business carried on in New Zealand if this supply was conducted by a non-resident firm and facilitated from a country other than the country of this firm’s incorporation.

New Zealand should also encourage Australia and its other trading partners to consider adopting their own ‘facilitation from abroad’ rule and to enter into an agreement for the mutual recognition of each other’s taxing rights based on this rule.

Comment

Under the current international tax framework, a non-resident is generally not subject to tax on its business profits unless it has a presence (e.g. a PE) in New Zealand. Section GB 54 is intended to prevent the avoidance of our current PE provisions. It is not intended to depart from the current international tax framework in substance.

If a supply is facilitated by a non-resident from another country outside of New Zealand, then there is still no physical presence in New Zealand. It would depart from the substance of the current international PE rules if we taxed a non-resident on its New Zealand business profits in these circumstances (where neither the non-resident nor the facilitator had a presence in New Zealand). Accordingly, we consider the submission is outside the scope of proposed section GB 54.

The submission does, however, raise an interesting point concerning the potential use of overseas facilitators to achieve double non-taxation. Officials will consider this further and decide whether it should be addressed in a subsequent policy project.

Recommendation

That the submission be declined, subject to officials’ comments.

Issue: Interaction between the PE anti-avoidance rule and the Transpacific Partnership

Submission

(New Zealand Council of Trade Unions)

The Committee should ask officials whether provisions of the proposed ‘Comprehensive and Progressive Transpacific Partnership’ (CPTPP, formerly the TPPA) will create any difficulties in deeming or requiring tax presence or PE. For example, Article 10.6 of the CPTPP states:

Local Presence: No Party shall require a service supplier of another Party to establish or maintain a representative office or any form of enterprise, or to be resident, in its territory as a condition for the cross-border supply of a service.

Comment

Officials consider that the CPTPP does not create any difficulties in relation to the PE anti-avoidance rule contained in the BEPS Bill.

Article 10.6 of the CPTPP only prevents New Zealand from actually requiring a non-resident to establish a presence in New Zealand. The proposed PE anti-avoidance rule in the BEPS Bill does not require the non-resident to establish an actual presence here – it simply allows New Zealand to tax the non-resident as if it did have a PE. In addition, Article 29.4 of the CPTPP provides that the CPTPP does not affect taxation measures, subject to certain specified exceptions. Article 10.6 is not included in those exceptions. Accordingly, it does not apply in relation to the tax measures in the BEPS Bill.

We have also reviewed the parts of the CPTPP that do apply for tax purposes. None of these should affect the proposed PE anti-avoidance rule in section GB 54. The main reason for this is that relevant CPTPP provisions generally require “national treatment” for imported goods and services. This means that a non-resident should not be subject to less favourable tax treatment than a resident. The proposed PE anti-avoidance rule basically removes the current exclusion of certain non-residents (i.e. those avoiding a PE in New Zealand) from New Zealand tax. The result of this is that such non-residents will be subject to essentially the same tax treatment as New Zealand residents. Accordingly the rule does not result in less favourable treatment for a non-resident compared with a resident.

The submission does not request a change to the Bill.

Recommendation

That the submission be noted.

Issue: The PE concept is outdated**Submission**

(Chartered Accountants Australia and New Zealand)

The OECD uses the concept of a PE to tax business profits. The model is becoming increasingly less relevant in the information age and to the sharing economy. Officials should work with their OECD counterparts to design a model that is more appropriate for 2020.

Comment

Officials agree with this submission. The OECD is currently discussing these issues as part of its project on taxing the digital economy. New Zealand officials are participating in these discussions. An interim draft report was published by the OECD on 16 March 2018.

Recommendation

That the submission be accepted. The submission does not request a change to the Bill.

PERMANENT ESTABLISHMENT SOURCE RULE

(Clauses 44 – 48)

Issue: The PE attribution rule is clear and workable

Submission

(Chartered Accountants Australia and New Zealand)

The proposal that income will have a New Zealand source if it is attributable to PE in New Zealand is clear and workable. We would like to thank officials for listening to earlier submissions.

Recommendation

That the submission be noted. The Submission does not request a change to the Bill.

Issue: PE source rule should not proceed

Submission

(Chapman Tripp, New Zealand Law Society)

The PE source rule in proposed section YD 17(C) should not proceed for a number of reasons. This rule provides that income will have a source in New Zealand if it is attributable to a PE in New Zealand.

First, the measures proposed in the Bill are intended to reflect New Zealand's response to BEPS. However, the introduction of a PE source rule is not proposed or endorsed by the OECD BEPS project.

Second, the Commentary to the Bill states that the proposed PE source rule is intended to reduce the compliance and administrative burden of determining a non-resident's tax liability for its sales to New Zealand customers. However, this in itself is not a strong enough reason to effectively depart from international norms by introducing standalone rules.

Third, given the focus of the rule is to ensure that an appropriate proportion of non-residents' income from sales to New Zealand customers is attributed to the sales activities carried out in New Zealand for the purpose of facilitating those sales, the proposed changes to the transfer pricing rules should be sufficient to address these concerns. The intended target of the rule can be adequately dealt with by applying the revised OECD Transfer Pricing Guidelines.

Fourth, it is not obvious that New Zealand should take an OECD restrictive rule that is designed to restrict a state's taxation power and use it as an affirmative taxing rule to expand New Zealand's base.

Fifth, proposed section GB 54 was modelled on the Australian MAAL, but Australia did not also introduce a new PE source rule.

Comment

The primary purpose of the PE source rule is not to capture non-residents' sales income from sales to New Zealand customers where sales activities are carried out in New Zealand for the purpose of bringing those sales about (although it will apply in respect of any PE deemed to exist under proposed section GB 54). The purpose is to align New Zealand's source rules with our taxing rights under our DTAs. This has always been the stated intention of the rule (see the March 2017 Discussion Document on the rule and the Bill Commentary).

This alignment will improve compliance and administration (so there is only a single test for determining whether New Zealand may tax a non-resident on business income that is covered by a DTA). It also ensures that New Zealand is able to tax non-residents under our domestic rules where we have agreed a right to do so with the non-resident's home jurisdiction under a DTA.

Further, income attributable to a PE is internationally recognised as being sufficiently connected with the source state to be taxable there. Accordingly, we consider that our source rules would be deficient if they did not allow for such income to be taxed here. In addition, the proposed PE source rule is fully consistent with international taxation norms – given that it effectively legislates one of them into our domestic legislation.

The rule is not part of the OECD's BEPS recommendations (but it is not inconsistent with it either). The OECD's BEPS recommendations were, however, not intended to restrict a nation's right to enact legislation not specifically covered by the recommendation. Otherwise, it would not be permissible for New Zealand to enact any non-BEPS related legislation. In addition, the amendment makes New Zealand's domestic laws more consistent with the OECD's international tax framework.

Australia already has a rule which deems income attributable to a PE to have an Australian source (although it is included in their DTAs, which are then incorporated into their domestic legislation). Accordingly, it was not necessary for Australia to introduce such a rule when it introduced the MAAL because such a rule already existed.

Finally, the application of transfer pricing rules is not sufficient to address concerns with the taxation of PE's in New Zealand. The reasons for this are explained in relation to an earlier submission in this report.

Recommendation

That the submission be declined.

Issue: PE source rule too broad

Submission

(Chapman Tripp, NZLS)

The target of the rule is non-residents' sales income from sales to New Zealand customers where sales activities are carried out in New Zealand for the purpose of bringing those sales about.

The rule as it is currently drafted is much broader and overreaches its target. For example, it may have the effect of transforming foreign dividends into New Zealand source income. It may

also inadvertently capture a non-New Zealand resident's income from sales to non-New Zealand customers. This result was not intended or contemplated when the rule was drafted. Further, it is not supported by the policy rationale used to justify the result for the intended target and was not part of the consultation process on the Bill.

Drafting changes are required to narrow the impact of the rule to that intended.

Comment

As explained above, the proposed source rule aims to ensure that New Zealand is able to tax non-residents under our domestic rules where we have agreed a right to do so with the non-resident's home jurisdiction under a DTA.

Officials understand that the submitters' primary concern in this particular submission is that non-residents may be inappropriately taxed on their foreign sourced income under the proposed PE source rule, section YD 4(17C). Dividend income paid by non-resident companies in respect of shares connected with a New Zealand PE is specifically identified as an issue. Income from sales to non-residents is identified as another.

Foreign dividends

Officials acknowledge the concern in relation to dividends. When designing the new source rule, officials did not specifically consider the scenario of foreign dividends being attributable to a PE in New Zealand. Understanding of this issue is also not widespread and more taxpayers may have wished to submit on the issue had it been specifically identified.

Officials' current view is that foreign dividends paid to a non-resident through a New Zealand PE should be exempted from New Zealand tax. Officials tentatively consider that it may be appropriate to apply the same active/passive distinction in this context as applies in the CFC rules, though these rules currently apply only to New Zealand residents. This would mean that only foreign dividends paid from active income (e.g. income from carrying on an ordinary business) would be excluded from the PE source rule.

However, incorporating an active/passive test into the rule would add significant complexity and is something that would require further analysis and consultation. Officials therefore consider it should not be included at this stage. Instead, officials recommend a broad exemption for dividends from foreign companies in the proposed rule, with a view to undertaking a separate policy project on the possibility of introducing an active/passive test and other potential limitations in the future. For consistency, the deemed source rule (proposed section YD 4(17D)) should also be redrafted to exclude foreign dividends attributable to a PE.

Finally, the dividend exemption should apply only where the foreign company is part of the business structure of the PE. It should not apply where the shares in the foreign company are held for investment purposes. For example, the New Zealand PE of an overseas share trader should continue to be taxed on the dividends it receives on its offshore shares.

The Specialist Advisor was concerned that tax could be avoided for foreign companies owned by the PE (that is, companies whose shares would be added to the PE's tax balance sheet in calculating the profit attributable to it) if the dividends are not taxable. This could occur if there was no commercial tension between the PE and the foreign companies (so that transactions between the PE and the companies could be on non-arm's length terms) but the transfer pricing rules did not apply to require an arm's length price to be substituted for tax purposes. For

example, profit could be shifted from the PE to the foreign companies by inflated payments, and then returned to the PE's owner as a tax free dividend.

We agree with the issue raised by the Specialist Advisor. We note that the concern is primarily in relation to the appropriate application of the transfer pricing rules. We are recommending amendments to the transfer pricing rules so that they apply appropriately as part of this Bill. We refer the Committee to our comments on those recommended amendments.

Foreign sales income

In relation to foreign sales, where these are attributable to a PE in New Zealand under the OECD's guidelines, officials consider that they should have a New Zealand source. This will allow New Zealand to tax the value contributed by the New Zealand PE's activity to the sales income (which would normally represent a proportion of the total sales income). In this regard, we note that New Zealand resident taxpayers are subject to tax on their foreign sales income. We do not see a reason to exempt New Zealand PEs from the same tax exposure, especially given we are entitled to tax the income under the DTAs we have agreed with other countries. In addition the PE's home jurisdiction often would exempt the PE's income from the foreign sales because it is attributable to New Zealand. For example, an Australian company's income from a New Zealand PE (including from foreign sales) would generally not be taxed in Australia (see section 23AH of the Income Tax Assessment Act 1936 (Australia)). As such, if New Zealand did not tax the PE's foreign sales income, double non-taxation could arise.

Finally, we expect that foreign sales derived by a non-resident through a New Zealand PE would already have a source in New Zealand under the existing source rules. In particular, under existing section YD 4(2), income has a source in New Zealand if it is derived from a business wholly or partly carried on in New Zealand. Accordingly, we doubt that proposed section YD 4(17C) actually broadens the current source rules in respect of foreign sales.

Accordingly, officials do not accept the submission in relation to foreign sales.

Recommendation

That the submission be accepted in part. Dividends from foreign companies should not have a New Zealand source under the proposed new rules in sections YD 4(17D) and YD 4(17C), provided the shares in the foreign company are not revenue account property for the PE.

Issue: PE income apportionment rule

Submission

(Corporate Taxpayers Group)

Section YD 5B is unnecessary and should be removed.

Section YD 5B provides an apportionment rule for income attributable to a PE under proposed section YD 17(C). It uses very similar wording to the test in most of New Zealand's DTAs, by providing that the amount of income with a New Zealand source under section YD 17(C) is the amount that would be income if the PE was a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the head office.

However, section YD 5B only provides for income to be apportioned. This differs from the corresponding article in New Zealand's DTAs, which requires net profits to be apportioned to the PE. While deductions for expenditure apportioned under a DTA are subject to standard deductibility rules, they are subject to the overriding effect of the DTA. This may result in a different outcome compared to PEs arising under domestic rules.

Existing sections YD 5(2) and YD 5(3) already achieve the same result as the PE apportionment provision of New Zealand's DTAs. This is because they require both gross income and deductions to be apportioned so that the net income or net loss of the PE is consistent with an arm's length return. Accordingly, existing sections YD 5(2) and YD 5(3) should determine the apportionment of income attributable to a PE under s YD 17(C), and section YD 5B should be removed.

The Specialist Advisor has recommended that proposed section YD 5B, if it is to be retained, should require the apportionment of income and expenditure in the same manner that existing section YD 5 does.

Comment

Sections YD 5(2) and YD 5(3) use different wording from the profit apportionment test in DTAs, so it is not clear that they will produce the same result as the DTA in all cases. The intent of section YD 5B was to replicate as closely as possible the wording of the DTA, so that the profit attribution calculation under the DTA could also be used to determine the amount of the income with a New Zealand source for domestic law purposes (thus avoiding the need for two separate calculations).

Officials therefore prefer to retain section YD 5B. However, we accept that the references to both income and expenditure in sections YD 5(2) and YD 5(3) make it clearer that the apportionment under those sections should produce an arm's length amount of profits. Accordingly, we recommend that section YD 5B be amended to require the amendment of both income and expenditure.

Recommendation

That the submission be accepted in part, by amending section YD 5B to require the apportionment of both income and expenditure.

Issue: PE rule is not an anti-fragmentation rule

Submission

(Chartered Accountants Australia and New Zealand)

The current drafting makes it clear that the rule is not an anti-fragmentation rule and is intended only to attribute and apportion income where required.

Recommendation

That the submission be noted. The submission does not request a change to the Bill.

Issue: Reference to the OECD Commentary will mean continuous law change

Submission

(Chapman Tripp, New Zealand Law Society)

The Government has proposed that the latest version of the OECD Commentary should be used as a guide to the interpretation of the proposed new PE definition, rather than the version applying when the Bill is enacted or the version applying when the relevant amount of tax became payable.

However, the accepted position for DTAs is that changes to the Commentary made after the date of a DTA are only relevant if they clarify or amplify the previous Commentary. Changes which represent a fundamental change in interpretation are not relevant. In relation to transfer pricing, it is also proposed that any revisions to the OECD guidelines be reviewed before they become part of the statutorily authorised guidelines.

Any revisions to the OECD Commentary on the meaning of a PE should be reviewed to ensure they are appropriate for New Zealand before they become applicable in determining the meaning of a PE under the domestic definition in section YD 4B.

The reference to the OECD Commentary “as amended from time to time” is inappropriate as it will have the effect of changes to the OECD Commentary being incorporated into New Zealand domestic law and retrospectively applied to tax positions that were taken before those changes were made.

OECD’s classification of a change as being either a so-called clarification (which can be applied retrospectively) or a change in interpretation (which can only be applied prospectively) is not necessarily reliable and is based on the political drivers of the myriad of countries that make up the OECD. Relying on that classification in our domestic law as protecting taxpayers against retrospective law changes is insufficient. In addition, no such changes will have been endorsed by New Zealand Parliament.

The Specialist Advisor also raised a concern with the retrospective application of the Commentary and any uncertainty as to which version applies. She considers that changes to the Commentary which change the interpretation of a DTA should not apply if they are made after the date the taxpayer takes its tax position.

Comment

The proposed new section YD 4B does not apply to any of New Zealand’s DTAs. It only applies to the domestic law definition of a PE, which in turn only applies where there is no applicable DTA. Given that section YD 4B is not part of an agreement with another jurisdiction, the Government has more flexibility in determining which version of the Commentary should apply.

There is a general presumption that changes to the Commentary are clarifications. Accordingly, most changes will be relevant retrospectively. However, the OECD does not indicate whether its changes to the Commentary are clarifications or changes in interpretation. Accordingly, if only clarifications to the Commentary were taken into account under section YD 4B(4), it would be uncertain which parts of the Commentary would be relevant.

In addition, officials consider that reviewing and legislating for every change to the Commentary relating to PEs would not be a good use of resources in light of the significance of the issue (noting that it only applies for residents of countries with whom New Zealand does not have a DTA).

However, officials agree that taxpayers should not be retrospectively affected by changes in the Commentary. Accordingly, officials recommend that proposed section YD 4B(4) be amended so the relevant Commentary be the version applying at the beginning of the income year in respect of which the relevant tax was payable.

Recommendation

That the submission be accepted in part.

DTA SOURCE RULE

(Clause 44)

Issue: General support for the deemed source rule

Submission

(Chartered Accountants Australia and New Zealand)

The deemed source rule deems an item of income to have a source in New Zealand under our domestic legislation if New Zealand has a right to tax the item of income under a DTA. We understand the rationale for the proposed amendment and it appears reasonable.

Recommendation

That the submission be noted.

Issue: Deemed source rule is a bad faith change

Submission

(KPMG, PwC)

The deemed source rule deems an item of income to have a source in New Zealand under our domestic legislation if New Zealand has a right to tax the item of income under a DTA. This rule should be deleted as it is unnecessary and fundamentally changes New Zealand's approach to interpreting DTAs, where the domestic law position should be established before a DTA is applied (*PwC*).

The Bill Commentary states that the measure is intended to ensure that a non-residents' sales income from a PE has a New Zealand source. However, this is already achieved by proposed section YD 4(17C). In addition, the current measure goes much further than this by deeming all income which New Zealand can tax under a DTA to have a New Zealand source. The Commentary is therefore misleading in its description of the effect of the proposed rule. (*KPMG*)

Further, expanding New Zealand's taxing rights beyond situations that our treaty partners agreed to may adversely affect New Zealand's position and standing internationally. For example, some payments (i.e. payments for services or use of equipment) to non-residents will now be classed as royalties, when they would not under our current domestic law definition. It is also likely that the unilateral nature of the amendment will create further disputes with New Zealand's treaty partners – particularly in the context of the royalties article. (*KPMG*)

As such, rather than unilaterally adopting new section YD 4(17D), the better approach would be for New Zealand to agree to such a rule with its treaty partners. If New Zealand's treaty partners have already accepted this change, that acceptance should be published. If not, and the new source rule is to proceed, New Zealand should notify its DTA partners of the intended law change and allow them to consider their position for NZ's DTAs. (*KPMG*)

Alternately, the deemed source rule should only apply in respect of DTAs entered into or modified after enactment of the rule. The main concern is that the proposed rule will unilaterally amend the scope of New Zealand's DTAs. By deferring the application to new or modified DTAs, the rule cannot be said to "ambush" our DTA partners. (KPMG)

Comment

We do not agree that the deemed source rule is a bad faith change in relation to our treaty partners. The deemed source rule does not override any of our DTAs or unilaterally change them. Instead it simply ensures that our domestic law allows New Zealand to tax income which the other party to a DTA has agreed we have a right to tax. It is therefore a purely domestic law change implementing what the DTA allows.

Given the other party to the DTA has agreed we may tax this income, we doubt they would consider it bad faith for us to actually do so. For this reason, we also consider there is no need to notify any of our DTA partners in relation to the change or limit the application of the proposed rule to DTAs entered into or modified after the enactment date.

In relation to the Commentary, we note that the effect of the proposed measure is clearly spelled out under the heading "key features". In particular, the Commentary states:

The Bill proposes inserting new subsection (17D) into section YD 4. The subsection will deem an item of income to have a source in New Zealand if we have a right to tax the item of income under a DTA. Subsection (17D) is intended to ensure that if a DTA applies in respect of an item of income, that item of income will automatically have a New Zealand source.

As to the royalties submission, the proposed deemed source rule merely widens the current domestic law definition of 'royalty' by applying the wider DTA definition of 'royalty', which was mutually agreed during DTA negotiations. As such, officials do not think that it will adversely affect New Zealand's position and standing internationally. Further, the new rule will apply only to payments from New Zealand, and will therefore not have any extra-territorial effect.

Recommendation

That the submission be declined.

Issue: Drafting issues

#	Section	Submitter	Submission	Response
1.	GB 54(1)(d)	Corporate Taxpayers Group	Proposed section GB 54(1)(d) states that “the activity is more than preparatory or auxiliary to making the supply”. It would be more grammatically correct if it stated “the activity is more than preparatory or auxiliary to the making of the supply”.	We agree with the submission. However, we recommend that the section be simplified so it states “the activity is more than preparatory or auxiliary to the supply”.
2.	GB 54(1)(c) and (d)	KPMG	The order of paragraphs GB 54(1)(c) and (d) should be swapped. The current paragraphs (b) and (d) establish the required connection of the activity to New Zealand. They should logically be together.	We consider that, in applying section GB 54(1), it is more logical to apply the test in paragraph (c) before the test in paragraph (d). This is because the first question should be whether there is a relevant facilitator. If there is, then the next question is whether that particular facilitator’s activities are more than preparatory or auxiliary. Paragraphs (b) and (c) together determine whether there is a relevant facilitator. Accordingly, they should appear sequentially, and before paragraph (d).
3.	GB 54(1)(h)	EY	In proposed section GB 54(1)(h) the word “purpose” should be replaced with “purpose or effect”.	We agree with this submission. The relevant part of section BG 1 refers to “purpose or effect”. Accordingly, section GB 54(1)(h) should also refer to “purpose or effect” so it is clear that the case law on the “more than merely incidental” test under s BG 1 also applies in respect of section GB 54(1)(h).
4.	GB 54	KPMG, PwC	“Supply” is listed as a defined term for proposed section GB 54. We consider this is incorrect given the use of the term “facilitated supply” in the section and given “supply” is defined in section YA 1 as applying for the purposes of sections GC 6, 9, and 10 only. “Supply” in section YA 1 needs amending to include a reference to proposed section	We agree with this submission. The word “supply” should be defined in section YA 1 for the purposes of section GB 54. The word should have the same meaning as it has under the Goods and Services Tax Act 1985.

#	Section	Submitter	Submission	Response
			GB 54.	
5.	GB 54(2)	Chapman Tripp	It is not clear from the wording of proposed section GB 54 whether all activities of the relevant facilitator will be attributed to the deemed PE or whether only the activities that are referred to in section GB 54(1)(b) will be attributed. Amendments should be made to clarify that it is the latter.	Proposed section GB 54(2) states that the activities of the facilitator referred to in subsection (1)(b) are attributed to the deemed PE. Officials consider this to be sufficiently clear.
6.	GB 54(1)(a)(i)	PwC	The meaning of when a person is “in New Zealand” needs to be clarified. What if a customer happens to be travelling to New Zealand?	<p>Officials consider that the meaning of when a person is “in New Zealand” is sufficiently clear. In addition, section GB 54(1)(b) requires the facilitator to carry on, in New Zealand, an activity for the purpose of bringing about the particular supply. Accordingly, section GB 54 would not apply if a customer was coincidentally in New Zealand at the time of the supply but all of the sales activities were carried on outside New Zealand.</p> <p>On the other hand, if the customer is in New Zealand at the time of supply and the selling activity takes place here, officials consider that the sale is in fact made in New Zealand. Consequently, New Zealand should be able to tax a portion of the sales income where the other requirements of proposed section GB 54 are met.</p>
7.	GB 54(1)(e)(ii)	PwC	It is impractical for a taxpayer to know the date on which a DTA began to be negotiated unless Inland Revenue provides this information. Should this refer to the date of signature instead?	Officials agree with this submission. The reference should be to the date the DTA comes into force.
8.	GB 54(2)	PwC	The heading of proposed section GB 54(2) is “Income and activities attributed to a permanent establishment”. However section GB 54(2) only refers to the	Officials agree with this submission. The heading should be renamed to better reflect the content of the section.

#	Section	Submitter	Submission	Response
			<p>attribution of activities. The reference to “income” may suggest that section GB 54 is intended to directly cause income to be attributed to a PE, whereas the Commentary states that whether income is attributable depends on the other provisions of the DTA and the Act.</p>	
9.	YD 4(17C) and YD 4(17D)	Officials	<p>Section YD 4(17C) provides that income has a New Zealand source if it is attributable to a PE in New Zealand. Section YD 4(17D) provides that income has a source in New Zealand if New Zealand has a right to tax the income under a DTA. These sections are intended to apply only to non-residents. To clarify this, the proposed sections should be amended so it refers to income derived by a non-resident.</p>	That the submission be accepted.

Recommendation

That the officials’ recommendations, as shown above, be accepted.

Transfer pricing and country-by-country reporting

TRANSFER PRICING

Clauses 35 and 36

Overview

Some multinational companies are known to use payments between themselves and related parties to shift profits offshore. Transfer pricing rules guard against this type of profit-shifting by requiring these payments to be consistent with an arm's length price and conditions that unrelated parties would agree to in comparable circumstances.

The Bill proposes amendments to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules.

The OECD's transfer pricing guidelines were substantially updated in 2017 as part of the OECD's BEPS project. The updates to Chapter I of the Guidelines were designed to align transfer pricing outcomes with value creation (BEPS Actions 8–10). The proposed amendments to New Zealand's transfer pricing legislation are intended to allow New Zealand to implement these BEPS recommendations.

The Bill proposes the following amendments to New Zealand's existing transfer pricing legislation:

- Including a reference to using the 2017 OECD transfer pricing guidelines as guidance for how the rules are applied.
- The economic substance and actual conduct of the parties will have priority over the terms of the legal contract. This is achieved by requiring the transfer pricing transaction to be “accurately delineated” consistent with section D.1 of chapter I of the new OECD transfer pricing guidelines.
- The ability for Inland Revenue to disregard or replace transfer pricing arrangements which are not commercially rational. For instance, because they include unrealistic terms that unrelated parties would not be willing to agree to. This is consistent with the guidance in section D.2 of chapter I of the new OECD guidelines.
- Referring to arm's length conditions (as per Australia's legislation) to clarify that the transfer pricing rules can be used to adjust conditions other than the price.
- The onus of proof for demonstrating that a transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the onus of proof being on the taxpayer for other tax matters).
- The time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased from four to seven years (in line with Australia).
- In addition to applying to transactions between related parties, the transfer pricing rules will also apply when investors “act together” to effectively control a New Zealand entity, such as through a private equity manager.

Submitters generally supported the proposals to align the transfer pricing legislation with the OECD Transfer Pricing Guidelines. They considered this would provide greater certainty for taxpayers and consistency with transfer pricing practices in other countries which also use the Guidelines.

Submitters considered that the legislation (and related guidance) needed to include greater detail on the circumstances in which commercially irrational transfer pricing arrangements can be disregarded or reconstructed as they wanted to ensure that this provision could not be misused beyond the intended scope.

However, submitters strongly opposed the administrative proposals to extend the time bar from four to seven years and to shift the onus of proof onto the taxpayer. Submitters considered these proposals would reduce certainty and place undue compliance costs on taxpayers.

Submissions were mixed on the proposal to apply the transfer pricing rules to a group of investors such as private equity structures which “act together” to control a New Zealand entity. Some supported it in principle, but others considered the proposed rules were unnecessary as they considered it was difficult to manipulate prices using such investment structures. Submitters also considered the proposed rules were unclear and could be better targeted.

Issue: Strengthening transfer pricing rules is not required

(Corporate Taxpayers Group)

The Group does not believe that further strengthening of the transfer pricing rules are required. Inland Revenue already has a number of tools available to it and these tools should be applied. Inland Revenue should simply ensure that it is appropriately resourced with transfer pricing expertise to allow it to apply the rules as they currently stand .

Comment

It is necessary to update New Zealand’s transfer pricing legislation as our existing legislation would not allow New Zealand to fully implement the OECD’s 2017 Transfer Pricing Guidelines that were developed to combat BEPS.

Recommendation

That the submission be declined.

Issue: Impacts on taxpayer and Inland Revenue resourcing of transfer pricing

Submissions

(Corporate Taxpayers Group, KPMG, Chartered Accountants Australia and New Zealand)

Reduction in resource use (including disputes) will not occur with these rules. More work will result for Inland Revenue and taxpayers. Inland Revenue’s transfer pricing and international tax capability is already stretched and the BEPS proposals will simply add to those pressures. .
(KPMG)

The new rules will increase compliance costs and require Inland Revenue to better resource its Transfer Pricing unit. In particular the economic substance criterion can be difficult to apply in practice and Inland Revenue should be given additional resources to administer this rule.
(Chartered Accountants Australia and New Zealand)

Inland Revenue should ensure that it is appropriately resourced with transfer pricing expertise to allow it to apply the rules as they currently stand. (*Corporate Taxpayers Group*)

The added layer of complexity and compliance cost expected from the proposed legislation, certain groups of taxpayers (SMEs, and multinationals with low levels or “plain vanilla” cross border associated party transactions) may be disadvantaged without the requisite expertise or resources to comply with the new rules. (*Deloitte*)

Comment

Officials agree that the proposed rules may require some taxpayers and Inland Revenue to devote additional resources to transfer pricing issues. This reflects the fact that the new rules require a more substance-based analysis than the existing transfer pricing rules, which is consistent with the OECD’s recommendations on how transfer pricing rules should be strengthened to combat BEPS. However, even if New Zealand’s rules were not being updated, many taxpayers would still need to invest additional resources in transfer pricing in order to comply with similar transfer pricing requirements in foreign countries which follow the OECD’s new transfer pricing recommendations.

Recommendation

That the submissions be noted. These submissions do not require a change to the Bill.

Clause 35

Issue: That New Zealand’s transfer pricing legislation explicitly refer to the OECD transfer pricing guidelines

Submissions

(*Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, EY*)

Supports including a reference to the 2017 OECD transfer pricing guidelines in the transfer pricing legislation (*Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group*)

Support the proposed approach that updates to the Guidelines be adopted in future taxation Bills, following a review by officials of the changes made. (*Chartered Accountants Australia and New Zealand*)

Updates to future versions of the Guidelines could be done through an Order in Council (*Corporate Taxpayers Group*)

It should be made clear at the time a revised version of the OECD Guidelines is adopted, how these revised guidelines apply both on a prospective or retrospective basis. This is because revisions to the Guidelines may provide guidance on a new topic, or may be purely interpretive, providing a new interpretation on existing issues. No changes to the guidelines should be applied retrospectively to the detriment of a taxpayer. (*Corporate Taxpayers Group*)

The Bill should clarify that the 2017 version of the OECD Transfer Pricing Guidelines will apply in New Zealand only to transactions occurring in income years commencing on or after 1 July 2018 once New Zealand transfer pricing rules are fully aligned to article 9 wording. For prior income years, the 2010 version of the OECD Guidelines should be applied, to the extent that applying the 2010 version is consistent with the existing legislation. (EY)

Support for updating the outdated names of pricing methods to conform to the OECD guidelines. (*Chartered Accountants Australia and New Zealand, Deloitte*)

Comment

Officials agree that when revisions are made to the Guidelines it should be made clear from what date each of the relevant revisions should be applied under New Zealand transfer pricing legislation. This could be achieved through making updated references to newer versions of the guidelines in future tax Bills as the new Bill provisions can be drafted with specific application dates.

A Bill process will also make it easier for taxpayers to identify if the relevant reference has been updated and will facilitate consultation on whether New Zealand should adopt the revisions and on application dates. New Zealand is involved in developing changes to the OECD transfer pricing guidelines and regularly introduces taxation Bills. Officials do not consider it necessary to allow for the reference to be updated through an Order in Council process (as an alternative to a Bill process).

Officials note that the legislative reference to the 2017 OECD Transfer Pricing Guidelines in the current Bill is already consistent with the submission from EY (it applies to income years commencing on or after 1 July 2018).

Recommendation

That the submission to include an Order in Council process to update the reference to the OECD transfer pricing Guidelines be declined and the other submissions (that do not require changes to the Bill), be accepted.

Clause 35

Issue: That the OECD transfer pricing guidelines should be annexed to the New Zealand Income Tax Act 2007 or otherwise made available free of charge to all taxpayers

Submissions

(*Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group*)

To access the Guidelines in downloadable or print format incurs a charge of \$185. (*Chartered Accountants Australia and New Zealand*)

If the Guidelines are going to become part of New Zealand law then they should be available for taxpayers to study in detail (not simply browse on screen) free of charge. The Guidelines are the property of the OECD so appropriate licensing arrangements would need to be agreed. (*Chartered Accountants Australia and New Zealand*)

Inland Revenue should have links to the OECD Guidelines (including those relevant to past periods, which may remain open to adjustment) available on its website so that taxpayers can easily access this information (*Corporate Taxpayers Group*)

Comment

The OECD guidelines are property of the OECD so cannot be reproduced by Inland Revenue. Inland Revenue will however, include links to the OECD Guidelines (including previous versions) on its transfer pricing website (www.ird.govt.nz/transfer-pricing).

The OECD Guidelines are already universally applied by transfer pricing practitioners as they are already applicable to transfer pricing positions that are taken under Double Tax Agreements. This means many of the affected taxpayers or their tax advisors will already be purchasing and using copies of the Guidelines. For those that are not already using them, the Guidelines can be read online for no charge.

If these taxpayers need to access a downloadable or hardcopy of the Guidelines, officials do not consider the \$185 charge is overly burdensome. This represents a very small cost compared to the overall cost of specialist transfer pricing tax advice.

Recommendation

That the submission for Inland Revenue to provide free copies of the OECD Transfer Pricing Guidelines be declined.

Clause 35

Issue: Applying the transfer pricing rules to investors that act in concert

Submissions

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, OliverShaw KPMG)

Support the proposal to extend the transfer pricing rules to investors who “act together”, provided it is limited to where there is a group of non-residents. (*Chartered Accountants Australia and New Zealand*)

The proposal should not proceed for the reasons outlined below. (*Corporate Taxpayers Group*)

Where the investors do not have the same economic interests, natural pricing tension will ensure pricing for goods or services by one shareholder is at an arm’s length rate. Treating a different group of persons as the one economic entity would not, therefore, reflect the economic reality unless all members of that group had the same proportional economic interests (for example, all were supplying the good or service in proportion to their shareholding). (*Corporate Taxpayers Group*)

It is arguably unnecessary to extend the transfer pricing rules to investors “acting together”. To the extent transactions are not priced correctly (i.e. not at arm’s length), there may be a transfer of value giving rise to a deemed dividend. For example, if a New Zealand subsidiary were to

pay greater than market value for goods purchased from a shareholder, the dividend rules would likely apply to this arrangement as there has been a transfer of value caused by a shareholding relationship. (*Corporate Taxpayers Group*)

The proposed definition of acting together is inherently vague and will create uncertainty. The definition is very unclear and could conceivably apply to all entities with nominal non-resident shareholders and to any New Zealand entity with a shareholder's agreement. This would extend the application of New Zealand's transfer pricing rules well beyond the notion of control that underlies transfer pricing's rationale. (*Corporate Taxpayers Group, OliverShaw*)

The proposal should be limited to a group of non-residents who act together. Shifting profits out of New Zealand is not a concern when the group is controlled by a New Zealand resident. (*Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, OliverShaw*)

The rules should not apply simply because two companies are consolidated for accounting purposes as accounting consolidation rules vary across countries and over time. (*OliverShaw, Chartered Accountants Australia and New Zealand*)

It is unclear why the transfer pricing rules use the control group test from the hybrids rules rather than the "non-resident owing body" concept from the thin-capitalisation rules. (*KPMG*)

Comment

As part of obtaining their return, some foreign investors acting together can and do use non-arm's length pricing of debt, management fee and royalty arrangements to shift profits out of New Zealand, particularly in tax aggressive private equity structures. Commercial pricing tensions between the investors do not adequately address these risks, as it can be in all the investors' interest to reduce the overall tax paid on their investment.

The deemed dividend rules also do not provide sufficient protection from profit-shifting. This is because the high-priced payment will still be fully deductible and reduce the profits that can be taxed in New Zealand.

For these reasons officials still consider it is necessary to apply the transfer pricing rules to non-resident investors who act together to effectively control a New Zealand business.

However, in response to the points raised by submitters, officials recommend the "acting together" rule be amended so it is better targeted at the policy concerns. In particular, the amendments should ensure:

- The acting together test only applies to a group of non-residents rather than a group of non-residents and residents. This would be consistent with the existing acting together tests in the thin capitalisation and NRWT rules.
- The transfer pricing rules do not apply simply because two companies are consolidated for accounting purposes.
- The transfer pricing rules do not apply simply because a company has a shareholder's agreement setting out how shareholders agree to exercise their individual shareholder rights (officials do not consider this is the case under the current provision, but this point can be clarified in the guidance materials).

Officials also recommend that the proposed “acting together” definition should be based on the existing “acting together” rules that already apply for the purposes of the thin-capitalisation and NRWT rules, rather than the control group definition in the proposed hybrid rules.

Recommendation

That the submission to remove the proposal from the Bill be declined, but that the rules for applying the acting together test be amended as per official’s comments.

Clause 36

Issue: Economic substance

Submission

(Chartered Accountants Australia and New Zealand, Deloitte)

The proposed change to take into account the economic substance of the transaction is appropriate. Most practitioners and revenue officials will take into account the economic substance of the transaction so it is sensible to include this change into legislation.

Recommendation

That the submissions be noted. These submissions require no changes to the Bill.

Clause 36

Issue: Definition of arm’s length conditions

Submission

(Chartered Accountants Australia and New Zealand, EY, KPMG)

The definition of arm’s length conditions in GC 13(4) should be amended to ensure it includes the profit-based methods. *(EY, KPMG)*

The definition of “arm’s length conditions” should be replaced with a concept of “actual conditions” which is based solely on the approach used in the Chapter I of the OECD Transfer Pricing Guidelines. The current position taken in the Bill is inconsistent with the OECD guidelines. *(Corporate Taxpayers Group)*

Section GC 13(4)(b)(ii) should be amended to replace “might” with “are about as likely as not” to be agreed upon by independent parties. The phrase “about as likely as not” is found in other parts of the New Zealand tax legislation and there is a body of case law concerning the phrase, so it will be familiar to officials and practitioners when looking to interpret the new rules. *(Chartered Accountants Australia and New Zealand)*

Care should be taken when drafting the New Zealand definition of “arm’s length conditions” such that it recognises: the availability of comparable company data; the fact that benchmarking does not necessarily allow for the identification and assessment of a number of the comparable

circumstances; and that some legitimate associated party arrangements only exist because of the related nature of the parties and may not have identifiable analogues between independent parties. (*Deloitte*)

Comment

Officials do not consider that the current drafting of arm's length conditions in section GC 13(4) is inconsistent with the OECD guidelines or that it excludes profit-based methods. This section is intended to be a statement of the overall goal of the arm's length principle on which transfer pricing is based. It is not intended to be a prescriptive instruction that limits the approach and methods that taxpayers may have to actually use in practice to perform a transfer pricing analysis. Furthermore it is obvious from the list of methods in GC 13(2) that the profit based methods can be used.

Officials will consider if the drafting of "arm's length conditions" can be improved to clarify these points, otherwise they will be clarified in the subsequent guidance materials on the new legislation.

The current drafting of section GC 13(4)(b) is based on the definition of arm's length conditions in section 815.125 of Australia's legislation which uses the term "might". It is desirable to retain consistency with Australia's definition of arm's length conditions.

Recommendation

That the submissions be declined.

Clause 36

Issue: Requirements for not recognising a transfer pricing arrangement

Submissions

(*Chartered Accountants Australia and New Zealand, Deloitte, EY, PwC*)

There should be a high threshold for disregarding or replacing a transaction. (*Chartered Accountants Australia and New Zealand*)

It should be clear that the ability to disregard or replace transactions should be exercised only in exceptional circumstances. (*Deloitte, EY, PwC*)

The specific references to the OECD Guidelines should be replaced with specific provisions containing the appropriate legislation as the Guidelines are designed to provide broad guidance only, rather than a legislative framework. Section GC 13(5) should be redrafted to remove the references to the paragraphs in the OECD guidelines and to instead include the relevant requirements in the legislation (*PwC*)

Section GC 13(5) should explicitly refer to the "exceptional circumstances" requirement in the OECD transfer pricing guidelines as a prerequisite to any adjustment to not recognise or recharacterise a transaction. (*EY*)

The reference in GC 13(5) to paragraph 1.122 of the OECD Guidelines should refer to paragraphs 1.118 to 1.123 as otherwise the rule could be misconstrued (*EY, KPMG*)

IRD should provide more extensive guidelines and examples than that provided by the OECD Guidelines as to the circumstances and hallmarks that would need to be present for para 1.122 of the OECD Guidelines to be applied. The guidelines and examples should provide greater clarity as to when a transaction may be not recognised in its entirety (as opposed to being recharacterised into another transaction). (*EY*)

Adjustments proposed by IRD to not recognise or recharacterise a transaction should require a high level of sign-off internally within IRD in the same manner as the general anti-avoidance laws. (*EY*)

The concept is subjective and Inland Revenue should provide guidance as to when it will consider a transaction to be “commercially irrational”. (*Chartered Accountants Australia and New Zealand*)

Comment

The OECD’s 2017 transfer pricing guidelines define in paragraph 1.122, the exceptional circumstances in which a commercially irrational transaction can be disregarded or replaced with an alternative transaction. The proposed legislation for reconstructing an arrangement explicitly refers to the requirements described in paragraph 1.122 of the OECD’s transfer pricing guidelines.

This paragraph also emphasises that there is a high threshold for disregarding or replacing a transaction. It states “...every effort should be made to determine the actual nature of the transaction and apply arm’s length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm’s length price is difficult.”

Officials do not consider it necessary to refer to “exceptional circumstances” in the legislation, as there is already an explicit reference to paragraph 1.122 that describes these circumstances. It is better to define these circumstances by reference to the relevant paragraph as the ordinary meaning of “exceptional circumstances” may lead to less precise interpretations.

Officials agree that before Inland Revenue uses the reconstruction power there should be a high level of sign-off within Inland Revenue (as is the case with our general anti-avoidance laws). This should also ensure the provision is applied consistently.

The examples of reconstructed and disregarded transactions provided in the OECD transfer pricing guidelines were developed and agreed amongst OECD member countries. Accordingly adding further guidance and examples for how countries should apply these guidelines would be best developed through the OECD’s existing Working Party 9 process for updating this relevant guidance. Aligning New Zealand’s rules with this OECD guidance also means that court cases and technical guidance prepared by other OECD tax authorities could be useful reference materials for taxpayers.

In addition the new rules are effectively anti-avoidance rules that apply to artificial and commercially irrational arrangements. This means it can be difficult to identify relevant examples until they are observed in actual taxpayer behaviour and that any examples are likely

to be unique or very specific to circumstances so documenting them may be of limited usefulness when considering how the rule may apply to other scenarios with different facts.

Inland Revenue does however understand taxpayers' desire to achieve certainty that their transfer pricing practices will not be challenged under these new rules. Inland Revenue's transfer pricing team welcomes taxpayers to contact them to discuss any specific transfer pricing arrangements they are seriously considering. If further certainty is required, an advance pricing agreement can be sought. In officials' view, this tailored approach to assisting taxpayer compliance is more useful for taxpayers than preparing more general guidance materials that may have only limited relevance for their particular situation.

Recommendation

That the submissions be declined.

Issue: Drafting of requirement for not recognising a transfer pricing arrangement

Submission

(Corporate Taxpayers Group)

The reference to "may" in the proposed reconstruction rule should be changed to "must". This would mean that if the requirements of Chapter I, section D.2, of the OECD guidelines are met, the taxpayer must recognise the reconstructed or rejected transaction as being the relevant transaction for the purposes of determining its tax position. This is consistent with the proposed shift in the burden of proof, the emphasis on economic substance in transfer pricing rules, the broader self-assessment approach to tax compliance and subdivision 815.130 of the Australian transfer pricing regime. *(Corporate Taxpayers Group)*

Comment

Officials agree that the proposed change will clarify that where the reconstruction rule applies, the taxpayer must use that approach. In practice, the relevant reconstruction rule will nearly always be applied in the context of an investigation by Inland Revenue, so an alternative drafting option could be to provide an ability for the Commissioner to trigger the application of the reconstruction rule in those cases where the requirements of Chapter I, section D.2, of the OECD guidelines are met.

Recommendation

That the submission be accepted, subject to officials comment.

Clause 36

Issue: Onus of proof for transfer pricing issues should remain with Inland Revenue

Submissions

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group)

The Onus of proof should not be shifted to the taxpayer.

The Commissioner has access to the tax records of every taxpayer in New Zealand, and has access to information from overseas tax authorities, so can be in the best position to determine whether the arrangement is similar to one that has been entered into elsewhere. (*Chartered Accountants Australia and New Zealand*)

The proposed change is inconsistent with other countries. The OECD states in its transfer pricing Guidelines at paragraph 4.11 “*in most jurisdictions, the tax administration bears the burden of proof*” (*Chartered Accountants Australia and New Zealand*)

The shift in the burden of proof, coupled with an increase in the time bar and other transfer pricing proposals, significantly increases compliance costs imposed on taxpayers without a sufficient trade off. The Group’s primary submission is that the onus of proof should remain with the Commissioner where the taxpayer has regularly prepared compliant documentation and has been open and transparent with the Commissioner. Further, the Group submits that this proposal should not proceed in addition to the extension to the time bar. At most, only one of those two proposals should proceed. (*Corporate Taxpayers Group*)

Comment

This proposal is consistent with the fact that burden of proof is already on the taxpayer for other tax matters. Self-assessment is at the heart of how New Zealand’s tax system works and helps encourage taxpayers to comply with the law and get it right from the start rather than having to subsequently amend their tax position as a result of an Inland Revenue investigation.

Shifting the onus of proof is necessary because transfer pricing has become increasingly complex and fact specific (for example, there is now a need to analyse economic substance as well as the legal contracts). Multinationals will have better information than Inland Revenue about their own economic activities, on market prices in their industry and on their supply chains. For this reason they are better placed to identify a relevant uncontrolled comparable and apply the arm’s length principle.

The comment in the OECD transfer pricing guidelines has not been updated since 2010 to reflect the fact that many OECD and G20 countries have shifted the burden of proof for transfer pricing onto the taxpayer. The burden of proof is on the taxpayer for transfer pricing matters in Australia, the US, Canada, China, Hong Kong, Singapore, the UK, Ireland, France and Germany. This means most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries. For this reason, the additional compliance costs that would be imposed under New Zealand’s transfer pricing rules from shifting the burden of proof onto taxpayers is not expected to be substantial.

The proposal in the Bill will effectively require multinationals to analyse and prepare transfer pricing documentation for their related party transactions that involve their New Zealand group members. This will make it easier for Inland Revenue to investigate (and if necessary adjust) transfer pricing positions as the onus will be on the multinational to provide documentation to justify that their position is correct (within the arm’s length range).

Recommendation

That the submissions be declined.

Clause 36

Issue: Consequential changes if the onus of proof for transfer pricing issues is shifted to the taxpayer

Submissions

(ASB, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, Russell McVeagh, KPMG, PwC)

If the burden were placed on the taxpayer then it should shift to the Commissioner in situations where she is using data that is not available to the taxpayer. *(Corporate Taxpayers Group)*

Inland Revenue should only use information which is available to the taxpayer in asserting a transfer pricing adjustment. This requirement should be legislated. *(Russell McVeagh, KPMG)*

If the burden is shifted to the taxpayer, the legislation should shift the burden back to the Commissioner where the taxpayer has adequate documentation. *(Chartered Accountants Australia and New Zealand)*

The onus of proof creates significant uncertainty as no guidance is provided on what level of documentation is required. Legislation should be introduced that allows taxpayers to prepare a defined level of documentation that would shift the burden of proof back to Inland Revenue and/or provide the taxpayer with penalty protection. *(PwC)*

Placing the burden on the taxpayer should not, of itself, give the Commissioner the right to assess where there is little or no information provided – unless she were to use the default assessment process (which is available to her under current law). *(Corporate Taxpayers Group)*

If a taxpayer has sufficient proof that a transaction is within a range that can be considered arm's length, then Inland Revenue should not be able to tell a taxpayer that the transaction should have been completed at a different point within that range. *(ASB, Corporate Taxpayers Group, Deloitte)*

Comment

It is common practice for multinationals and Inland Revenue to access commercially available databases to identify comparable arm's length transactions to support their analysis. In particular, Inland Revenue does not use taxpayer secret information that cannot be shared with taxpayers to support transfer pricing adjustments. We do not consider it is necessary to codify this practice in the legislation as New Zealand's legislation already includes a requirement that it is applied consistently with the OECD transfer pricing Guidelines. These guidelines advise that such information should not be used by tax authorities when it cannot be provided to the taxpayer.

Inland Revenue's administrative practice and the OECD transfer pricing Guidelines both acknowledge that there is a range of conditions that can be considered to be arm's length conditions. In particular, the OECD guidelines state that *"If the relevant condition of the controlled transaction (e.g. price or margin) is within the arm's length range, no adjustment should be made."*

The OECD has recently issued extensive international guidance on transfer pricing documentation, which New Zealand endorses, and Inland Revenue has issued some short supplementary guidance as well.

In practice, the actual level of documentation required to demonstrate compliance with the transfer pricing rules will depend on the complexity and risk profile of the relevant transactions. Some transfer pricing practices can be easily shown to align with comparable arm's length arrangements whilst others require more evidence. Inland Revenue considers that taxpayers are best-placed to exercise their own judgement and prepare documentation that manages their associated transfer pricing tax risks.

Officials do not agree that the legislation should shift the onus of proof back to the Commissioner in cases where the taxpayer has adequate or a prescribed level of documentation for their transfer pricing positions. Firstly, the existence of transfer pricing documentation does not in itself mean that Inland Revenue has been provided with copies of the relevant documentation on which to base its own assessment prior to the court proceedings.

Assuming that the onus would only shift in cases where adequate documentation had been filed or provided to Inland Revenue, there would still be subjectivity and disputes around what level of documentation was considered "adequate". This is because the level of evidence and analysis required to be "adequate" will vary depending on the specific features of each particular transaction. Requiring a minimum standard of documentation could also lead to some taxpayers incurring additional compliance costs from preparing unnecessary detail for low-risk transactions whilst others may prepare inadequate documentation for higher risk transactions which require a higher standard of analysis and evidence.

Finally, the burden of proof remains on the taxpayer for all other tax issues, regardless of how much evidence they have provided to Inland Revenue to support their tax position.

Recommendation

That the submissions be declined.

Clause 36

Issue: Transfer pricing documentation requirements and timeframe

Submission

(Chartered Accountants Australia and New Zealand, Deloitte)

Inland Revenue's apparent position that contemporaneous documentation is required to avoid penalties should be prescribed in the legislation. *(Deloitte)*

It would be useful for taxpayers if Government were to give guidance as to the timeframe required for preparation of transfer pricing documentation. If the timeframe is to be legislated this should be done in conjunction with appropriate reduction in penalties or a shift of the burden of proof where taxpayers have complied. *(Chartered Accountants Australia and New Zealand)*

Comment

Inland Revenue will generally apply a “lack of reasonable care” penalty to incorrect transfer pricing positions taken by taxpayers who have failed to adequately document their transfer pricing positions at the time those tax positions were taken.

This administrative practice was noted in the May 2017 discussion document. Officials do not consider it is necessary to codify this administrative practice in the legislation and note that including such rules in the legislation could disadvantage taxpayers by providing less flexibility for Inland Revenue to consider the taxpayer’s particular circumstances. Inland Revenue’s expectations for the timeframe by which transfer pricing documentation should be prepared will be further explained in the guidance materials on the transfer pricing rules.

Recommendation

That the submissions be declined.

Clauses 35 and 36

Issue: Guidance materials for transfer pricing documentation and investigations

Submissions

(Deloitte, EY, PwC)

There should be a legislative *de minimis* that would exempt smaller taxpayers from preparing documentation based on New Zealand revenue or the quantum of cross-border associated party transactions. *(Deloitte)*

Inland Revenue should develop and publish administrative practice statements to provide simplification safe harbours to reduce compliance costs on low-risk transactions. This could be similar to the transfer pricing guidance and safe harbours that the Australian Tax Office provides to taxpayers. *(PwC, Deloitte)*

Practical guidance should be developed and published to help taxpayers navigate the new rules, while providing a case for a reduced documentation threshold where certain criteria are met. This guidance must also clearly and unambiguously establish what the taxpayer is required to do to evidence eligibility for the simplified documentation option, and compliance with the arm’s length principle. *(Deloitte)*

Internal guidelines need to be put in place setting out what taxpayers can expect in an IRD transfer pricing audit, including the timing of various stages. These guidelines could be co-developed with practitioners. *(EY)*

IRD should provide robust guidelines covering:

- The expectations for New Zealand companies to prepare transfer pricing documentation and various supporting documentation; and
- Benchmarking searches and the use of comparability adjustments.

The Australian Tax Office has issued extensive guidance to taxpayers on various aspects of the transfer pricing rules in the form of taxation rulings and practice statement (*EY*)

Comment

New Zealand's proposed transfer pricing legislation has been designed to align with the OECD's 2017 transfer pricing guidelines and includes a new requirement that New Zealand's legislation should be applied consistently with these Guidelines. The OECD Guidelines provide 600 pages of extensive guidance on how key aspects of transfer pricing should be applied by multinationals and tax authorities. The 2017 update to these guidelines includes some new guidance on what information should be included in taxpayer's transfer pricing documentation.

To supplement the OECD guidelines, Inland Revenue publishes some short guidance on certain transfer pricing topics on its website (www.ird.govt.nz/transfer-pricing/transfer-pricing-index.html). This includes a topic on Inland Revenue's expectations for transfer pricing documentation.

Officials agree that Inland Revenue's transfer pricing specialists should work with their counterparts in the private sector to identify and prioritise the topics which would most benefit from additional guidance materials and to develop guidance on the agreed priority topics. These guidance materials could potentially include some further simplification *de minimis* or safe harbours to provide certainty and reduce compliance costs for low-risk transactions (such as some of the common transactions entered into by SMEs). In officials' view such simplification measures are best provided through administrative statements (rather than legislation) as this provides more flexibility to update and add to the measures over time.

Inland Revenue already publishes some transfer pricing simplification *de minimis* to reduce taxpayer's compliance costs. These provide a *de minimis* for related party services valued below \$1m and an acceptable margin for pricing smaller related party loans of up to \$10m of principal.

Inland Revenue's transfer pricing team also welcomes taxpayers to contact them to discuss any specific transfer pricing arrangements they are seriously considering. If further certainty is required, an advance pricing agreement can be sought. In officials' view, this tailored approach to assisting taxpayer compliance is more useful for taxpayers than preparing more general guidance materials that may have only limited relevance for their particular situation.

Recommendation

That the submission to include a legislative *de minimis* be declined, and the other submissions on Inland Revenue developing further guidance and administrative safe harbours be noted.

Issue: A consistency committee should be established within Inland Revenue

Submission

(*Deloitte*)

The new rules will be complex for both taxpayers and the Inland Revenue to get right. In particular, the transfer pricing changes are the biggest changes to transfer pricing since the regime was developed and we are concerned there will be inconsistent application of the rules

between different investigators and principal advisors. We recommend that a “Consistency Committee” be established within Inland Revenue to ensure there is consistency in application of the new rules. In order to provide further guidance to taxpayers on how the transfer pricing provisions operate, the committee should be required to publish on a regular and confidential basis, the decisions in matters referred to it under escalation.

Comment

Officials do not consider a consistency committee is necessary as Inland Revenue’s team of Transfer pricing experts form a small team working closely together. This helps ensure the rules will be applied consistently.

Recommendation

That the submission be declined.

Clause 36

Issue: Extending the time bar for transfer pricing issues from four to seven years

Submissions

(Chapman Tripp, Corporate Taxpayers Group, EY, Russell McVeagh, PwC, Powerco, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, KPMG)

The proposed extension of the time bar from four to seven years should not proceed. *(ASB, Chapman Tripp, Corporate Taxpayers Group, Russell McVeagh, PwC, Powerco, KPMG)*

The increased time bar will increase uncertainty, prolong disputes and disadvantage small to medium sized businesses. The introduction of the new administrative measures for large multinationals will be more than sufficient to address the policy reasons for the increased time bar. *(PwC)*

A longer time bar period is likely to exacerbate the expediency of transfer pricing audits. Lengthy audits are costly for taxpayers, create more uncertainty, and pose a greater risk for taxpayers where employees may have left the company. *(EY)*

There are significant costs involved in a transfer pricing dispute and extending the time bar to seven years will only increase these costs. *(Corporate Taxpayers Group)*

Only Australia and Canada have a four year / seven year time bar split; most other OECD nations have the same or a similar time bar for transfer pricing matters as for other tax matters. *(Chartered Accountants Australia and New Zealand, KPMG)*

The selection of seven years is an example of “cherry picking” the worst option as this is the longest time bar in a sample of other countries (excluding China who applies a 10 year time bar across all taxes, not just transfer pricing). *(Corporate Taxpayers Group)*

The concern that modern commercial arrangements are becoming increasingly complex can be addressed by increasing resource to investigate and deal with arrangements at the time they occur. *(Chartered Accountants Australia and New Zealand)*

In practical terms, it is often more difficult to investigate transactions once several years have passed. There will likely have been changes in taxpayer personnel and institutional knowledge will no longer be there. (*Chartered Accountants Australia and New Zealand*)

Increasing the time bar is inconsistent with the direction Inland Revenue is heading in its customer-centric approach. Inland Revenue's compliance management approach for multinational enterprises has been to move to resolving any issues with commercial transactions in real time. The time bar has remained at four years but many taxpayers are now able to achieve practical certainty within one year. (*Chartered Accountants Australia and New Zealand*)

Transfer pricing arrangements are typically not one-off events (like many other tax disputes) and there will be an impact year after year. To have tax years open for seven years leaves taxpayers open to far too much risk and uncertainty. (*Corporate Taxpayers Group*)

Increasing the time bar puts New Zealand at risk of transfer pricing reassessments. In particular, other jurisdictions will have longer to claim a larger share of revenue which has been taxed in New Zealand. New Zealand businesses who find themselves subject to transfer pricing adjustments in New Zealand will not have the benefit of obtaining offsetting reassessments in the other jurisdiction if that country's time bar period is shorter (*Corporate Taxpayers Group, PwC*)

If the time bar is extended it should be raised by one or two years and then only for taxpayers who repeatedly do not comply with Inland Revenue information requests or who mislead Inland Revenue in some way. For example, in the UK the four year time bar is extended to six years if the taxpayer has acted carelessly and in the US the three year time bar is extended to six where there are substantial omissions of income. (*Corporate Taxpayers Group*)

Any time bar extension should only arise where a taxpayer is being uncooperative and is put on notice of a possible extension and still fails to provide information in a timely way. (*ASB*)

The proposed extension is inconsistent with the need to provide certainty to taxpayers and unnecessary in light of the timely information gathering mechanisms at the disposal of Inland Revenue. (*KPMG*)

There are other complex tax arrangements for which an increase in the time bar is not proposed. (*KPMG*)

Comment

Officials consider there is a good justification for extending the time bar to seven years for transfer pricing issues.

The 2017 OECD Transfer Pricing Guidelines state that “*Transfer Pricing cases are fact-intensive and may involve difficult evaluations of comparability, markets, and financial and industry information. Consequently, a number of tax administrations have examiners who specialise in transfer pricing, and transfer pricing examinations may take longer than other examinations and follow separate procedures.*”

There are a number of reasons why transfer pricing issues can take more time to resolve than other types of tax investigations:

- The factual review for transfer pricing cases is typically much more detailed than other tax issues and may involve discussions with numerous staff and the taxpayer, in addition to the usual review of legal documents etc. It may also involve wider industry interviews, e.g. with regulators, competitors, customers etc. to provide the necessary market context. The relevant documentation or information may be held outside New Zealand which can delay when this information is provided to Inland Revenue.
- Assessing compliance with the arm's length principle requires very detailed and specific information and analysis of how a comparable transaction between unrelated parties would have been conducted. This means there are effectively two parallel investigations – determining the facts of the actual related party transaction and identifying a comparable arm's length arrangement.
- Certain complex transactions require input from market experts typically based overseas. Vetting, engaging, and briefing an overseas expert takes time. Depending on the nature of the issues, the expert's opinion may also take some time to prepare.
- There is usually a range of possible answers in transfer pricing cases and this leads to more frequent and extensive discussions and negotiations throughout the process. Taxpayers generally wish to engage in discussions and negotiations (and exchange issues papers) prior to entering the disputes process. There are also often settlement discussions during the disputes process that can go on for many months at a time.
- There may also be numerous and lengthy discussions with treaty partners in the course of a transfer pricing investigation to not only obtain additional information but also endeavour to resolve differences without double taxation arising.

Submitters have suggested that a longer time bar will create an incentive for Inland Revenue to prolong investigations and disputes. Officials disagree. Inland Revenue has strong incentives to efficiently resolve investigations as there is a high cost from allocating staff resource that could be better used on another investigation.

Furthermore, in many cases the delay may be due to the actions of the taxpayer, rather than Inland Revenue. Taxpayers may delay providing the information needed by Inland Revenue to make an assessment and often want more time to negotiate and exchange issues papers with Inland Revenue.

In fact, the current four year time bar can provide taxpayers with an incentive to not co-operate with an investigation. If the investigation is nearing the four year limit, Inland Revenue may need to abandon the investigation, or the taxpayer may be able to achieve significant tax savings by having fewer years that can be challenged by Inland Revenue. For some cases or income years there can be insufficient time to make an assessment and then go through the 18 month dispute process. This 18 month dispute process effectively means Inland Revenue only has 2.5 years (rather than 4 years) in which to obtain the information and expert advice needed to make an initial assessment.

New Zealand is adopting Article 17 of the multilateral instrument which will update our DTAs so that they require New Zealand to make corresponding adjustments in transfer pricing cases even if these are adjustments beyond New Zealand's time bar. This means that if New Zealand has a shorter time bar than other countries, we could be disadvantaged as we would be required to provide tax relief under our treaties, but would not be able to make tax positive adjustments in respect of those same years. In particular, Australia has a seven year time bar for transfer pricing so New Zealand must provide up to seven years of tax relief to Australian businesses, whereas New Zealand can only currently go back four years when adjusting the transfer prices

of taxpayers that owe tax to New Zealand. Our DTA with Australia provides that both countries are allowed to propose transfer pricing adjustments up to seven years after tax returns have been filed.

As shown in the table many other jurisdictions have a more than four year time-bar for transfer pricing assessments.

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

The proposed seven year time bar for transfer pricing is consistent with Inland Revenue’s customer-centric objectives as it does not preclude using other administrative measures such as the compliance management approach or advance pricing agreements to provide compliant taxpayers with certainty.

Two submitters suggested the extended time bar should only apply to those taxpayers who are not co-operating with the relevant Inland Revenue investigation. However, officials consider that this option is likely to lead to further disputes with these taxpayers as to whether their co-operation could be considered adequate or reasonable.

Many submitters have suggested that as an alternative to extending the time bar, Inland Revenue should look to better resource its transfer pricing team. Inland Revenue may need to recruit a larger team of transfer pricing specialists to investigate transfer pricing issues. However, officials do not agree that additional transfer pricing specialists would eliminate the need for a longer time bar. The longer time bar will only be necessary in a small number of complex cases. These cases require commissioning of overseas experts and multiple rounds of site visits, interviews and negotiations with taxpayers. These tasks are best performed by a small project team working in a logical sequence. Trying to use a larger team to simultaneously perform each task would be unlikely to shorten the overall time needed to resolve the dispute. Finally, it can be difficult for Inland Revenue to recruit or retain the relevant expertise as there is high global demand for transfer pricing experts.

Recommendation

That the submissions be declined.

Clause 36

Issue: Deadlines for investigation of transfer pricing matters and responding to Advance Pricing Agreement applications

Submissions

(PwC)

If the 7 year time bar is extended, legislation should be introduced to require Inland Revenue to conclude an audit within a certain timeframe.

Strict timeframes should be introduced for Inland Revenue to respond to Advance Pricing Agreement applications to ensure taxpayers can obtain certainty.

Comment

Currently, most transfer pricing investigations take less than four years and Inland Revenue expects this will continue under the proposed new rules. The longer time bar is therefore only expected to be relevant in a handful of complex cases. However, it is important to have more time available to identify, investigate and resolve these cases as they can involve very large sums of tax.

Inland Revenue aims to conclude unilateral Advance Pricing Agreements within 6 months. However, more time may be required to reach an agreement in some cases due to the uniqueness or complexity of the arrangement. For example, additional information or international expertise may need to be obtained to support the analysis. A strict deadline would likely lead to fewer Advance Pricing Agreements being agreed between Inland Revenue and taxpayers, particularly in complex or high-risk cases where concluding an Advance Pricing Agreement would provide the greatest benefits.

Recommendation

That the submissions be declined.

Clause 36

Issue: Seven year time bar should not apply to the restricted transfer pricing rules for related party debt

Submission

(Corporate Taxpayers Group, KPMG)

The restricted transfer pricing approach in section GC 15 – GC 18 is not a transfer pricing approach and therefore the seven year time bar should not apply to it. *(Corporate Taxpayers Group)*

The restricted transfer pricing rule is aimed at reducing the scope for disputes about loan pricing. This should mean less, not more time is required by Inland Revenue to challenge arrangements. *(KPMG)*

Comment

The restricted transfer pricing approach was included in the transfer pricing rules, rather than the thin capitalisation rules as was previously suggested, as it supports and adds onto the existing transfer pricing rules. Where the restricted transfer pricing rule applies this effectively modifies the facts of an arrangement before the standard transfer pricing rules are applied. Applying the same time bar for transfer pricing and restricted transfer pricing provides certainty to both taxpayers and the Commissioner as to how the time bar applies.

Applying a shorter time bar to restricted transfer pricing could result in an audit which included transfer pricing and non-transfer pricing adjustments changing whether a borrower was a high BEPS risk which would result in the restricted transfer pricing rules applying and a position that was previously well within time bar becoming time barred or being sufficiently close to time bar that assessments could not be raised. This could result in the perverse outcome that a higher risk multinational that was subject to the restricted transfer pricing rules for debt could only be audited by Inland Revenue on the last four years whereas a lower risk multinational that was subject to the general transfer pricing rules (for debt or other arrangements) could be audited on the last seven years.

Recommendation

That the submissions be declined.

Clause 36

Issue: Refund provision should match the proposed seven year time bar and drafting of the time bar

Submissions

If the statute bar is to be extended for transfer pricing matters, the refund rule in section RM 2 should also be extended to seven years for transfer pricing matters. *(Corporate Taxpayers Group, EY, New Zealand Law Society, PwC)*

Comment

Officials agree that the refund rule in section RM 2 should also be extended to seven years for transfer pricing matters.

Recommendation

That the submission be accepted.

Clause 36

Issue: Drafting of the transfer pricing time bar

Submissions

(EY, New Zealand Law Society, Corporate Taxpayers Group)

The terminology used in s GC 13(6) should be consistent with the terminology used in the time bar provision in s 108 of the Tax Administration Act 1994. For example, section 108(1) refers to “tax return” whereas s GC 13(6) refers to “return of income”. *(EY, New Zealand Law Society)*

It would be more appropriate to amend the time bar by amending section 108 of the Tax Administration Act 1994 *(Corporate Taxpayers Group)*

Comment

Officials agree that using consistent terminology is desirable. As currently drafted the transfer pricing time bar is in the same sections as the other transfer pricing rules. Officials consider this is the best place for the transfer pricing time bar but will consider if it would be useful to include a cross-reference in section 108 of the Tax Administration Act.

Recommendation

That the submissions be accepted, subject to officials’ comments.

Clause 36

Issue: Drafting structure of the transfer pricing rules

Submission

(Corporate Taxpayers Group)

The concepts of arm’s length conditions and reconstruction should be shifted from section GC 13 (which relates to the amount of consideration) to section GC 6 (which relates to the identifying transaction which is subject to the transfer pricing rules). *(Corporate Taxpayers Group)*

Comment

Section GC 6 is currently used to determine when the transfer pricing rules need to be applied. Officials do not consider it would be sensible to include in section GC 6 the concepts of arm's length conditions and reconstruction as these provisions are about identifying the relevant economic conditions of the transaction.

However, it may be logical to re-order some of the provisions in the Bill, so that the provisions for identifying the relevant conditions of the transaction, precede the provisions for determining the arm's length consideration. This ordering would align with the logical sequence for conducting a transfer pricing analysis and the order that these topics appear in the OECD transfer pricing guidelines.

Recommendation

That the submission be declined.

Clause 36

Issue: Redrafting of existing transfer pricing rules

Submission

(EY)

Sections GC 7 and GC 8 should be redrafted to clarify they are not limited to situations where there is an increased assessment of New Zealand tax.

Comment

The current Bill does not include any amendments to the existing transfer pricing rules in sections GC 7 and GC 8 as it was considered desirable to only change the existing legislation to the extent required to achieve the policy decisions (as opposed to a complete rewrite or replacement of the existing legislation). To respond to the submission would require new provisions to replace the existing sections GC 7 and GC 8. This would have significant policy and drafting implications that would be best considered and consulted on as part of a future taxation Bill.

Recommendation

That the submissions be declined.

COUNTRY-BY-COUNTRY REPORTS

Overview

One of the OECD's BEPS recommendations was to require large multinational groups (those with annual consolidated group revenue of EUR €750m or more in the previous financial year) to provide a Country-by-Country report which contains certain high-level information on the groups' global activities to tax authorities who would then exchange this information with each other.

Inland Revenue already requires New Zealand headquartered multinational groups with annual consolidated group revenue of EUR €750m or more in the previous financial year to file a Country-by-Country report using the IR 1032 prescribed form for all income years beginning on or after 1 January 2016. The Bill proposes inserting a specific provision in the Tax Administration Act which will codify the requirement for large multinationals to file a Country-by-Country report.

Submitters supported the proposal to codify these requirements. Because the information could be commercially sensitive, Chartered Accountants Australia and New Zealand wanted to ensure the information was protected by tax authorities. In contrast, Oxfam wanted to require multinationals to publish their information as they consider transparency and public scrutiny will provide incentives for multinationals to pay taxes. The Corporate Taxpayers Group submitted that the application date for the provision should be prospective and that existing processes continue to be used to obtain the information prior to the Bill's enactment.

Clause 52

Issue: Protection of information provided in Country-by-Country reports

Submission

It is sensible and logical to codify the specific requirement. Some of the information provided through this process will be commercially sensitive. Government should share with affected companies its rules about when the information may be provided to other government departments or New Zealand organisations and when it may be provided to overseas agencies. (*Chartered Accountants Australia and New Zealand*)

Comment

The information provided through the Country-by-Country reports is subject to the general tax secrecy rules in the Tax Administration Act 1994. It will be shared with other tax authorities under the *Multilateral Competent Authority Agreement on the Exchange of CbC Reports* and through a bilateral agreement with the United States. These agreements require the information to be protected so it is only available to tax authorities.

Recommendation

That the submission be noted.

Clause 52

Issue: Publication of Country-by-Country reports

Submission

The legislation should require multinationals to publish their Country-by-Country reports (*Oxfam*).

Comment

Officials do not consider it appropriate to require multinationals to publish their Country-by-Country reports as:

- The reports can contain commercially sensitive information.
- The raw information can be easily misinterpreted. For example a multinational may have reported a low amount of tax paid in a country due to commercial reasons that are unrelated to BEPS such as costs related to a new investment or the use of tax losses from prior years.
- Country-by-Country reporting is a multilateral measure and the multilateral agreement for sharing the information requires the information to be protected so it is only available to tax authorities. Any changes to this requirement would be best achieved through changes to this multilateral agreement.
- New Zealand could only require New Zealand-headquartered large multinationals to publish their reports. This represents only about 20 of the approximately 6,000 large multinationals in the world so there would be only a small gain in overall transparency, but New Zealand-headquartered multinationals could be disadvantaged by revealing commercial information that their competitors do not need to reveal.

Recommendation

That the submission be declined.

Clause 52

Issue: Application date of Country-by-Country reports provision

Submission

It is inappropriate for a filing obligation to be retrospectively created, which will have the effect of making some taxpayers non-compliant. The provision should be prospective only, as this will not remove the obligation of notified taxpayers to file the Country-by-Country report for the relevant periods, as the notifications were made under Inland Revenue's existing information gathering powers. (*Corporate Taxpayers Group*)

Comment

Officials agree that the proposed provision codifying the requirement to provide Country-by-Country reports should only apply from the date of enactment.

Inland Revenue will continue to use sections 17 (which allows the Commissioner to request information) and 35 (which allows the Commissioner to prescribe a form) of the *Tax Administration Act 1994* to require Country-by-Country reports to be filed for periods prior to the date of enactment.

Recommendation

That the submission be accepted.

Clause 52

Issue: Drafting uses incorrect definition of “ultimate parent”

Submission

(Officials)

Comment

The current drafting in the Bill incorrectly refers to the definition of ultimate parent used in “subpart FE” which is limited to banking groups. The reference to subpart FE should be removed to ensure that country-by-country reporting is not limited to banks.

Recommendation

That the submission be accepted.

Clause 43

Issue: Definition of large multinational group

Submission

(Corporate Taxpayers Group)

A NZD denominated threshold would provide greater certainty for New Zealand taxpayers, rather than having their Country-by-Country reporting obligations subject to foreign exchange fluctuations.

The threshold should be measured based on the consolidated group revenue earned in the preceding year, consistent with OECD Guidelines.

The Bill incorrectly references the threshold in paragraph 5.53 of the OECD Guidelines, this should be 5.52.

Comment

The requirement to file Country-by-Country reports, the application of the permanent establishment avoidance rule and most of the administrative measures in the Bill will only apply to large multinational groups. This is defined as a multinational group with annual consolidated revenues of more than €750m in the previous income year. This €750m threshold aligns with the OECD's suggested threshold for requiring large multinationals to file Country-by-Country reports with tax authorities.

The EU has estimated that there may be up to 6,000 large multinationals groups with annual consolidated revenues of more than €750m. Only about 20 of these large multinational groups are headquartered in New Zealand and would already report their revenues in New Zealand dollars.

Furthermore, many of these New Zealand headquartered groups will have operations in European countries, in which case they would still need to consider if they are above the €750m threshold that applies for the purposes of some European tax laws.

For these reasons officials consider that that denominating the threshold in New Zealand dollars would not reduce the need to perform an exchange rate calculation, and would in fact lead to a greater number of multinationals needing to convert their reporting currency to consider if the rules are applicable.

The policy intention was that the definition of large multinational group would be measured using the consolidated group revenue from the preceding year, consistent with OECD Guidelines. Officials will ensure that the drafting achieves this.

The reference to paragraph 5.53 in the Bill is correct. The €750m threshold is stated in both paragraphs 5.52 and 5.53, although 5.52 also includes a reference to an equivalent amount in local currency.

Recommendation

That the submission to use the preceding year to measure consolidated group revenue be accepted, and the other submissions be declined.

Hybrid and branch mismatch rules

OVERVIEW

Hybrid and branch mismatch arrangements are cross-border arrangements that exploit differences in the tax treatment of an instrument, entity or branch under the laws of two or more countries.

A hybrid or branch mismatch arrangement can result in a deduction with no corresponding taxable income inclusion or a single payment leading to a double deduction. The result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

The OECD in its BEPS Action Plan made a number of recommendations to help countries deal with hybrid and branch mismatches. This Bill includes a comprehensive adoption of the OECD recommendations with suitable modification for the New Zealand context.

Many submitters to the Bill opposed the comprehensive nature of the proposed rules, suggesting that a reduced set of measures targeting the known hybrid mismatches directly affecting New Zealand would be a better approach. Related to this is a common view that the proposed rules are highly complex, and this complexity will raise compliance costs for taxpayers in understanding and complying with the proposed new rules.

Many submitters have made valid points on technical matters or matters that will aid implementation and compliance, some of which are recommended as changes to the Bill by officials.

There are also a number of drafting submissions that have been made and which are summarised in tabulated form at the end of this section.

GENERAL ISSUES

Issue: Complexity of proposed rules and compliance costs

Submissions

(Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, KPMG, OliverShaw, PwC)

The proposed rules are complex. If enacted, the increased complexity of these rules will increase compliance costs for taxpayers and Inland Revenue.

The rules affect a number of different tax regimes. They also rely on an understanding of the laws of foreign jurisdictions. Proceeding with these rules will lead to a significant amount of uncertainty in practice. *(Chartered Accountants Australia and New Zealand)*

Taxpayers who may not have hybrid arrangements will need to confirm that the rules do not apply to them. *(Corporate Taxpayers Group)*

The complexity of the rules has little benefit and is likely to have unforeseen consequences. *(KPMG)*

The complexity results in an incoherent package of rules. *(OliverShaw)*

The complexity of the rules has been amplified by unsatisfactory drafting. *(PwC)*

Comment

While the hybrid and branch mismatch rules included in this Bill are complex, they are in line with the OECD's recommendations and are being adopted by many countries with which New Zealand has close investment links (such as Australia and the UK). The US has also enacted some of the hybrid rules.

Officials also consider that the hybrid mismatch rules will not apply to most businesses, unless the business wants them to apply. That is, if a taxpayer replaces a hybrid arrangement with a simpler, non-hybrid arrangement they will be outside the scope of the rules and will not have to deal with the associated complexity from that point on. Taxpayers with branches are perhaps an exception to this optionality.

Finally, officials consider that the rules are unavoidably complex due to their intended application to highly complex arrangements.

Recommendation

That the submission be noted.

Issue: Breadth of proposed rules

Submissions

(Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, KPMG, OliverShaw, PwC)

New Zealand should not introduce a comprehensive set of hybrid and branch mismatch rules as this will affect more taxpayers than is needed and will increase compliance costs for those taxpayers. A targeted set of rules dealing with known hybrid arrangements affecting New Zealand would be a better approach.

The small scale of hybrid issues in New Zealand does not justify the full set of OECD recommendations as a response. Overreach will be inevitable. A targeted response would be sufficient to demonstrate that New Zealand is dealing with hybrids abuse. *(Chapman Tripp)*

Overreach in the rules will impact small and medium-sized enterprises. *(Chartered Accountants Australia and New Zealand)*

The number of taxpayers that have hybrid entities or instruments according to Inland Revenue's International Questionnaire is small (3% of surveyed taxpayers) and compliance costs will be imposed on taxpayers without hybrid entities or instruments due to the breadth of the rules. *(Corporate Taxpayers Group)*

A targeted or phased approach would reduce the risk of overreach. *(KPMG)*

Hybrid mismatch proposals have been the subject of extensive consultation, but this has been focused on the central parts of the proposed rules. Other important parts, such as branch mismatches, imported mismatches, and changes to controlled foreign company (CFC) rules have not had the same level of attention. There is a risk New Zealand is going further than other countries in these areas and that it will affect unaware taxpayers. Only core hybrid rules relating to double deductions and deductions with no inclusion should proceed at this time. *(OliverShaw)*

Comment

The proposed comprehensive scope of the rules is comparable with the approach of other countries that have introduced or are introducing hybrid and branch mismatch rules.

If the proposed rules are modified by removing certain elements, this could invite undesirable tax planning in relation to those elements.

On compliance costs, initially it is true that all taxpayers will need to consider the potential impact of the rules, as they and their advisors become more familiar with them. This is the case for much new tax law. As familiarity grows, taxpayers and their advisors will become much more adept at determining quickly whether or not the hybrid and branch mismatch rules are relevant to their transactions. The vast majority of the time they will not be, and this is the intended aim of the rules. Officials consider that after the initial familiarisation period, any additional costs imposed will in most cases be negligible, and will only be significant where there is a genuine hybrids issue that needs to be addressed.

We note that the International Questionnaire which one submitter referred to is directed at inbound investment into New Zealand. Outbound investment which also produces hybrid mismatch concerns is not considered by the questionnaire, and nor are foreign-owned banks and

insurers due to their particular compliance relationships with Inland Revenue. Furthermore, even if only a relatively small number of taxpayers do have arrangements currently subject to the rules, that is not a strong reason for not enacting them. Those arrangements can have large tax consequences, and the rules will also prevent the proliferation of such arrangements.

Branch mismatches were included in targeted consultation officials organised after the release of the Government discussion document *Addressing Hybrid Mismatch Arrangements*. Officials consider that branch mismatches will not apply as widely for New Zealand as other countries due to New Zealand's approach to taxing the foreign branches of New Zealand companies.

Officials note that the imported mismatch rule has a deferred application date for unstructured imported mismatches, which should allow more time for taxpayers and advisors to understand the implications of what is undoubtedly a complicated rule.

Officials note that there are no CFC proposals in the Bill in relation to the hybrid and branch mismatch rules.

Recommendation

That the submission be declined.

Issue: New Zealand should not be a leader on hybrid and branch mismatch rules

Submissions

(Chapman Tripp, PwC)

New Zealand should not enact hybrid and branch mismatch rules in the form proposed at this time. This is due to the complexity of the proposals and the effect of discouraging foreign direct investment into New Zealand. *(Chapman Tripp)*

New Zealand should not be an early adopter of hybrid and branch mismatch rules. The UK's rules have faced difficulties, and Australia is still in consultation on its rules. Enacting the proposed rules for the intended application date will result in complexity and uncertainty as to when the rules of other countries interact with New Zealand's rules. US tax reform has also complicated the international tax context. *(PwC)*

Comment

Officials consider that the rules are being widely adopted, and by many countries with which New Zealand has close investment links. Australia, the UK and the countries making up the EU account for approximately 62% of the direct investment into New Zealand. It is expected that these countries will have hybrid and branch mismatch rules in place alongside New Zealand or will enact rules shortly after. For instance, EU countries are required to introduce rules by 1 January 2020. The US already has rules relating to double deductions, and has now added some rules relating to hybrid payments and entities, effective 1 January 2018. These rules are similar in their intent to some of the OECD hybrid recommendations.

Because Australia is committed to introducing hybrid mismatch rules, adoption of the rules will not make New Zealand a less favourable destination of investment from Australia (our largest

source of direct investment), nor will it make New Zealand a less favourable investment jurisdiction than Australia.

While officials acknowledge that there may be some benefits to watching the implementation of hybrid and branch mismatch rules in other jurisdictions first, there is also a significant advantage to New Zealand being in a group of early adopters. New Zealand has the chance to have some influence in how the rules are implemented around the world, we have been able and are able to benefit from engaging with other countries who are also actively engaged in developing their rules (particularly with Australia).

Recommendation

That the submission be declined.

Issue: Purpose/targets of OECD recommendations are flawed

Submission

(Chapman Tripp)

Whether taxpayers are allowed deductions in New Zealand depends entirely on foreign tax outcomes under the proposed rules. This will often protect the tax bases of other countries, not New Zealand's tax base. This is not appropriate given the limited uptake of these rules.

By only targeting character mismatches and not rate mismatches, the hybrid mismatch rules will be ineffective as taxpayers will use debt funding through low-tax jurisdictions instead of hybrid funding.

Comment

One of the core principles of the OECD hybrid mismatch proposals is for countries to look wider than their own tax base because it is often difficult to tell with hybrid and branch mismatch arrangements the country in which tax is being avoided. Officials consider that this approach is necessary to address the problem.

Officials acknowledge that financing New Zealand operations by debt funding through low or no tax countries is an alternative to the use of hybrid funding. The hybrid rules will not put an end to all tax planning using cross border transactions. But they make useful progress towards that objective.

Officials also note the integrity rule that was part of the revised Australian exposure draft legislation of hybrid mismatch rules. The Australian approach may be a solution to the debt funding through low or no tax jurisdictions issue that the submitter raises.

Recommendation

That the submission be declined.

Issue: Reassessment of corporate income tax rate

Submission

(Chapman Tripp)

New Zealand will need to reassess whether its corporate income tax rate is appropriate if it enacts hybrid and branch mismatch rules.

Comment

Officials consider that the corporate income tax rate issue the submitter refers to is outside the scope of the Bill.

Recommendation

That the submission be declined.

Issue: Transitional period

Submissions

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group)

If the application dates of hybrid and branch mismatch rules of New Zealand and another country (for instance, Australia) are misaligned, this should be ignored. *(Chartered Accountants Australia and New Zealand)*

A transitional period should be included in the measures in relation to other countries implementing hybrid and branch mismatch rules, particularly Australia. *(Corporate Taxpayers Group)*

Comment

Officials agree that a transitional period would help taxpayers comply with the defensive parts of New Zealand's rules in situations where another country's rules are implemented part of the way through a taxpayer's income year. Officials consider that this is particularly relevant in the case of the entity based rules due to the possible interaction of other countries' dual inclusion income rules and New Zealand's surplus assessable income concept.

Accordingly, officials recommend that the defensive rules in proposed sections FH 6 and FH 9 should not apply in relation to a particular mismatch if another country's rules are implemented and apply to that taxpayer or another taxpayer in the same control group (in respect of the same mismatch) in the same income year.

Recommendation

That the submission be accepted in part, subject to officials' comments.

Issue: Restructuring safely

Submissions

(EY, PwC)

A specific provision is needed that ensures that a taxpayer who restructures an arrangement that would be subject to the hybrid and branch mismatch rules so that it is not subject to those rules is not subject to the general anti-avoidance rule (GAAR). Additionally, Inland Revenue should publish guidance confirming this, and which specifies acceptable alternative arrangements to those within the scope of the rules. *(EY)*

Taxpayers that unwind hybrid arrangements are complying with the policy intent of the rules and should not be disadvantaged for doing so. This should be acknowledged in guidance and such an action should not carry audit or tax dispute risk. *(PwC)*

Comment

It would not be appropriate to limit the general anti-avoidance rule in the way suggested by the submitter. However, officials agree that guidance supporting the submitter's position on restructuring safely would help with certainty of the rules. Some specific alternative arrangements that are acceptably outside the scope of the hybrid and branch mismatch rules may be included in this guidance. For example, suppose a New Zealand resident is the borrower under a hybrid debt instrument, and will be disallowed interest deductions once the Bill takes effect. If the non-resident lender transfers the debt to another group member who treats the instrument as debt and the return as income, the New Zealand resident will be allowed a deduction. That should not mean that the transfer is a tax avoidance arrangement.

Recommendation

That the submission as to a specific rule be declined, but that the suggestion that guidance on this issue be published be accepted.

Issue: Widened corresponding hybrid mismatch legislation

Submission

(KPMG)

The concept of corresponding hybrid mismatch legislation (which has the effect of 'switching off' the defensive hybrid mismatch rules in the Bill) should be widened so that it includes the laws of countries that have enacted hybrid and branch mismatch rules that predate the OECD recommendations on hybrid mismatch arrangements. An example is the US dual consolidated loss rule. This rule is similar to OECD recommendation 6 primary rule. However, it was not enacted in pursuance of the OECD BEPS programme, and is not part of a suite of rules which can be said to comprehensively address hybrid mismatches.

Comment

Officials agree that the Bill's definition of "hybrid mismatch legislation" might be read as being limited to legislation that contains an equivalent to each of sections FH 3 to FH 11. This is not intended. When another country has a rule that achieves the same outcome as a hybrid primary

rule, and that rule applies to a particular mismatch, then New Zealand should not apply its secondary rule to that mismatch, whether or not the other country's rule was enacted in response to Action 2 and whether or not the other country has a comprehensive suite of rules.

Recommendation

That the submission be accepted and an appropriate change made to the definition of hybrid mismatch legislation to clarify that comprehensive anti-hybrid rules are not required.

Issue: List of corresponding hybrid mismatch legislation

Submissions

(Corporate Taxpayers Group, Russell McVeagh)

Inland Revenue should maintain a list of countries that have corresponding hybrid mismatch legislation (in relation to the disregarded hybrid payments rule).

Comment

Officials consider that the provisions that grant primacy to the hybrid mismatch rules of other countries are clear enough such that taxpayers will be able to comfortably determine whether to apply a New Zealand defensive rule or not. Like any other provision, this is also a matter on which IRD guidance can be sought. However, if there is a sufficient benefit to be gained from maintaining and publishing a list of such countries, this will be considered.

Recommendation

That the submission be noted.

Issue: Clarity of tax regimes affected by rules

Submissions

(New Zealand Law Society)

The proposed rules override a number of existing income tax regimes and will cause unintended consequences for those regimes. There should be an explicit list of the tax regimes affected by the proposed rules.

Comment

Officials acknowledge the interaction of the proposed hybrid and branch mismatch rules and several income tax regimes which are affected. However, the tax regimes affected can be identified from the Bill and, with more specificity, from the Commentary on the Bill. Guidance will also be published by Inland Revenue that helps taxpayers to understand the implications of any new rules on existing tax regimes.

Recommendation

That the submission be declined.

Issue: Split ownership

Submission

(Russell McVeagh)

The rules as drafted seem to be generally targeted at wholly owned hybrid mismatch structures, but in practice many arrangements have split ownership and the Bill does not appropriately cater to these arrangements. In particular:

- The defensive deductible hybrid payments rule (proposed section FH 9) should be amended to ensure that it does not apply if the owner who is allowed a deduction is not a controlling owner; and
- The definition of surplus assessable income, and in particular the component “unrecognised amounts” should account for split ownership. For example, if a New Zealand resident hybrid is 60% owned by a foreign shareholder who treats it as fiscally transparent, section FH 9 prima facie applies to 100% of the entity’s expenditure, even though there is only a double deduction as recognized by the hybrid rules for 60% of it. Similarly, 100% of its income should prima facie be surplus assessable income, even though the controlling shareholder will not be taxed on 40% of that income.

Comment

Officials agree that some parts of the Bill do not cater to situations of split ownership.

Recommendation

That the Bill be amended so that it more effectively caters for split ownership arrangements, and that in particular both of the above situations be addressed.

Issue: Determination-making power to correct errors

Submission

(Russell McVeagh)

Issues with the Bill will inevitably arise for complicated arrangements following enactment. Instead of relying on retrospective remedial amendments to get the right policy outcome, a binding determination or regulation making power should be provided to the Commissioner of Inland Revenue or the Minister of Revenue so that issues can be addressed quickly. Taxpayers should have the option of whether or not to apply such a determination or regulation.

Comment

This submission has merit. The Government has recently consulted on allowing such a power to exist with respect to the provisions of the tax law more generally (see Chapter 6 of the Government Discussion Document *Making Tax Simpler: Proposals for Modernising the Tax Administration Act*). That separate consultation and decision making process, which is currently on track to produce a policy decision in the near term, is the best forum to consider this kind of issue.

Recommendation

That the submission be declined, on the basis that it is better dealt with in the context of the existing consultation process regarding extra-statutory corrections.

Issue: Application of rules to consolidated groups

Submission

(Russell McVeagh)

A provision should be included in the hybrid and branch mismatch rules clarifying that the rules can be applied to a New Zealand consolidated group as if it were a single entity.

Comment

Officials consider that the consolidation rules already produce this result in many cases. For example, under those rules, if a company is not entitled to deduct expenditure on its own account, but (broadly speaking) would be entitled to deduct it if the consolidated group members were a single company, then a deduction is allowed for that expenditure. This would seem to allow a company with expenditure denied under section FH 4 or FH 8 (for example) to deduct that expenditure if there were surplus assessable income derived by another company in the consolidated group, though there may be doubt over whether the nexus requirements in section FM 11(2) is met. There also seems to be no ability for a company with mismatch income under proposed section FH 6 to use surplus assessable income arising to another consolidated group member to justify a deduction for that mismatch amount, in the same way as the company could if it earned the surplus assessable income itself.

Recommendation

That the submission be accepted, and a change made to the consolidation provisions accordingly.

Issue: Legislative deferrals and consultation

Submission

(KPMG)

Implementation of the OECD's hybrid recommendation 5.2 does not feature in this Bill. This legislative deferral is supported, with hope that further consultation will be undertaken by officials before the proposal is progressed.

Comment

Officials consider this submission to be outside the scope of the Bill, but note the submitter's comments.

Recommendation

That the submission be noted.

Issue: Branch mismatch rules consultation and application

Submission

(PwC)

Branch mismatches have not had the same level of consultation as the other rules due to the fact that the final OECD report on branch mismatches was only finalised in July 2017.⁵ It is submitted that the branch mismatch rules should be removed from the Bill so that further consultation can occur.

The hybrid mismatch rules should also be deferred while branch mismatch rules consultation is taking place so that taxpayers can assess their structures against both sets of rules.

Comment

Officials recognise that some parts of the OECD-recommended branch mismatches were not part of the Government discussion document *Addressing Hybrid Mismatch Arrangements*, released in September 2016. This is because the first public document on branch mismatches released by the OECD was the discussion draft on branch mismatch structures, which was released very shortly before the Government discussion document.⁶ The branch mismatches identified by the OECD are analogous to hybrid mismatches. The only difference is that these mismatches arise because of differences in countries' rules for taxing branch income and allowing deductions for branch expenses, rather than because of differences in how countries tax entities or instruments.

Officials undertook targeted consultation on branch mismatches in March 2017 and considered that there was value in including branch mismatch proposals in the progress of the hybrid

⁵ OECD (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris

⁶ OECD (2016), *Public Discussion Draft, BEPS Action 2 Branch Mismatch Structures*, OECD/G20 Base Erosion and Profit Shifting, OECD Publishing, Paris.

mismatch rules project. There was no objection to the inclusion of the proposed branch rules in the project.

There is no need to defer the application of the branch mismatch rules and officials do not agree with the submission that the whole package of hybrid and branch mismatch rules should be delayed.

Recommendation

That the submission be declined.

Issue: De minimis threshold/safe harbour

Submission

(PwC)

Due to the complexity, scope, and practical difficulties of complying with the rules, a safe harbour threshold should be adopted.

Even if not applied generally, then this safe harbour threshold should be applied to the imported mismatch rule.

Comment

The OECD Final Report does not have a de minimis/safe harbour threshold, and officials are not aware that any other countries have adopted or proposed such a threshold for their hybrid mismatch rules.

For many of the rules, e.g. The disregarded hybrid payments rule and the deductible hybrid payments rule, it would be very complex to have a safe harbour threshold based on transaction size which could not also be abused. The issue of size is partly resolved by observing that the rules only apply to taxpayers entering into more complex cross border transactions, and only where those transactions are between related parties, within a control group, or structured.

Officials also consider that the nature of hybrid mismatch rules weighs against a safe harbour threshold. This is because in some cases a threshold would only transfer the obligation to apply hybrid mismatch rules from a New Zealand group member to an overseas group member who would apply hybrid mismatch rules with no such safe harbour threshold.

Officials have greater sympathy for a safe harbour threshold for the imported mismatch rule. Such a safe harbour might make the process of checking a group for an imported mismatch less difficult. However, officials believe that for the moment, it is preferable to follow the OECD consensus. In large part this is because if New Zealand were to adopt a de minimis, residents of other countries making payments to New Zealand might have to consider the possible application of the imported mismatch rule to those payments. If there is no de minimis, they will not need to do so. Officials also note the deferred application date for the unstructured part of the imported mismatch rule.

Recommendation

That the submission be declined.

Issue: Practical implications of rule with foreign country laws

Submission

(PwC)

The Bill does not adequately deal with practical matters that may arise from the interaction between the proposed rules and foreign equivalent rules. It should be redrafted with further consultation to deal with this issue.

Comment

Officials expect that practical solutions to the submitter's concerns will be developed as Inland Revenue officials, foreign officials and taxpayers become more familiar with the proposed rules.

Recommendation

That the submission be declined.

Issue: Drafting issues

#	Section	Submitter	Submission	Recommended response
1	Various	KPMG, PwC	That character and timing mismatches are split into separate provisions or section in FH 3 and 4, and that branch mismatch rules are split from hybrid mismatch rules in other sections.	That the issue be considered at the revised track version of the Bill stage.
2	EX 46(10)(db)	PwC	The words “outside New Zealand” should be inserted after “country or territory” for clarity.	That the submission be accepted.
3	FH 1(3)	PwC	The word “mismatch” should be added before “situation”	That the submission be accepted.
4	FH 1(4)	KPMG	Paragraphs (f) and (g) should also refer to recommendation 4 of the Branch Report	That the submission be accepted.
5	FH 1(5)(b)	PwC	Since an election may only be made for certain financial arrangements, the words “an eligible” should be added before “financial arrangement”.	That the submission be accepted subject to wording.
6	FH 1(6)	PwC	Since some terms defined in section FH 15 are not the same as those used in the Final Report, the wording of this subsection should be changed to refer to equivalent terms.	That the submission be accepted.
7	FH 2(1)	PwC	Reference to “expenditure of loss” should be to “expenditure or loss”.	That the submission be accepted.
8	FH 2(2)	PwC	Reference to “mismatch amount” should be to “assessable income”.	That the submission be declined. A mismatch amount is an amount that will give rise to expenditure if offset under FH 12. Assessable income under FH 4 and FH 6 meets that test.
9	FH 3(1)	Matter raised in consultation	FH 3 needs to be clarified so it is clear that it looks at future payments as well as current ones. This could be clarified by adding the words “when made” after the word “payment” in FH 3(1)(b). It might also be useful to have a specific provision in section FH 3, such as a new subsection (10) “ <i>In this section references to a</i> ”	That the submission be accepted with exact wording to be finalised.

#	Section	Submitter	Submission	Recommended response
			<i>payment under a payment instrument include one or more payments which the payer has made or is required to make under the instrument.”</i>	
10	FH 3(2)(b)	CTG, Matter raised in consultation	The meaning of the phrase “if the classification of the payment or payment instrument were varied.” is not clear.	That the submission be declined.
11	FH 3(3)(c)	Matter raised in consultation	The words “including possible extensions” are too broad. It is always open to parties to agree to extend the term of an instrument.	That the submission be accepted with exact wording to be finalised.
12	FH 3(3)	Matter raised in consultation	It should be clear that a difference in the timing of recognition of FX gains and losses should not of itself attract the operation of section FH 3, even where the instrument has a term of more than 3 years.	That the submission be accepted.
13	FH 3(5)	Matter raised in consultation	The amount for which a deduction is denied should simply be the expenditure incurred in the income year in relation to the financial instrument. So “ <i>incurred amount</i> ” should simply be the amount incurred by the <i>payer in relation to the financial instrument</i> in the income year. No reference is required, in the disallowance subsection, to the payment. This would deal much better with FX fluctuations.	That the submission be accepted.
14	FH 3(5)(b)(i)	PwC	This amount should include any withholding tax credit, consistent with subparagraph (ii).	That the submission be declined. The amount in subsection (i) is not actual tax paid by the payee, it is income multiplied by the tax rate. Subsection (ii) does look at actual tax paid, and therefore the treatment of withholding tax credits is an issue that must be dealt with.
15	FH 3(5)(b)(ii)	PwC	The inclusion of an amount as CFC income should exclude it altogether from FH 3, rather than forming part of the calculation	That the submission be declined. CFC taxation is

#	Section	Submitter	Submission	Recommended response
			mechanism.	treated by the OECD as requiring additional proof of payment in order to be relevant to the hybrid mismatch issue.
16	FH 3(6)(a)	PwC	The words “the amount can reasonably be treated as accruing” are too vague and should be made more specific.	That the submission be declined. It should be possible to form a judgement on whether or not an accrual method is reasonable. This sometimes needs to be done, for example, in the financial arrangement rules – see for example section EW 20(2)(c).
17	FH 3(7)	PwC	Taxpayers should have an option to take a deduction for amounts under this subsection in prior periods, when the deduction ordinarily would have been taken.	That the submission be declined. This would be complex and cause administrative difficulties out of proportion to the benefit.
18	FH 3(8)	PwC	The subsection should be redrafted as it is vague and ineffective.	That the submission be declined.
19	FH 3(8)	Matter raised by officials	The words “on payments” on line 16 of the Bill should be deleted	That the submission be accepted.
20	FH 4(1)	PwC	The subsection should apply to a person who receives or is deemed to receive the payment for New Zealand tax purposes.	That the submission be declined. This is the intended effect. The reference to “assessable income” in subsections (2) and (3) should achieve it.
21	FH 4(1)	PwC	The wording assumes the amount of the deduction equals the amount of the payment received. Partial amounts should also be included.	That the submission be declined. This is already the effect of the wording. A payment made by a single

#	Section	Submitter	Submission	Recommended response
				person to a number of persons at once (e.g. joint owners) can be treated as two or more) different payments.
22	FH 4	Matter raised in consultation, PwC, CTG	The opening words of section FH 4(1) do not accommodate the possibility that the payment does give rise to assessable income for the New Zealand payee but on a deferred basis. This could be accommodated by adding the words in the fourth line after <i>section FH 6</i> , “or would give rise to assessable income of the payee in the circumstances described in subsection (3).	That the submission be accepted.
23	FH 4(2)(b)	Matter raised in consultation, CTG	The meaning of the phrase “if the classification of the payment or payment instrument were varied.” is not clear.	That the submission be declined.
24	FH 4(3)	Matter raised in consultation, PwC	The words “including possible extensions” are too broad. It is always open to parties to agree to extend the term of an instrument.	That the submission be accepted with exact wording to be finalised.
25	FH 4(4)	PwC	Reference should be made to subsection (3).	That the submission be declined. FH 4(4) relates to (2) and (3)
26	FH 4(6)	PwC	The subsection should apply to a person who derives/receives or is deemed to derive/receive the payment under the Act.	That the submission be declined. Subsection (4) already deals with who it is that derives the income.
27	FH 4	PwC	Taxation of an amount under a CFC regime should mean this provision does not apply.	That the submission be declined. If the amount is taxed in New Zealand that will mean it does not have to be taxed under the relevant CFC regime.
28	FH 5(1)	PwC	“incurs a charge to the New Zealand branch” should be “expenditure allocated to the New Zealand branch”.	That the submission be accepted subject to exact wording.
29	FH 5(1)	Matter raised in	As well as having a nonce term “ <i>branch charge</i> ” it would be	That the submission be

#	Section	Submitter	Submission	Recommended response
		consultation	helpful to have a nonce term “incurred amount”.	accepted.
30	FH 5(1)(a)	Matter raised in consultation	The opening words should say “the <i>incurred amount or branch charge</i> .”	That the submission be accepted.
31	FH 5(1)(b)	PwC	“tax status of the payer” is too vague.	That the submission be declined.
32	FH 5(1)(d)	PwC	“no country or territory outside NZ and the payee jurisdiction is paid tax” is unclear drafting.	That the submission be accepted.
33	FH 5(3) and (5)	KPMG	Subsection (3) should simply deny a deduction for the specified amount. The rest of the machinery in subsection (5) simply duplicates what already occurs in section FH 12. Mismatch amount should also go in the list of defined terms at the end of the section.	That the submission be accepted.
34	FH 5(3) and (4)	Matter raised in consultation	The mismatch amount should be the incurred amount or branch charge. There is no need for a reference to FX, since that is built in to the incurred amount or branch charge.	That the submission be accepted.
35	FH 5(4)(b)	PwC	References to financial instrument should be removed for foreign exchange fluctuations, and there is complex drafting in the provision – FH 5(1) inherently includes fx	That the issue be considered at the revised track version of the Bill stage.
36	FH 6(1)	PwC	The provision does not allow for partial deduction in payer jurisdiction.	That the submission be declined. Officials consider that the provision does apply to those situations.
37	FH 6(1)(a)	PwC	The provision should require that deduction <i>is actually</i> claimed, not that deduction <i>can be</i> claimed.	That the submission be declined. It is sufficient that a deduction can be claimed.
38	FH 6(1)(d)	PwC	“Tax status of the payer” terminology is too vague.	That the submission be declined. Officials disagree that the terminology is vague and consider that it reflects the policy.
39	FH 6(5)	KPMG	Subsection (3) should simply include income for the specified amount. The rest of the machinery in subsection (5) simply	That the submission be accepted.

#	Section	Submitter	Submission	Recommended response
			duplicates what already occurs in section FH 12. Mismatch amount should also go in the list of defined terms at the end of the section.	
40	FH 8(1)	Matter raised in consultation	Readability would be improved by introducing a nonce term at the end of paragraph (a) “ <i>the set off entity</i> ” and using that term in paragraph (b).	That the issue be considered at the revised track version of the Bill stage.
41	FH 8(4)(a)	Matter raised in consultation	The requirements of subsection (1) do not all relate to the person to whom the section applies. so the last phrase of (4)(a) should be “ <i>but the requirements of paragraphs (a) and (b) are not met.</i> ”	That the submission be declined.
42	FH 8(4)(b)	Matter raised in consultation	The second to last line should refer to income <i>of the set off entity</i> .	That the issue be considered at the revised track version of the Bill stage.
43	FH 8(5)	PwC	Assessable income deemed derived at the start of the transitional period should instead be derived as the loss is used in the hybrid entity country.	That the submission be declined. Recognition at the transition time produces the same net income outcome as if the New Zealand resident had met the requirements of section FH 8(1) for the whole of the unaffected period. In that case, none of the net loss for that period would have been able to be used against income that was not surplus assessable income. The double deduction rules do not look at actual loss use but potential loss use.
44	FH 11(1)	PwC	Clarity required that the reference to a payment is to interest expenditure.	That the submission be declined. The provision applies to all deductible expenditure.
45	FH 11(1)(d)	PwC	The payment and the funded payment should be part of the structured arrangement.	That the submission be noted, as officials consider that this is

#	Section	Submitter	Submission	Recommended response
				already achieved by the drafting.
46	FH 11(5)	Chartered Accountants Australia and New Zealand, Matter raised in consultation	The cross reference should be to subsection (4), not (4)(a).	That the submission be accepted.
47	FH 12	Russell McVeagh	Clarify that surplus assessable income can be offset against mismatch amounts arising under different provisions.	That the submission be declined. Officials are not convinced this clarification is needed in the legislation. The commentary on the Bill already clarifies this, as will guidance.
48	FH 12	PwC	Dual inclusion income and carry forward provisions should not be in the same section.	That the submission be declined. Officials do not consider that having the two concepts in the same section is confusing.
49	FH 12	PwC	Current drafting does not take mismatch amounts from prior years into account.	That the submission be declined. Officials disagree and refer the submitter to the “earlier” item in FH 12(4)(a), as well as FH 12(6) which provides .
50	FH 12(4)(c)	PwC	“Owner” is undefined.	That the submission be noted. Officials do not consider that the term needs to be defined however.
51	FH 12(4)(d)	PwC	Definition of “unrecognised” is difficult to understand, unclear and vague.	That the submission be noted. Some amendments are proposed to this term, and

#	Section	Submitter	Submission	Recommended response
				officials undertake to clarify the intended application in guidance.
52	FH 12(8)	PwC	Current wording overcomplicated and could be simplified by replacing “a tax loss of the payee could be carried forward from the initial year to the carry year in the absence of offsets” with a subsection that outlines the continuity requirement.	That the submission be declined, but that an explicit reference is made to subpart IC of the Income Tax Act 2007 to clarify the provision.
53	FH 12(5) and (8)	Russell McVeagh, PwC	These provisions should refer to “the person” rather than “the payee”	That the submission be accepted.
54	FH 13	PwC	To provide clarity, section should stipulate that the election is available for “financial instruments”.	That the submission be declined. The dividend election rule in proposed FH 13 is only intended to be available for financial <i>arrangements</i> .
55	FH 13(2)	PwC	Clarification required that the share deemed to be issued is a non-participating redeemable share.	That the submission be accepted, but the clarification should go in paragraph 4(b). This will ensure that the NRPS treatment applies if the loan is repaid.
56	FH 13(5)	PwC	Situation where election ceases to be able to be made is not well expressed – currently it is only if a deduction would be allowed for a payment of interest.	That the submission be accepted. The dividend election only applies if the payment is non-deductible due to section FH 3. Subsection (5) should apply if section FH 3 ceases to.
57	FH 14(1)	PwC	Drafting presumes only one NZ person with an ownership interest in the entity. Clarification required whether each person with an interest must elect.	That the submission be declined. Officials consider that all owners must be

#	Section	Submitter	Submission	Recommended response
				members of a wholly owned group, but that only one needs to make the election.
58	FH 15	CTG	<i>Act together</i> definition – reference to a person or entity. Submitter suggests an entity and a person are the same thing for tax purposes and refers to the Interpretation Act 1999. If they are different does “entity” need to be defined.	That the submission be accepted. The reference should be to a person.
59	FH 15	CTG	The <i>act together</i> definition should only apply to arrangements involving non-residents.	That the submission be declined. Officials consider that for the purpose of the proposed rules these tests are about establishing the extent of common ownership. The residence of the owners is irrelevant.
60	FH 15	CTG	In relation to paragraph (b) of the <i>act together</i> definition, it is unclear what it means for a holder to typically act in a way preferred by another holder. What if the coincidence of actions is purely by chance, or a result of common sense, e.g. the business has made a profit so the shareholders agree to pay a dividend?	That the submission be accepted. The definition should be limited to where a holder typically acts in a way preferred by another holder because it is preferred by the other holder.
61	FH 15	CTG	Paragraph (c) of the <i>act together</i> definition could apply very widely, e.g. to any company with a shareholder agreement detailing what to do in the event of a shareholder dying or wanting to exit.	That the submission be accepted. Officials consider that there should be some safe harbours, so clauses in an agreement dealing solely with sale do not result in the parties acting together.
62	FH 15	CTG	Paragraph (d) of the <i>act together</i> definition and subsection (2) are closely related but far away from each other in the drafting. They should be combined in this definition.	That the submission be accepted.
63	FH 15	PwC	<i>Mismatch amount</i> definition is overly complex and multiple	That the submission be

#	Section	Submitter	Submission	Recommended response
			interpretations can be produced.	declined. The mismatch amount concept is intended to be flexible, and its intended application will be further clarified in guidance.
64	FH 15	PwC	Surplus assessable income should instead be termed dual inclusion income.	That the issue be considered at the revised track version of the Bill stage.
65	YA 1	PwC	<i>Deductible foreign equity distribution</i> definition should not be amended as proposed. If a deduction is disallowed in the other country, NZ should not tax.	That the submission be declined. The OECD Final Report gives priority to the country receiving a deductible dividend. So New Zealand should tax if it is the receiving country, and the paying country's hybrid mismatch rule should not apply to deny a deduction.

Recommendation

That the officials' recommendations, as shown above, be accepted.

HYBRID FINANCIAL INSTRUMENT RULE

Clause 30

Issue: Franking credits and partial deduction denial

Submissions

(ASB, New Zealand Bankers' Association, Russell McVeagh)

The hybrid financial instrument rule should be clarified so that the amount of deduction denied is certain in cases where the payee country is Australia, franking credits are granted and the ultimate recipient is subject to residual tax after franking credits are used. The submitters suggest that some part of the deduction in New Zealand should remain available.

Comment

The intended effect of the provision in question is that the deduction is denied in its entirety. The attachment of franking credits to the payment is enough to achieve this outcome, because it means that none of the payment is taxed as ordinary income. Officials consider that the drafting could be made clearer on this point.

Recommendation

That the submission be declined, with a clarification in the drafting to better achieve the intent of the provision in question.

Issue: Scope of rule

Submissions

(Chartered Accountants Australia and New Zealand, EY)

The scope of the rule should be clarified as the current drafting leaves open the possibility of application to situations that are not intended by the policy.

The drafting of the rule should exclude mismatches that only arise due to foreign exchange fluctuations. *(Chartered Accountants Australia and New Zealand)*

Source and rate mismatches may be unintentionally caught by the current drafting. *(EY)*

Comment

The submissions support the intention of the Bill, but say it has not been achieved or is not sufficiently clear. Officials agree that the rule in question should be clarified to exclude mismatches that are only caused by foreign exchange fluctuations. In addition, guidance will be published to clarify the intended scope of the rule.

Recommendation

That the submission be accepted in relation to foreign exchange fluctuations being explicitly excluded from the scope of the rule.

Issue: Full grandparenting

Submission

(Chartered Accountants Australia and New Zealand)

All financial instruments in place at the time of introduction of the Bill should be exempt (grandparented) from the proposed rules.

Comment

The Bill currently grandparents hybrid regulatory capital that was in place before 6 September 2016 when the *Addressing hybrid mismatch arrangements* discussion document was released. This grandparenting recognised that regulatory capital issued by financial institutions conforms with statutory requirements and that it is more difficult to unwind in comparison to related party financial arrangements due to the large number of third party retail investors that are party to the arrangement. Officials do not consider that grandparenting treatment should be provided to any other financial instruments in respect of the hybrid mismatch rules. This is the approach recommended by the OECD and that other countries are taking.

Recommendation

That the submission be declined.

Issue: Payment tax status in payee country

Submission

(Chartered Accountants Australia and New Zealand)

When determining whether a deduction should be denied in New Zealand for a payment made under a hybrid financial instrument, the issue should be the expected tax treatment in the payee country, not the actual tax treatment as the current drafting does.

Comment

In relation to assessing whether an amount is taxable in the payee country (proposed FH 3(2)(a)), using the expected tax treatment of the payment in the payee country to determine whether or not the hybrid rules apply to deny a deduction to the payer ultimately seems unattractive. For example, it means that if it is expected that the payee would treat the payment as a payment on a debt instrument, but for some reason does not do so, the hybrid rules would not apply. In cases where the characteristics of an instrument are such that Inland Revenue has a good basis for believing that it would be treated as equity by the tax law of the payee country, the taxpayer should be able to prove that in fact the payment is taxable as ordinary income.

Using an “expected” test also seems to introduce an undesirable level of uncertainty and subjectivity to the issue.

However, officials consider that in relation to the counterfactual part of the hybrid financial instrument rule (proposed FH 3(2)(b)), the test should to a greater degree ask what the expected treatment would be for a taxpayer of ordinary status if the treatment of the relevant instrument is varied. The drafting of the rule should be amended to clarify this.

Recommendation

That the submission be generally declined, but that the drafting be clarified as per officials’ comments.

Issue: Scope of ordinary income counterfactual test

Submission

(Chartered Accountants Australia and New Zealand)

Remove the words “received under a financial instrument” from proposed section FH 3(2)(b) in order to narrow the scope of that provision.

Comment

Officials consider that the words can be removed, because the financial instrument reference is nonetheless part of the rule through the ordinary income provision in proposed section FH 3(9). Officials consider that the reference to financial instrument is appropriate.

Recommendation

That the submission be accepted, although officials do not consider that the suggested amendment will narrow the scope of the provision.

Issue: Level of association required for rule to take effect

Submission

(KPMG)

The hybrid financial instrument rule should rely on the ‘control group’ test that is used by other hybrid mismatch rules instead of the ‘related’ test which has a lower threshold of association.

Comment

The current proposal in the Bill is the OECD-recommended approach as to the threshold of association for the hybrid financial instrument rule and it provides a balance between effective targeting of transactions and reducing the risk of overreach.

Using the OECD-recommended approach also has the benefit of consistency with other countries that use the same or similar thresholds of association for their hybrid financial instrument rule.

Recommendation

That the submission be declined.

Issue: Need for defensive rule

Submission

(KPMG)

The defensive part of the hybrid financial instrument rule is unnecessary, given New Zealand law taxes dividends which are deductible in another country and has comprehensive financial arrangement rules. It should be removed, or its need should be clarified.

Comment

Officials acknowledge that the defensive rule in proposed section FH 4 will only apply in limited circumstances. However, officials are aware of possible fact scenarios where it will be needed. An example is where a non-resident borrower is entitled to deduct immediately an interest prepayment, which would be spread over time under the New Zealand financial arrangement rules. Section FH 4 would be required to tax this income on receipt in New Zealand so that there is no timing mismatch.

The rule also forms part of a coherent package of OECD-recommended hybrid mismatch rules and so the defensive rule's inclusion in the proposals will be consistent with other countries.

Recommendation

That the rule remain in the Bill and that officials undertake to clarify its possible application as part of guidance.

Issue: Regulatory capital for insurers

Submission

(IAG)

One submitter specifically supported the grandparenting approach taken by the Government in relation to regulatory capital of insurers. However, that submitter noted that the drafting of the Bill's grandparented treatment for regulatory capital instruments should be widened so that issuers who are licensed insurers or associated with a licensed insurer are able to access the exemption.

Comment

It is the policy intent that hybrid regulatory capital issued by banks and insurance companies in accordance with their regulatory requirements can be grandfathered from the application of the hybrid financial instrument rule. Extending the rule to issuers associated with a licensed insurer is consistent with that policy.

Recommendation

That the submission be accepted.

Issue: Taxation in jurisdiction other than payee jurisdiction

Submission

(Russell McVeagh)

The hybrid financial instrument rule needs clarification to ensure that it only applies where the relevant payment is not taxed in any payee jurisdiction.

Comment

Officials agree that if a payment is included in ordinary income in any jurisdiction, it should not give rise to a hybrid mismatch under the rule.

Recommendation

That the submission be accepted.

Issue: Definition of ordinary income

Submission

(PwC)

The ordinary income definition is too wide. It could include capital gains tax in some countries but not others. It could also include income taxed at source in New Zealand.

Comment

The definition of ordinary income is only relevant to financial arrangement mismatches. In order to be ordinary income, income must be taxed at a person's full marginal rate, without exemption, exclusion, credit or tax relief other than for foreign withholding tax. It does not matter whether the tax imposed is described as capital gains tax or income tax. It also seems to make sense that if a payment on a financial instrument which is deductible to a New Zealand borrower and exempt to the lender in its home country due to the treatment of the instrument is nevertheless subject to New Zealand net income tax, the payer (borrower) should not be denied a deduction under the proposed rules

Recommendation

That the submission be declined.

Issue: Effect of delayed recognition

Submission

(Russell McVeagh)

The calculation of the amount denied under the hybrid financial instrument rule for character and timing mismatches should be redrafted so that it does not deny a deduction for mismatches that have delayed recognition tolerated by the rule (under proposed section FH 3(6)).

Comment

Officials agree that the status quo is not appropriate in cases where a hybrid financial instrument mismatch has both character (through partial taxation) and timing elements (although officials do not consider these cases to be common). To remedy this, the formula in proposed FH 3(4) and (5) should be amended so that it incorporates the level of delayed recognition contemplated by proposed section FH 3(6).

Recommendation

That the submission be accepted.

DISREGARDED HYBRID PAYMENTS RULE AND DEEMED BRANCH PAYMENTS

Clause 30

Issue: Third party expense margin

Submission

(KPMG)

The disregarded hybrid payments rule should apply in the same way that the deemed branch payments rule works in relation to branch charges. That is, the rule should only apply to the extent the disregarded payment exceeds third party expenses.

Comment

The disregarded hybrid payments rule and the deemed branch payments rule are separate rules that are located in the same provisions in the Bill due to their structural similarity. The rules do not have to be consistent in relation to this issue. The Bill as drafted reflects the OECD approach for the two rules. In relation to branch charges, section FH 5 applies to the margin over third party expenses, and section FH 9 applies to the third party expenses themselves. In relation to disregarded payments, section FH 5 applies to the whole amount of the payment.

Recommendation

That the submission be declined.

Issue: Payments taxed in New Zealand

Submission

(Russell McVeagh)

Payments that are subject to tax in New Zealand should be excluded from the scope of the rule.

Comment

There is no potential for hybrid mismatch abuse if a disregarded payment is subject to tax in New Zealand. The Bill should be amended so as to exclude such a payment from counteraction under the disregarded hybrid payments rule.

Recommendation

That the submission be accepted.

Issue: No definition of a branch

Submission

(PwC)

The term “branch” should be defined. In particular, it needs to be clear whether or not this term includes a deemed permanent establishment (PE) under the proposed PE avoidance rule.

Comment

Officials agree with this submission. The definition of a branch should be appropriate to the purpose of this rule in preventing a deduction in New Zealand for an amount which is disregarded in another country due to that other country’s rules for determining the allocation of profit to the branch. Accordingly, the definition should pick up any activity of a non-resident as a result of which the non-resident is entitled to a deduction in New Zealand in calculating its income subject to New Zealand income tax.

Recommendation

That the submission be accepted, and the legislation amended to achieve the outcome referred to above.

REVERSE HYBRID RULE AND BRANCH PAYEE MISMATCH RULE

Clause 30

Issue: Foreign trusts

Submission

(Chartered Accountants Australia and New Zealand, PwC)

The Bill should specifically exclude foreign trusts established in New Zealand from the scope of the ‘reverse hybrid entity’ definition. *(Chartered Accountants Australia and New Zealand)*

The Government should clarify whether the foreign trust (and limited partnership) proposals are to proceed. *(PwC)*

Comment

Officials consider that a New Zealand foreign trust is a reverse hybrid entity. This Bill does not contain hybrid mismatch proposals relating to *New Zealand* reverse hybrid entities. The reverse hybrid rule in this Bill deals with mismatches caused by a New Zealand-sourced payment to a foreign reverse hybrid entity.

Recommendation

That the submission be declined.

DEDUCTIBLE HYBRID AND BRANCH PAYMENTS RULE

Clause 30

Issue: Active income exemption for branches

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

An active income exemption for branches should be considered or introduced, on either a mandatory or elective basis. This would reduce much of the complexity associated with applying the hybrid rules to branches, which are a common feature of SME business structures.

The Government is to be commended for ensuring that simple offshore structures are not subject to the hybrid rules. However, in any case where the hybrid rules mean a foreign loss is not able to be deducted against New Zealand income, then the foreign income should also be exempt if it is active (*Chartered Accountants Australia and New Zealand*)

The proposed rules will capture any New Zealand company with a foreign branch and a subsidiary in the same country.

This submission was made in connection with proposed section FH 6 as well as proposed section FH 8. In relation to the former provision, a submitter gave the example of a New Zealand company with a foreign branch where the foreign branch sells goods manufactured in New Zealand. The goods are sold for some amount (call it \$400), and the foreign country allows the branch a deduction of \$250. This represents an allocation of third party costs incurred by the branch and New Zealand operations in manufacturing and transporting the goods of \$150, and a mark up for profit in New Zealand of \$100. This \$100 might be assessable in New Zealand under proposed section FH 6. (*Chartered Accountants Australia and New Zealand*)

Comment

An active business exemption was ruled out during the policy development process due to it being outside the scope of the proposed reforms. Officials also consider that an active income exemption for branches carries increased risks of branch mismatches.

Officials note the support for the Bill's narrowing of the OECD proposal. That is, that the double deduction primary rule in proposed section FH 8 does not apply to losses of foreign branches which are not able, in the foreign country, to use their losses against any income which is or may be earned by an entity which exists and which New Zealand does not tax. Officials believe this narrowing will ensure that the vast majority of SME foreign branches will not be affected by that provision.

Officials do not agree that proposed section FH 8 will deny a New Zealand company the ability to use a foreign branch loss against its New Zealand income if the company has a subsidiary in the same country. It is only when the branch loss is able to be used against the subsidiary's income that the loss will be subject to that section. Officials understand that in Australia, branch losses cannot be offset against corporate income so section FH 8 would not apply in that case.

The example given by Chartered Accountants Australia and New Zealand and set out above in relation to section FH 6 (which taxes income from disregarded payments and branch mismatches) in fact supports the continued taxation of foreign branch profits. So long as New Zealand taxes those profits, the full \$400 earned by the foreign branch from the sale of the goods is taxable. The \$100 mark up would only be potentially taxable as a branch mismatch if New Zealand:

- exempted foreign branch profits, so did not tax the \$400 of foreign sales;
- recognised as income attributable to New Zealand less than the \$100 mark up allocated to it by the branch country.

Recommendation

That the submission be declined.

Issue: Actual offset before deduction denial

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

The rule that denies deductions to New Zealand entities with foreign branches or New Zealand owners of foreign hybrid entities should be restricted to cases where an actual offset of a foreign loss against foreign income not taxed in New Zealand has occurred.

Comment

The rule in question works by denying a New Zealand tax deduction only if the relevant country allows losses of the hybrid entity/branch to be offset against income of a person whose income is not taxed in New Zealand. The advantage of this rule is that it provides a clear exclusion from the rule for simple offshore structures, such as a New Zealand company with (only) a foreign branch in a country. If this exception was wider and relied on actual offset of losses, it would become much more complicated for taxpayers to self-assess and for Inland Revenue to administer the rule.

Recommendation

That the submission be declined.

Issue: US dual consolidated loss rules

Submission

(KPMG)

The rules should be amended such that the US dual consolidated loss (DCL) rules are explicitly said to be hybrid mismatch legislation equivalent to the New Zealand primary deductible hybrid payments rule. These US DCL rules were enacted before the OECD's work on hybrid mismatch arrangements.

Comment

Officials agree that the US DCL rules are broadly equivalent to the Bill's proposed deductible hybrid payments rule, and that where they apply, the defensive rule in proposed section FH 9 should not apply. However, officials disagree that legislation is needed to specify this equivalence (other than amendment to the definition of hybrid mismatch legislation as referred to earlier). Instead, guidance will be published explaining that foreign tax rules that deny dual use of a loss (such as the US DCL rules) but which predate the OECD recommendations on hybrid mismatch arrangements do correspond to the New Zealand deductible hybrid payments rule. However, this position may be limited by the particular way in which those foreign tax rules apply. For instance, if a US taxpayer subject to the DCL rule were to make a "domestic use election", (as referred to in the KPMG submission) the defensive deductible hybrid payments rule would apply in New Zealand.

Recommendation

That the submission for legislative change be declined, but that officials undertake to produce guidance that generally supports the submitter's position.

DUAL RESIDENT PAYER RULE

Clause 30

Issue: Rule should not be enacted

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

New Zealand's hybrid and branch mismatch rules do not need the dual resident payer rule. Dual residence is often accidental, can be difficult to avoid, and is partly due to New Zealand's wide definition of company residence.

Comment

New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group. However, the dual resident payer rule is needed as existing law does not prevent a dual resident company offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership. Importantly, any deductions denied by the rule are able to be carried forward against surplus assessable income in current or future years.

Recommendation

That the submission be declined.

Issue: Priority of rules

Submission

(Chartered Accountants Australia and New Zealand)

If the dual resident payer rule is to proceed, it should include a priority similar to other hybrid and branch mismatch rules so that two countries do not counteract the same dual resident mismatch. Without this priority in the rule, double taxation could result.

Comment

The OECD-recommended dual resident payer rule does not assign priority in counteracting the mismatch to a particular country affected by the mismatch. This is because there is no logical way to assign priority where both countries have the same outlook regarding the mismatch; that a company is resident under domestic law and it is also resident under the laws of another country. Pre-hybrids laws denying loss grouping to dual resident companies already achieve this outcome in many cases.

Officials do not want New Zealand's hybrid and branch mismatch rules to depart from the OECD recommended approach to the dual resident payer rule and consider that the risk of double taxation is minimal.

Recommendation

That the submission be declined.

Issue: Stranded losses

Submission

(KPMG)

The hybrid and branch mismatch rules should provide for stranded losses in a dual resident company context. The OECD recommends that double deductions should be allowed to the extent that they are not able to be set off against income in the relevant foreign country.

Comment

Officials agree with the submitter regarding the OECD recommendation. On the other hand, there is currently no stranded loss exception in relation to the existing rule against grouping dual resident company losses. It would seem odd to have such a rule in relation to proposed section FH 10 and not also in relation to the more generally applicable rule in existing section IC 7(2).

Recommendation

That the submission be declined until such time as it can be considered along with an amendment to the existing rule regarding dual resident company losses.

IMPORTED MISMATCH RULE

Clause 30

Issue: Incorporation of OECD guidance into domestic law

Submissions

(Chartered Accountants Australia and New Zealand, PwC)

The imported mismatch rule should not incorporate the OECD recommendations on hybrid mismatch arrangements into New Zealand law.

The recommendations are insufficiently clear and detailed, nor are they easily understood. *(Chartered Accountants Australia and New Zealand)*

It is not appropriate to refer to an external document in legislation when this is to be relied on for more than guidance. *(PwC)*

Comment

Officials agree that determining the amount of a payment that should be denied under the non-structured imported mismatch rule is complicated. However, this rule is only likely to apply to highly sophisticated corporate groups. By the time the rule applies, if it does apply there will also be other countries applying their versions of the rule.

Officials believe there is a much better chance of a sensible allocation if New Zealand adopts a broad and flexible approach that refers to the OECD report. This approach can be adjusted to fit the circumstances of any particular case and is preferable to drafting what is likely to be a complex and lengthy rule to govern a handful of cases, which is more likely to result in unfair results.

Recommendation

That the submission be declined.

Issue: Opposition to imported mismatch rule

Submission

(KPMG)

New Zealand should not enact the imported mismatch rule. Its introduction will increase complexity, compliance costs and uncertainty for taxpayers.

Alternatively, the rule should be limited to structured arrangements and should only apply from January 2020.

Comment

The structured and unstructured imported mismatch rules are important to the integrity of the hybrid and branch mismatch rules. Without the structured rule, multinational companies have the ability to structure a mismatch between countries without hybrid mismatch and branch rules and import the mismatch into New Zealand through inbound investment. The unstructured rule seems to have a more general purpose, which is to use the hybrid rules to eliminate the benefit of tax arbitrages between countries without the rules, even where those arbitrages are not intended to produce tax benefits in countries that do have the rules.

Once EU countries begin enacting hybrid and branch mismatch rules, the imported mismatch rule will be prevalent worldwide and most multinational groups will have to deal with the implications of the rule regardless of whether New Zealand has an imported mismatch rule or not. This is why the legislation proposed to delay implementation of the unstructured imported mismatch rule until 1 January 2020, when the EU countries are also required by the EU to have unstructured imported mismatch rules in place.

Recommendation

That the submission be declined.

Issue: Timing mismatches

Submission

(KPMG, PwC)

The imported mismatch rule should not include timing or temporary mismatches. The mismatch can be reversed over time, and it would be difficult to measure the magnitude of an imported timing mismatch. *(KPMG)*

Dual inclusion income has not been taken into account for the imported mismatch rule. *(PwC)*

Comment

Officials agree that the imported mismatch rule currently contains no provision for reversing a deduction denial. This is consistent with the OECD Final Report. Determining and allocating a reversal could be complex. However, officials also note that the timing mismatch rule in this respect is less prescriptive than it is in relation to proposed sections FH 3 and FH 4. That is because proposed section FH 11 counteracts hybrid mismatches as defined in section FH 15, rather than as defined in the other operative provisions of the subpart. Under the definition in proposed section FH 15, there is only a timing mismatch if an amount is not recognised as ordinary income within a reasonable period of time. What is a reasonable period of time can be interpreted broadly, having regard to the lack of any reversal provision.

Recommendation

That the submission be declined.

Issue: Guidance on imported mismatch rule

Submission

(KPMG)

Guidance needs to be published by Inland Revenue to help taxpayers correctly discharge their obligations in relation to the imported mismatch rule.

Comment

Officials acknowledge that the imported mismatch rule is complex, and will endeavour to provide enough guidance to assist taxpayers to comply with the rules, particularly in relation to the level of enquiry that should be made by a New Zealand taxpayer to its foreign payees to ensure taxpayers have met their reasonable care obligations when filing tax returns.

Recommendation

That the submission be accepted.

Issue: Redraft of imported mismatch rule

Submission

(PwC)

It would be difficult for a taxpayer to reach a position on whether the rule applies or not. The rule needs to be redrafted.

Comment

Officials acknowledge that the imported mismatch rule is complicated, but consider that the drafting accurately reflects the policy intent of the rule. Guidance will help taxpayers take positions on the rule with certainty.

Recommendation

That the submission be declined.

SURPLUS ASSESSABLE INCOME

Clause 30

Issue: Application to each mismatch situation

Submission

(Chartered Accountants Australia and New Zealand)

The surplus assessable income rules should be clarified so that they apply separately to each mismatch situation. Examples should be included in the legislation to aid understanding.

Comment

Officials consider that the current drafting is clear in that the surplus assessable income calculation applies to each mismatch situation. Officials do not consider that examples should be part of the legislation itself, but undertake to produce more examples in published guidance to assist taxpayers in complying with the rules.

Recommendation

That the submission be declined.

Issue: Definition of surplus assessable income needs to be revisited

Submission

(PwC)

The surplus assessable income definition is confused and overcomplicated and needs to be revisited. The label of the concept is not helpful either.

Comment

Officials accept that the surplus assessable income definition is complex. The role of the definition is to allow a person who is prima facie denied a deduction for expenditure in New Zealand on the basis that the same expenditure is also deductible in another country, to take that deduction. The basis for this allowance is that the person also has income that has been taxed in two countries.

The OECD Final Report recommends that countries adopt administrative practices to make it as simple as possible for taxpayers to identify double deductions. After extensive consultation, New Zealand has decided not to try to apply these rules by looking at the actual amounts of deductions and income claimed in each country. Such an approach would be very complex. It would also be somewhat arbitrary, in terms of foreign currency differences, timing differences, and differences in the definition of income. Accordingly the approach taken in the Bill is to start with New Zealand taxable income, and then to make certain adjustments. While defining these adjustments is inevitably somewhat complex, and amendments may be required at some time, officials consider this is the only workable approach.

The label “surplus assessable income” is intended to more accurately identify the approach described above than the label “dual inclusion income” would do. However, officials accept that it may be confusing on a first encounter.

Recommendation

That the submission be declined, and that the drafter consider the label issue.

Issue: Continuity

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

The surplus assessable income rules should not be subject to the 49% of ownership continuity rules that apply to tax losses.

A mismatch amount is not a tax loss, it is a tax deduction that has been deferred pending possible surplus assessable income in the future. *(KPMG)*

Comment

It is established New Zealand tax policy that tax losses are subject to continuity rules that prevent loss companies from being traded. Mismatch amounts that are denied a deduction under a hybrid mismatch rule are conceptually similar to tax losses, and officials therefore consider that the continuity requirement in the Bill is appropriate and will assist with the integrity of the rules. Without them, it would be possible for a company to incur an expense, and for that expense to be deducted in a subsequent year when the company is owned by shareholders who did not bear that expense.

Recommendation

That the submission be declined.

Issue: Offset of carried forward mismatch amounts

Submission

(PwC)

It is difficult to see how the definition allows denied deductions carried forward from a prior year to be offset against surplus assessable income.

Comment

Section FH 12(6) allows mismatch amounts to be carried forward. These amounts then form part of the total of the mismatch amount for the succeeding year, which can be set off under section FH 12(2) against surplus assessable income. Officials believe this is clear.

Recommendation

That the submission be declined.

Issue: Unrecognised amounts

Submission

(Russell McVeagh)

The formula for surplus assessable income should be amended so that it:

- includes a new positive item for unrecognised deductions, being those deductions not recognised in the relevant counterparty jurisdiction due to the tax status of the payer; and
- clarifies that unrecognised income includes income not subject to tax due to the tax status of the payer.

Comment

Officials consider that the suggested amendments will more closely align the surplus assessable income provisions with their intended effect.

Recommendation

That the submission be accepted.

Issue: Grouping of surplus assessable income amounts

Submission

(Russell McVeagh)

It is submitted that mismatch amounts of one taxpayer should be able to be offset against or grouped with the surplus assessable income of a taxpayer that is in the same group (if those entities are able to group losses). This is consistent with the policy intent of the rules.

Comment

While the suggestion may increase the complexity of the surplus assessable income calculation to some extent, officials on balance agree with the submitter that the wrong economic outcome is reached without the grouping mechanic that is suggested. However, grouping should not allow companies to offset mismatch amounts with surplus assessable income if that would not have occurred were the companies a single company.

Recommendation

That the submission be accepted, subject to the above comments.

Issue: Broader stranded losses provision

Submission

(Russell McVeagh)

It is submitted that the stranded losses provision in proposed section FH 12(9) should apply to the defensive deductible hybrid payments rule found in proposed section FH 9 in addition to its current application to the primary deductible hybrid payments rule found in proposed section FH 8.

Comment

Officials consider that stranded losses are unlikely to apply in situations where New Zealand is the country of the hybrid entity or branch (proposed Section FH 9). It would also be difficult to verify the use of losses in a foreign country in order to appropriately apply the rule the submitter has asked for.

Recommendation

That the submission be declined.

Issue: Foreign tax credits and surplus assessable income

Submission

(Russell McVeagh)

The definition of surplus assessable income should not include protected amounts, those being amounts for which a New Zealand foreign tax credit is granted.

In addition, surplus assessable income carried forward should not be limited by the foreign tax credits granted by another country in relation to the mismatch situation. There is no explanation for this limitation in the Commentary on the Bill.

Comment

Officials consider that mismatch amounts should not be able to be offset against surplus assessable income to the extent that income is not subject to double taxation because a foreign tax credit is available for that income.

The inclusion of protected amounts in proposed FH 12(4)(e) is necessary to ensure that mismatch amounts are not allowed a deduction due to income which is not actually taxed twice due to New Zealand's foreign tax credit rules.

The limit on carrying forward surplus assessable income is necessary to ensure that net New Zealand income from a mismatch situation cannot be offset against future mismatch amounts if foreign tax credits are granted by a foreign country in relation to that net New Zealand income. Officials do acknowledge there is insufficient explanation as to this rule in the Commentary on the Bill and undertake to provide guidance as to this rule.

Recommendation

That the submission be declined.

Issue: Additional limit on ability to carry forward mismatch amounts

Submission

(Matter raised by officials)

In relation to the transitional period submission above, officials have realised that an additional limit is needed on the ability of a taxpayer to carry forward mismatch amounts. A limit should be applied in situations where defensive entity based rules (proposed sections FH 6 and 9) have been applied in New Zealand and the other relevant country introduces hybrid mismatch legislation equivalent to New Zealand's primary rules (proposed sections FH 5 and 8). This will ensure that if surplus assessable income (dual inclusion income) arises in a later year, it will not result in allowed deductions in both countries.

Recommendation

That the submission be accepted.

ELECTION RULES

Clause 30

Issue: Support for rules

Submissions

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, KPMG)

Submitters supported the Government's inclusion of a dividend election rule and an opaque election rule in its hybrid and branch mismatch rules.

The dividend election rule will relieve double taxation arising from the application of the hybrid financial instrument rule and any possible interaction with existing non-resident withholding tax rules. *(Chartered Accountants Australia and New Zealand, KPMG)*

The opaque election rule will reduce compliance costs and add simplicity to the rules. *(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand)*

Comment

Officials proposed the dividend election rule after consultation with industry groups on the issues of potential double taxation arising from the hybrid financial instrument rule and existing non-resident withholding tax rules. These would arise when a non-deductible interest payment is subject to NRWT.

Similarly, the opaque election rule provides an option for a taxpayer with a double deduction hybrid structure to forfeit its tax advantage but keep funding and arrangements relating to the structure in place. This will help with taxpayers' compliance costs and some of the complexity of the deductible hybrid payments rule can be avoided by taxpayers who choose to make an opaque election.

Recommendation

That the submissions be noted.

Issue: Broadening the opaque election to non-wholly owned entities

Submissions

(Chartered Accountants Australia and New Zealand, KPMG, PwC)

The opaque election rule should be broadened such that the foreign hybrid entity for which an opaque election would be made does not have to be wholly owned by a New Zealand resident or the New Zealand resident's wholly owned group.

Comment

Officials are concerned that a broadening of the opaque election rule in the way suggested could increase the complexity of the rule. For instance, a potentially arbitrary threshold of ownership of the foreign hybrid entity would have to be considered sufficient to make the election. Further, this opaque treatment would apply to all owners of the foreign hybrid entity and this would have to be communicated in a way that is certain. From an administrative perspective, it is better that the rule is limited to cases where there is clear and complete control over the foreign hybrid entity.

Recommendation

That the submission be declined.

Issue: Opaque election for new entities

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

Currently the opaque election is only available in respect of wholly owned foreign hybrid entities that are owned by the relevant New Zealand taxpayer at the time of the Bill's introduction. It is submitted that the opaque election rule should be available for New Zealand taxpayers that acquire interests in a foreign hybrid entity at a later point in time.

Comment

The purpose of the opaque election is not to make a significant change to the definition of a company in New Zealand tax law. That would require significant policy and administrative resource. For example, Inland Revenue would need to be satisfied that once a person chose to treat a foreign entity as a company for New Zealand tax purposes, that choice continued to be made by all future New Zealand owners of that entity or that if it did not, there was a deemed liquidation of the deemed company. Taxpayers might also want the ability to revoke the election, which would create the need for further legislation and procedures.

The purpose of the election is to ameliorate the complexity of applying the hybrid rules for taxpayers who committed themselves to structures before those rules came into existence. Accordingly, the rule is narrow and targeted.

Recommendation

That the submission be declined.

Issue: Further consideration needed on election regimes

Submission

(PwC)

There is potential for a dividend election under proposed section FH 13 to result in a negative available subscribed capital impact.

Deemed disposal for an opaque election under proposed section FH 14 could have adverse impacts, including base price adjustments.

Comment

Officials do not believe the dividend election can result in a negative available subscribed capital (ASC) impact, though it may result in income or expenditure under the base price adjustment, and in an NRWT obligation. When the election is made, the loan is deemed to be repaid for the amount owing. Any unpaid interest will be deemed to be paid, which will give rise to an NRWT liability for the debtor. There may also be expenditure or income to the debtor under the base price adjustment. Generally the base price adjustment will not apply to the lender, since that person is non-resident. The reinvestment of that amount (net of NRWT) will give rise to additional ASC. When the election ceases to apply, the amount owing at that time will be treated as a return of capital. This should eliminate the ASC arising when the election was made. There is unlikely to be any net ASC impact.

In relation to deemed disposals under the opaque election, it is intended that any disposals of appreciated revenue account assets or financial arrangements will give rise to tax obligations. If they did not, these gains, which currently are in the New Zealand tax base, would never be taxed. At the same time, deemed disposals of depreciated revenue account assets or financial arrangements will give rise to a tax loss.

Recommendation

That the submission be declined.

Issue: Opaque election should not be permanently binding

Submission

(PwC)

The election to treat a foreign hybrid entity as a company under proposed section FH 14 should not be permanently binding on that entity due to future uncertainties if the entity is sold.

Comment

The opaque election rule must be simple for taxpayers and Inland Revenue so that it may be effective in reducing compliance and administrative costs. Officials do not consider that the opaque election should be undone and redone as a foreign hybrid entity is sold and on sold as this will reduce the simplicity of the rule.

Recommendation

That the submission be declined.

INTERACTION WITH OTHER TAX REGIMES

Clauses 41, 19(1)–(3), and 26, 12–16

Issue: Removal of NRWT liability when deduction denied permanently

Submissions

(Chartered Accountants Australia and New Zealand, EY, PwC)

The Bill should be amended to ensure that there is no non-resident withholding tax (NRWT) liability when a deduction is permanently denied under the hybrid and branch mismatch rules. This is inequitable, and will push up the cost of capital if there is a gross up clause in the agreement.

It should be clarified in commentary or guidance as to whether a denied deduction is removed or included in the denominator for the equation that calculates a person's non-resident financial arrangement income. *(Chartered Accountants Australia and New Zealand)*

Comment

Officials do not agree that denial of a deduction under the hybrid rules for a payment of interest should mean that the payment is not subject to NRWT. There is no general principle in the NRWT rules that interest is only subject to NRWT if it is deductible. The election to treat a hybrid financial instrument as a share allows the NRWT to be eliminated, so long as the payment is treated as a dividend. Simply eliminating the NRWT would allow a non-resident to extract unimputable profits and capital gains from a New Zealand company with no tax cost, which would not be appropriate.

Regarding the cost of capital argument, it seems unlikely that such a minor issue will have any effect on the general cost of capital in New Zealand. Furthermore, it may well be the case that the NRWT is eligible for a foreign tax credit.

Officials agree that the commentary on the Bill contains an error. The last sentence on page 99 should say "*Once the deductions are **allowed**, they are intended to be included in the denominator.*"

Recommendation

That the submission be declined and that officials will clarify the intention of the rule in guidance.

Issue: NRWT overreach

Submission

(PwC)

A taxpayer making a dividend election may have NRWT liability as the loan will be treated as repaid. There may also be a dividend if the dividend election ceases to apply, and the shares are

treated as cancelled and replaced by a loan. These are both cases of over-taxation, and amendments should be made to remove the NRWT.

Comment

Officials agree that there may be an NRWT liability if there is accrued interest outstanding on a hybrid instrument when a dividend election is made. This is entirely appropriate. It is the same outcome as if the hybrid instrument were fully repaid and the funds used to subscribe for shares.

Officials do not agree that there will be a dividend if the dividend election ceases to apply. That is because the hybrid instrument is deemed to be a non-participating redeemable share (NPRS) (proposed section FH 13(5)(a). Redemption of a NPRS will not give rise to a dividend except if it is in substitution for a dividend.

Recommendation

That the submission be declined.

Issue: Support for consequential thin capitalisation changes

Submission

(Chartered Accountants Australia and New Zealand)

The submitter supports the thin capitalisation changes consequential to the hybrid mismatch rules. These changes ensure that interest for which a deduction is denied does not result in income and corresponding debt is not treated as debt under the thin capitalisation rules.

Recommendation

That the submission be noted.

Issue: Banking thin capitalisation rules

Submissions

(ASB, New Zealand Bankers' Association)

The Bill's amendments to ensure that the hybrid and branch mismatch rules do not inappropriately interact with thin capitalisation calculations should be widened to apply to bank thin capitalisation rules also. Interest for which no deduction is available should be removed from the scope of interest expenditure under the bank thin capitalisation rules, and corresponding debt arrangements should be treated as equity under those rules.

Comment

Officials agree that if a member of a banking group issues capital that qualifies as regulatory capital, or which is part of a chain of transactions giving rise to regulatory capital, and a deduction is denied for the interest on that regulatory capital under the hybrid rules, the

regulatory capital should be treated as shareholders' equity for purposes of the banking thin capitalisation rules.

Similarly, the hybrid instrument and the interest in respect of it should be excluded from the calculation of additional income under the thin capitalisation rules, in cases where the rules do deem additional income to arise. This treatment reflects the fact that for banking regulatory purposes, the instrument is prima facie treated in the same way as shareholder's funds. It is only the interest deduction that takes it outside that treatment. If the interest deduction is no longer available, the regulatory capital should revert to treatment as shareholders' equity.

Recommendation

That the submission be accepted.

Issue: FIF rule changes

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

The foreign investment fund (FIF) rule amendments proposed in the Bill as consequential to the hybrid and branch mismatch rules are unnecessary and should be removed. These amendments may affect small investors who will be unable to request the information they need to use the comparative value (CV) method to calculate FIF income.

Comment

Officials consider that the amendments are targeted and appropriate.

- The amendment proposed to section EX 46(10)(db) applies only if the investor and the FIF are related or the FIF is structured to provide a hybrid tax benefit. A similar rule, denying a FIF investor the ability to use the FDR method, already applies to FIF interests which are economically similar to debt investments.
- Proposed section EX 47B, and the amendments to sections EX 52 and EX 53, apply only to persons who are parties to a returning share transfer, and so will only apply to large sophisticated investors. Officials consulted on this change and no issues were raised, largely because these changes apply only to related party or structured arrangements.

Recommendation

That the submission be declined.

Issue: Share lending provision difficult to understand

Submission

(Bryce Jensen)

The submitter encountered difficulty in understanding the provision and expressed that the effect should be a level playing field.

Comment

Officials acknowledge that some of the provisions in the Bill are complex and may be difficult to understand. Officials note that the rules apply unevenly as the hybrid mismatch rule will apply only where the parties are related or are party to a structured arrangement. Guidance will be produced to aid taxpayers in their understanding and compliance.

Recommendation

That the submission be noted.

OTHER DEFINITIONS

Clause 30

Issue: Structured arrangement facts and circumstances and exclusion

Submissions

(Chartered Accountants Australia and New Zealand, KPMG)

The definition of a structured arrangement should be consistent with the OECD report recommendations 10.2 and 10.3 which state respectively that the definition:

- should list facts and circumstances to be considered in determining whether an arrangement is structured or unstructured, and
- should exclude taxpayers from the structured arrangement if they (and any person in their control group) could not reasonably expect to have been aware of the mismatch and did not share in the tax benefit.

Comment

The definition of a structured arrangement in the Final Report does refer to an arrangement where the facts and circumstances indicate that it has been designed to produce a hybrid mismatch, and then goes on to provide an inclusive list of relevant facts and circumstances. The Australian exposure draft definition also refers to facts and circumstances, though it does not go on to provide a list. The UK definition (see e.g. section 259CA(7)) refers to an arrangement if it is reasonable to suppose that it has been designed to secure a hybrid mismatch, or the terms share the economic benefit of a mismatch between the parties or otherwise reflect the fact that the mismatch is intended to arise. It also mentions that a financial arrangement may be designed to secure a hybrid mismatch despite also being designed to secure another objective.

Officials agree that it would be useful for the legislation to include a reference to “facts and circumstances”. The precedent of the Australian and UK legislation suggests it may be preferable to have a list of relevant facts and circumstances included in guidance rather than legislation.

Officials also agree that a taxpayer should not be considered party to a structured arrangement if neither they nor a person in their control group is aware of the hybrid mismatch and did not share in the tax benefit of the arrangement.

Recommendation

That the submission be accepted.

Issue: Definition of a control group

Submission

(PwC)

The control group definition is too wide, particular in light of the inclusion of the “acting together concept”. “Acting together” could be read to catch shareholder agreements, or unitholder subscription agreements

Comment

An “acting together test” is recommended by the OECD (Final Report recommendation 11.3) and has been adopted by the UK (section 259NC(6) –(8). The “acting together” definition in section FH 15(1), along with the exception in subsection (2), reflects both of these precedents. The definition is intended to cover the situations referred to in the PwC submission as an over-reach. Where a group of minority shareholders acting together control a company, it is reasonable to apply the hybrid rules to a hybrid transaction between the company and one of those shareholders.

Officials do note that because the acting together test is limited to paragraphs (g) and (h) of the control group definition, it may not apply as widely as it should.

A shareholder agreement which has the result that the shareholders act together to control the company should mean that the shareholders and the company are in a control group. If the shareholders agreement is more limited, for example it only deals with sales of shares, then there is no control element to the agreement and the shareholders and the company will not be in a control group. A unitholder subscription agreement is analogous to a shareholder agreement.

Recommendation

That the submission be declined. Officials also recommend that the acting together test be incorporated into paragraph (c) of the control group definition.

Issue: Trumping existing legislation

Submission

(PwC)

The submitter has asked for confirmation that the hybrid mismatch rules will not trump specific legislation. Specifically, the following two examples are raised:

- the choices made by a person under the foreign superannuation rules in section CF 3 of the Income Tax Act 2007 should not be considered a structured arrangement and subject to the proposed rules; and
- clarification is needed as to whether the proposed rules are intended to apply to transitional residents.

Comment

The hybrid and branch mismatch rules have the effect of trumping various parts of specific existing legislation. This is because the vast majority of existing tax legislation does not consider the tax treatment of an arrangement in a relevant foreign country. For instance, New Zealand's existing financial arrangement rules routinely allow deductions for expenditure across the life of a financial instrument rather than when payments on the instrument are made and when they are taxed in the payee jurisdiction. However, under the rules proposed in the Bill in some circumstances those deductions will be denied.

However, the hybrid rules do not apply in every case of deduction/no inclusion. Taking the transitional residence exemption as an example, this rule is only likely to be relevant in relation to the defensive rules in section FH 4 and FH 6. However, these rules will not trump the transitional rule, because the reason for the transitional residence exemption has nothing to do with the status of the relevant financial instrument (section FH 4) or the New Zealand tax treatment of the paying entity (section FH 6). No further legislative clarification is necessary or desirable. Officials will consider providing specific guidance on the issue if it is appropriate to do so.

Recommendation

That the submission be declined.

NRWT ON HYBRID ARRANGEMENTS – TREATY ISSUE

Clauses 4 and 42

Issue: Amendment should not override New Zealand's DTAs

Submissions

(Chartered Accountants Australia and New Zealand, Corporate Taxpayer Group)

The amendment ensures that NRWT or AIL applies in all instances where a deduction is allowed in New Zealand for an interest expense, notwithstanding any DTA.

Currently, when a New Zealand branch or PE of a non-resident company borrows money from another non-resident in the same jurisdiction as the PE's corporate residence, and the borrowing takes place under a hybrid instrument (ie. the instrument is treated as debt in New Zealand but shares in the foreign jurisdiction) there is some doubt as to whether NRWT can be withheld. The particular legal issue is whether the payments on the hybrid instruments should be classified from the source state's perspective (in which case they would be interest, and so NRWT could be withheld) or the residence state's perspective (in which case they would be dividends, and so interest could not be withheld). The proposed amendments clarify this issue, by providing that NRWT can be withheld notwithstanding any DTA. Accordingly the amendment overrides New Zealand's DTAs.

The proposed amendment unilaterally changes the effect of New Zealand's DTAs. An indirect amendment to override DTAs is unacceptable. If the proposed change is a clarification then this should be clearly stated in our treaty negotiation papers and supported by our DTA partners. Any change should be a negotiated amendment with our DTA partners. Unilateral action undermines our international reputation and could have significant ramifications for future treaty negotiations and international agreements more generally.

Comment

Overriding a DTA is very undesirable and something Officials do not take lightly. However we consider it is justified in this case. As the problem arises under a DTA, a DTA override is necessary for the amendment to be effective. Further, there is general consensus that DTAs should be applied from the source country's perspective. Accordingly, it is unlikely that the proposed rule would draw any opposition from our DTA partners – as it merely clarifies the current treaty interpretation approach.

We also note that Australia already has a domestic rule providing for the same result. In particular Australia's rule also overrides its DTAs. However this rule has not attracted any adverse comment from other countries (including New Zealand).

Further it is clear that NRWT or AIL was intended to be payable on cross border interest payments. This was also Inland Revenue's interpretation of the law until now, which was followed by many taxpayers. The ability to avoid NRWT or AIL through the use of a hybrid instrument is a clear loophole in the current rules, and taxpayers aware of the issue would have perceived it as such.

Recommendation

That the submission be declined.

Issue: Lack of certainty and consolation

Submission

(Corporate Taxpayer Group)

The Disclosure statement to the change states that the proposed rule “should not conflict with New Zealand’s DTAs”. It is inadequate to be giving only tentative “should” views on the implication for tax treaties, and in particular to not even consult with MFAT about some of the rule changes (which have been proposed since September 2016). New Zealand Officials having informal discussions with Officials in another country on the potential acceptability of a tax law overriding a double tax agreement does not create certainty for affected taxpayer

Comment

Officials disagree that “Should” is tentative view. Instead, it represents a high degree of confidence, but one falling short of 100% certainty.

The particular issue at which the change is directed arose very late in the policy process and unfortunately there was insufficient time to consult with MFAT.

It is the DTA override which provides certainty for affected taxpayers about the proposed change. In the absence of the DTA override, the effectiveness of the legislation would be uncertain.

Recommendation

That the submission be declined.

Issue: Clarify drafting of RF 11C(2)

Submission

(Matter raised by Officials)

The operative part of proposed section RF 11C(2) provides that “the NRWT rules apply to the amount as being interest, despite any provision in a double tax agreement that would otherwise require the NRWT rules to apply to the amount as being a dividend”.

Some Inland Revenue officials in the technical interpretation area have suggested that the NRWT rules have always applied to the amount as if it was interest and the DTA does not actually affect this. Instead the DTA arguably just prevents NRWT from being withheld from the amount on the basis that the DTA separately treats the amount as being a dividend.

To clarify this, officials recommend that proposed section RF 11C(2) be amended to provide something like “the amount is treated as interest for the purpose of the NRWT rules and any

double tax agreement, despite any provision in a double tax agreement that would require the amount to be treated as a dividend”.

Recommendation

That the submission be accepted.

Issue: Hybrids treaty issue and tax havens

Submission

(Bryce Jensen)

The submitter objects to the use of offshore tax havens to pay a fair share of tax in relation to clause 42 of the Bill.

Recommendation

That the submission be noted.

Other policy matters

INLAND REVENUE'S ADMINISTRATIVE POWERS TO INVESTIGATE LARGE MULTINATIONALS

Overview

It can be difficult and resource intensive for Inland Revenue to investigate multinationals with complex tax structures. Inland Revenue is at a significant evidential disadvantage, as the multinational possesses the information required to prove Inland Revenue's case. Further, some of the information may be held by the non-resident offshore, making it difficult or impossible for Inland Revenue to obtain it. This can allow a multinational to stymie an Inland Revenue investigation through non-cooperation, particularly through withholding the information required by Inland Revenue to perform the investigation.

Inland Revenue has strong existing powers for requesting information under section 17 of the Tax Administration Act 1994. These powers require New Zealand taxpayers to provide any requested information or documents that are in their knowledge, possession or control (including in an offshore company that a New Zealand taxpayer controls). However in many cases, the relevant information needed to investigate a multinational's New Zealand tax position may be held by an entity such as in an offshore holding company or head office. As a consequence, it can be more difficult for Inland Revenue to investigate multinationals compared to other taxpayers. The Bill therefore proposes extending the scope of these existing powers so they allow Inland Revenue to request information that is held by any member of a large multinational group.

The Bill also provides the ability for Inland Revenue to apply various sanctions on large multinational groups which do not co-operate with requests for information. These include criminal and civil penalties (a fine of up to \$100,000). They make it easier for Inland Revenue to assess the multinational's tax position based on the limited information that is available to the investigators and to prevent the multinational from subsequently using information that was requested but not provided to Inland Revenue as evidence to support its case in a subsequent court proceeding.

The Bill also allows Inland Revenue to make a wholly-owned New Zealand subsidiary of a large multinational group liable to pay any unpaid taxes owed by other members of the multinational group.

Submitters were strongly opposed to all of these proposals to extend Inland Revenue's administrative powers for investigating large multinationals. They considered that it would be difficult in practice to require the New Zealand operations of a large multinational to obtain information from non-resident group members. They suggested that Inland Revenue should instead use its multilateral agreements whereby it can seek help from foreign tax authorities to obtain the information or collect tax from the non-resident businesses. Submitters also considered it would not be fair to impose penalties or require the New Zealand operation to pay tax due to the actions of a non-resident group member.

Submitters sought limitations and procedural safeguards such as court orders to constrain Inland Revenue and ensure the powers were applied in a reasonable manner.

Clause 50

Issue: Inland Revenue's ability to request information held by offshore group members

Submissions

(ASB, BNZ, Chapman Tripp Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh, Westpac, Chartered Accountants Australia and New Zealand, KPMG)

Inland Revenue already has the power to request assistance from other jurisdictions in respect of the collection of taxpayer information in a cross-border context. *(ASB, BNZ, Chapman Tripp Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh, Westpac)*

The proposal is a significant overreach and should not proceed. Offshore jurisdictions often have privacy and secrecy rules which prevent disclosure of certain information (including, for example, information held about bank customers in the relevant jurisdiction). New Zealand, itself, has such privacy law requirements. The proposals risk placing the large multinational group in the untenable position of either breaching such offshore jurisdiction privacy or secrecy laws or breaching proposed section 17(1CB). *(ASB, BNZ, Chapman Tripp, New Zealand Bankers' Association, Westpac)*

The amendments may be impossible to comply with and are not necessary given existing powers. *(Corporate Taxpayers Group)*

A similar proposal has been rejected previously at the Select Committee stage in 2002. *(Corporate Taxpayers Group)*

There appears to be no international precedent to support the scope of the amendments in proposed section 17(1CB). *(Russell McVeagh)*

Comment

To combat BEPS, Inland Revenue needs to be able to properly investigate and challenge the tax positions taken by multinationals. One of the main practical difficulties that Inland Revenue has encountered in conducting these investigations is a lack of willingness by some multinationals to provide information.

When investigating BEPS, the multinational has a significant information advantage over tax authorities as it possesses the information that is required to determine whether its own tax position is correct, or if a higher amount of tax should have been paid under the relevant international tax rules.

The required information is often held by an offshore group member of the multinational, rather than in a New Zealand company or office. This includes legal contracts, transfer pricing documentation and evidence about commercial and economic activities carried on by offshore entities. For example, it is common for multinationals to prepare and retain transfer pricing documentation within a specialist transfer pricing unit in their head office.

Inland Revenue does not consider it is reasonable to allow multinational corporations to locate information that is relevant to investigating their New Zealand tax position in a jurisdiction where it is legally (e.g. because of a tax haven having secrecy laws) or practically difficult for Inland Revenue to access that information. We note that this ability is not available to

businesses that are based in New Zealand. Such businesses are required to keep their tax records in New Zealand (section 20 of the Tax Administration Act 1994) and must provide to Inland Revenue any requested information that is in their knowledge, possession or control (section 17), including when the information is in offshore branches or subsidiaries that they control (section 17(1C)).

Why can't New Zealand just use its tax treaties?

New Zealand has a network of tax treaties which allow Inland Revenue to ask for assistance from the relevant foreign tax authority to obtain the information or collect tax from the non-resident businesses. However, just because New Zealand has an ability to request assistance from a foreign tax authority under a tax agreement, it does not mean that the request will be agreed to, or actioned effectively by the foreign tax authority.

In practice, relying on tax treaties to request information from other tax authorities is not always adequate. Some countries do not have very effective tax laws or tax administration. In other cases, the foreign tax authority may be slow or reluctant to respond to reasonable requests for information. And the practical reality is that, in order to action the request from Inland Revenue requires the foreign tax authority to divert some of its own resources away from administering its own tax system. Helping New Zealand to collect tax will be a lower priority than collecting tax for its own government.

For these reasons we consider it is still necessary to provide Inland Revenue with a direct ability under New Zealand's Tax Administration Act, to request information or documents that are held by, or accessible to, a group member that is located outside New Zealand.

How should we limit potential conflicts with foreign secrecy and privacy laws

Submissions have argued that in some cases, if the multinational supplied the requested information to Inland Revenue, they could be in breach of a secrecy or privacy law of a foreign country.

Most countries are repealing their secrecy laws in order to meet new standards for exchange of information established by the Global Forum on Tax Administration over the last ten years. In any case, most secrecy laws are related to bank information so there would be few examples of secrecy laws that would prevent a multinational from supplying their own information to one of their New Zealand members, who could then provide the information to Inland Revenue. In rare cases there may be an unavoidable conflict with a foreign secrecy law. For example, a tax haven could have a secrecy law that makes it illegal to provide certain information to a foreign government.

In response to submitters concerns about foreign privacy laws, officials recommend an amendment to limit the provision in the Bill so it requires the requested information to relate to an investigation of the multinational groups' tax position (rather than relating to an investigation of a natural person, such as a bank customer, who is not part of the multinational group). For multinational tax investigations the relevant information sought will be about companies rather than natural persons – so the proposed change should greatly reduce the risk of breaching foreign privacy laws. It will often be possible for a multinational to redact privacy-related information and still comply with the request.

Finally the risk of breaching a foreign privacy or secrecy law already exists when the relevant information about a foreign company or natural person is held in New Zealand (such as a New

Zealand office or data centre). This is because such information can be requested by Inland Revenue under the existing section 17 power.

For example, existing section 17(1C) of the Income Tax Act 2007 states that “*a law of a foreign country that relates to secrecy must be ignored*” when the information is held by a non-resident that is controlled by a New Zealand resident. Similarly, section 17A states that a person cannot be excused from complying with a court order to provide information simply because providing the information would “*subject the taxpayer to a fine, penalty or conviction.*” In this regard, the proposed provision simply extends these existing issues to large, foreign-controlled multinationals.

Practicality

Inland Revenue considers that the proposed rules will be practical for multinationals to comply with. The new power only applies to large multinational groups. Inland Revenue understands that these groups typically have processes whereby information requests from tax authorities are escalated and approved by their head office (this can include cases where the relevant information is already held in New Zealand). The head office will have the authority to require the other group members to provide the information.

The proposal that was previously rejected by Select Committee in 2002 had a much broader scope as it applied to any person who was associated with a New Zealand resident. In contrast, the proposal in this Bill only applies to members of large multinational groups (with more than €750m of global consolidated revenues) and will be targeted at information relating to investigating the multinational’s own tax position. In addition, BEPS and the ability to large multinationals to frustrate tax investigations was less of a concern in 2002.

Recommendation

That the submissions be declined.

Clause 50

Issue: Limitations and safeguards on Inland Revenue’s ability to request information held by offshore group members

Submissions

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, KPMG)

There should be a legislative process that the Commissioner must follow before she uses this extension to her powers. *(Chartered Accountants Australia and New Zealand)*

The Commissioner should be required to have regard to other sources of information before using the proposed new power. *(Chartered Accountants Australia and New Zealand)*

There should be an ability to object to information demand notices on the basis that the information is not available or does not exist. *(KPMG)*

Inland Revenue should be required to advise the taxpayer when information is sought from another group member. *(Chartered Accountants Australia and New Zealand)*

If amendment to section 17 proceeds, Inland Revenue should require a court order to use these powers. (*Corporate Taxpayers Group*)

Additional safeguards should be put in place to prevent misuse of the new information powers such as an ability to object on the basis that the information is not available or does not exist. (*KPMG*)

The new powers should apply only to future tax years (as opposed to investigations of tax returns that were filed prior to the Bill's enactment). (*Chartered Accountants Australia and New Zealand*)

Comment

The proposed extension of Inland Revenue's existing information request powers to information held offshore by large multinational groups is needed to allow Inland Revenue to investigate multinationals that are not co-operating with a tax investigation. In this context, adding procedural limitations to the legislation will lead to these uncooperative multinationals bringing forward challenges on procedural issues to block or unduly delay the investigation.

It would also mean that these large multinational groups would have a greater ability to resist providing information to Inland Revenue, compared with other New Zealand taxpayers. This is because the proposed provision is based on the existing section 17 powers under the Tax Administration Act 1994 which applies to information held by New Zealand taxpayers and does not include such limitations.

Inland Revenue should be able to request the information without requiring prior court approval. Requiring a court order would undermine the practicality of requesting the information and would impose delays and additional court costs. The affected taxpayer can dispute Inland Revenue's decision to issue the information request notice, using the usual tax disputes process, which includes court proceedings, if they consider that the request is unlawful or is being incorrectly applied.

Officials consider the new powers are necessary, but should not be limited to investigating income tax returns filed after the date of enactment as this would make it more difficult for Inland Revenue to investigate multinationals in respect of any tax avoidance or BEPS activity they engaged in during the income years prior to the enactment of the Bill.

Recommendation

That the submissions be declined.

Clause 51

Issue: Limitations on Inland Revenue’s ability to impose the consequences in section 21BA when a multinational does not provide the requested information

Submissions

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, EY, New Zealand Law Society, PwC)

Sections 21BA(1)(b), (c) and (d) apply when the “Commissioner considers...”. These provisions should fall to the court or Authority to determine, as opposed to the Commissioner. *(EY, New Zealand Law Society)*

Given the breadth of the power, and the possible sanctions for non-compliance, any use of that power should be delegated on a very limited basis (for example, to Deputy Commissioners). *(Westpac, Chartered Accountants Australia and New Zealand)*

Any assessment based on the operation of this expanded power must be soundly based at law. The Commissioner should issue guidance as to when information will be misleading, incomplete or otherwise inadequate. *(Chartered Accountants Australia and New Zealand)*

Section 21 should be repealed and section 21BA drafted to have general application, as there are fewer safeguards under section 21. This would ensure that the process and consequences in respect of a taxpayer's non-response to (or provision of an inadequate response to) an information request are consistent. *(Corporate Taxpayers Group, PwC)*

Comment

Proposed section 21BA allows Inland Revenue to apply sanctions to large multinational groups which do not adequately co-operate with a request for information as part of a tax investigation. It does this by allowing Inland Revenue to assess the multinational’s tax position based on the limited information that is available to the investigators and by preventing the multinational from using information that was requested but not provided to Inland Revenue as evidence to support its case in a subsequent court proceeding. In order to provide a judicial check on the evidence exclusion rule, proposed section 21BA(4) of the Bill allows a court to decide that requested information can be admitted as evidence. This means that the court, rather than Inland Revenue, ultimately decides whether the evidence is excluded from the court proceedings.

The proposed provision applies to large multinational groups who do not co-operate with a tax investigation. In this context, adding procedural limitations to the legislation will lead to these uncooperative multinationals bringing forward challenges on procedural issues to block or unduly delay the investigation. Requiring a court order to apply section 21BA would undermine the practicality of applying the provision and would impose delays and additional court costs.

Officials note that the proposed section 21BA is consistent with the existing section 21 power that applies to requests for information relating to deductible payments to non-residents which can be applied by Inland Revenue without requiring prior court approval.

Inland Revenue considers that the consequences that can be imposed under the proposed provision are necessary to ensure that uncooperative multinationals do not gain an unfair advantage by refusing to provide information.

The proposed provision allows Inland Revenue to make an assessment based on the limited information it has available. Inland Revenue already has a general power to make default assessments, but officials consider it useful to clarify that an assessment can be made in this specific context. It also prevents the multinational from introducing evidence in subsequent court proceedings if Inland Revenue has specifically asked for that information as part of the earlier investigation. Officials consider that both of these consequences are reasonable as they help to partly mitigate the incentives for multinationals to refuse to co-operate with a tax investigation.

Officials agree that operational delegation of the power should be limited and that any resulting assessment should be soundly based on the law and the information that is available to the Commissioner. This will be clarified in the guidance materials on this provision.

Officials agree that it may be appropriate to expand the scope of section 21BA so that it replaces the existing section 21 which applies to deductible payments to offshore persons. However, it may be better to do this as part of a later tax bill to allow submissions to be made on the drafting for this change.

Recommendation

That the submissions be declined.

Clause 51

Issue: The scope of section 21BA should be narrowed

Submission

(New Zealand Law Society)

Proposed section 21BA(1) should be redrafted to state explicitly that it applies only to investigations relating to the transfer pricing or permanent establishment matters stipulated in paragraph (c).

The wording in section 21BA(1)(c) referring to “whether or not in the knowledge, possession, or control of the member” is problematic as even if good faith efforts to fulfil the request have been made, there could nevertheless be unfair results for the taxpayer, upon whom the onus rests in tax disputes.

Comment

Inland Revenue’s investigations of large multinationals can cover a range of issues beyond transfer pricing and permanent establishment issues so it would not make sense to limit section 21BA to just these two topics. For example, Inland Revenue may need information to support an investigation of a multinational on tax avoidance, thin capitalisation rules, hybrid rules, controlled foreign company rules or non-resident withholding tax.

The reference to “whether or not” the information is held by the group member is necessary to ensure that Inland Revenue is not prevented from making an initial assessment of the multinational’s tax position in cases where the required information or documents have been lost

or do not exist yet. For example, in a case where the multinational has been asked for transfer pricing documentation but has not prepared the documentation, Inland Revenue may need to make an assessment in the absence of this documentation. It also means that if the multinational subsequently prepares the documentation (or collects the necessary information) they can be prevented from presenting this evidence in subsequent court proceedings.

Recommendation

That the submissions be declined.

Clause 51

Issue: Evidence exclusion rule when the requested information has not been provided

Submissions

(EY, New Zealand Law Society, PwC)

The evidence exclusion rule in section 21BA(3) is too harsh. Proposed section 21BA(4)(a) should be removed entirely, or at a minimum, rewritten to have a more general focus on the reasonableness of the efforts undertaken by the taxpayer to locate and assess the relevance of the requested information. *(PwC)*

Section 21BA(4) should be amended to permit the court or Authority to directly scrutinise the Commissioner's decision under section 21BA(1). The test should be expressed in general language, such as whether it is in the interests of justice that the evidence should be admissible. *(EY, New Zealand Law Society)*

It is not clear why all of the criteria listed in subsection (4) must be satisfied in every instance before the exception can apply. Each criterion should provide a separate ground to have the information admitted. At present it does not allow for admissions following good faith attempts by the taxpayer to obtain and provide the requested information which could be in the interests of justice but may not satisfy the other requirements. *(New Zealand Law Society)*

The proceedings referred to in section 21BA(3) should relate to the same issue under which section 21BA(1) is engaged. *(EY, New Zealand Law Society)*

Comment

Officials consider it is necessary to provide criteria for the court to apply when considering whether evidence that has been excluded under section 21BA(3) should be admitted during the court proceedings. The criteria in section 21BA(4) has been designed to protect taxpayers from disproportionately burdensome information requests from Inland Revenue. It does so by allowing evidence to be readmitted when the scope of the original request would require an unreasonable amount of time and resources to obtain, relative to the significance of the potential tax at stake and admitting the evidence is necessary to avoid a manifest injustice.

Removing some of these criteria or applying them independently of each other would provide the court with too little guidance as to the circumstances as to when the evidence should not be excluded.

Replacing the proposed criteria with a more general requirement that admitting the evidence was in the interests of justice would likely lead to the evidence being admissible in nearly all cases. This would effectively eliminate the effectiveness of the proposed provision in providing an incentive for the multinational to co-operate with the information request as they already have an information advantage over Inland Revenue, and are unlikely to face any real evidence exclusion risk if the dispute goes to court.

At the time that Inland Revenue requests the information it may not yet be known what specific tax issues may be disputed in any subsequent court proceedings. In other cases, an investigation may start off focused on one issue such as the transfer pricing of a transaction but Inland Revenue may subsequently discover other issues such as tax avoidance. This makes it impractical to limit the evidence exclusion rule based on the issue that initially prompted a request to be made. Inserting such a limitation would likely lead to further disputes about whether the information should be excluded based on differing views as to the nature of the issues being investigated. It could also increase taxpayer compliance costs by encouraging Inland Revenue to make broader requests that cover a wide number of potential tax issues or multiple requests for the same information as new issues are identified.

Recommendation

That the submissions be declined.

Clause 51

Issue: Deadlines for responding to a request for information under new section 21BA

Submissions

(Corporate Taxpayers Group, KPMG)

It is unclear what period of time needs to have elapsed prior to the Commissioner issuing the first information demand notice. This point needs to be clarified in the legislation. *(KPMG)*

Inland Revenue should be able to provide taxpayers with an extension of the respective deadlines for responding to notices in section 21BA. *(Corporate Taxpayers Group)*

Comment

Under the current bill proposal, Inland Revenue can issue the first information demand notice without having to wait a specific amount of time. This is appropriate as the first notice starts the three month deadline by which the taxpayer has to respond with the requested information.

If the information was not provided or was inadequate, Inland Revenue can then issue a second notice to the taxpayer. The taxpayer then has a further one month deadline from the date of the second notice to provide a satisfactory response. After that one month deadline has expired, the taxpayer can be assessed based on the information available to Inland Revenue and any requested information that was not provided can be excluded from being used by the taxpayer as evidence to support their case in a subsequent court proceedings. In this context, officials do not consider it is necessary or efficient for the legislation to provide a specific deadline before the first notice can be issued.

The proposed section 21BA is intended to be used by Inland Revenue as a last resort to try to obtain information that has been requested from a large multinational that is refusing to co-operate with a tax investigation. In this context, officials consider that providing an ability in the legislation to extend the relevant three and one month deadlines, is likely to lead to these uncooperative taxpayers advancing arguments in a dispute as to why they should have qualified for an extension of time, and should therefore not be subject to the consequences of the provision.

Where a taxpayer begins to adequately co-operate with the investigation, Inland Revenue can return to using its ordinary investigation and disputes process, as opposed to making an assessment of tax under the proposed section 21BA(2).

Recommendation

That the submissions be declined.

Clauses 54 and 55

Issue: Criminal penalties for not providing information requested about an offshore group member

Submissions

(ASB, Corporate Taxpayers Group, EY, Russell McVeagh, New Zealand Bankers' Association, Westpac, New Zealand Law Society, Chapman Tripp, Chartered Accountants Australia and New Zealand, KPMG, Public Health Association)

Taxpayers should not be exposed to criminal penalties for the acts/omissions of another group member over whom they have no control. *(ASB, Corporate Taxpayers Group, EY, Russell McVeagh)*

It is inappropriate to impose a criminal penalty in a scenario, where the information requested places the large multinational group in a position of having to breach another jurisdiction's laws. *(New Zealand Bankers' Association, Westpac)*

There should be a defence against criminal prosecution where the taxpayer can establish that they made genuine and reasonable requests for the information from the overseas entity. *(EY)*

It should be a defence under sections 143 and 143A that the member charged with the offence did not have the knowledge that the requested information was in the knowledge, possession or control of another member of the group. *(New Zealand Law Society)*

Comment

The current Bill has two types of penalties that can be imposed on large multinational groups that do not provide information that has been requested by Inland Revenue:

- A proposed civil penalty which involves a fine of up to \$100,000; and
- The existing criminal penalties in sections 143 and 143A of the Tax Administration Act 1994 which the Bill proposes expanding to cover cases where the information is held by another group member of the large multinational group.

Officials agree that it is not appropriate to apply a criminal penalty to a New Zealand person where the failure has actually been caused by an associated offshore person. Officials therefore recommend that the criminal penalties should be removed from the Bill, subject to retaining a civil penalty.

Recommendation

That the submissions be accepted, subject to officials' comments.

Clause 53

Issue: Civil penalties for not providing information requested about an offshore group member

Submissions

(Westpac, Chapman Tripp, Chartered Accountants Australia and New Zealand, KPMG, Public Health Association)

Imposing a civil penalty liability that exceeds the available criminal sanctions is equally inappropriate – particularly if its intent is to avoid the need for Inland Revenue to bring criminal proceedings. There are no equivalent civil penalties in the Act relating to comparable failures. *(Westpac)*

If a civil penalty is to be retained, there should be defences available for where the taxpayer has taken reasonable steps to comply with the Inland Revenue's notice. *(Westpac)*

The proposed section 139AB needs to be expanded upon to include a “reasonable efforts” defence as provided under similar civil penalty provisions in sections 142I(4) and 142H(2), to recognise the potential delays or difficulties for a New Zealand company to collect information held by an overseas associated party. *(Chapman Tripp)*

The Commissioner should not have the power to levy a penalty if a taxpayer fails to provide information that does not exist. *(Chartered Accountants Australia and New Zealand)*

The penalties should apply in exceptional circumstances. *(KPMG)*

Penalties for failure to provide requested information should be imposed for each day on which failure occurs, rather than to a maximum of \$100,000 *(Public Health Association)*

Comment

It is necessary to retain a civil penalty as otherwise there would be little incentive for a multinational to comply with an information request. Although Inland Revenue is able to apply shortfall penalties to tax that is owed, these shortfall penalties rely on Inland Revenue having sufficient information on which to make an assessment – in most cases it will need to source this information from the multinational.

Inland Revenue will only seek to apply the civil penalty in cases where a large multinational group is not making a reasonable effort to co-operate with a tax investigation. Inland Revenue

will have discretion as to whether to apply this penalty and the amount of the penalty (up to \$100,000). This discretion is intended to encourage multinationals to take steps to try to comply with the request or explain to Inland Revenue why the relevant information does not exist or cannot be accessed.

Because there is already flexibility for Inland Revenue to vary the amount of the penalty, officials do not consider it necessary to automatically increase the penalty based on each day that the information has not yet been provided. However, the proposed civil penalty in section 139AB does not currently have a due date. Officials recommend a due date be added to the Bill and that this be at least 30 days after the taxpayer has been notified they are liable to pay the penalty.

Officials consider that including an explicit “reasonable efforts” defence in the legislation could lead to additional disputes around what is considered “reasonable” as this concept is subjective and the threshold will vary based on the overall circumstances of the case (such as the amount of tax at stake, the difficulty in obtaining the information and what other information may have been provided).

Recommendation

That the submissions be declined.

Clause 53

Issue: Civil penalty should be imposed by a Court, rather than Inland Revenue

Submission

(Ministry of Justice)

As part of their role in advising on penalties in new legislation, the Ministry of Justice provided the following submission to Inland Revenue officials.

The Ministry of Justice’s view is that the civil penalty proposed in the Bill would be more appropriately established as a pecuniary penalty that can be imposed by a court. The reasons for this are:

- A judicial and independent decision-maker is more appropriately placed than the Commissioner (being the party affected by the failure) to fairly assess whether a penalty is appropriate in the circumstances and what quantum of penalty reflects the gravity of the multinationals’ failure to comply with the Commissioner’s request
- A penalty imposed as a result of civil proceedings would increase the legitimacy of the outcome (by ensuring procedural rights are observed) and reduce the potential for claims of abuse of process (e.g. the potential for the Commissioner to directly penalise failures in respect of repeated requests for information the multinational is unable to provide).
- Far greater penalties can potentially be available to the courts under a pecuniary penalties provision than could be imposed directly by the Commissioner. This would increase the likelihood of meaningfully deterring multinationals from obstructing the Commissioner.

Comment

Inland Revenue considered this option but ultimately recommends that the Commissioner of Inland Revenue be able to impose a civil penalty on multinationals that do not provide the requested information, without requiring court approval. This would be consistent with all of the existing civil penalties under the Tax Administration Act 1994, which are imposed by the Commissioner but can be disputed by the taxpayer.

The penalty applies to multinationals that are not co-operating with a tax investigation. Requiring a court to impose the penalty would undermine the practicality of applying the penalty. This would reduce the effectiveness of the penalty in providing an incentive for multinationals to co-operate and provide the information that Inland Revenue needs to investigate their tax position.

In the absence of this contextual information about the income tax dispute, it will be very difficult for a court to determine if the penalty is appropriate and what quantum of penalty should be applied. For this reason Inland Revenue considers the current position is much more practical as it allows a court to consider the appropriateness of the proposed civil penalty (along with any other tax penalties) at the end of the disputes process, as part of the same court proceedings as the substantive income tax dispute.

A requirement to take court proceedings at the beginning of the investigation in order to apply a civil penalty would be contrary to an overall aim of the tax disputes process which is to try to efficiently resolve disputes without needing to go to court.

It would also prolong the dispute. In particular, uncooperative taxpayers would bring forward further challenges on procedural issues. This would make it necessary to “stop the clock” on the time bar to ensure that uncooperative multinationals could not use the court proceedings to reduce the number of years which could be adjusted by Inland Revenue.

Recommendation

That the submission be declined.

Clause 38

Issue: Collecting any unpaid tax owed by large multinational group from a New Zealand member of that group

Submissions

(ASB, Bryce Jensen, Corporate Taxpayers Group, Russell McVeagh, New Zealand Bankers' Association, Chartered Accountants Australia and New Zealand)

Proposed section HD 30 is an unjustified override of fundamental corporate law principles and should not proceed. The Group is unaware of (and Inland Revenue has not provided any evidence of) any difficulty in collecting tax owing from a multinational group. Further, Inland Revenue already has the power to request assistance from other jurisdictions in respect of the collection of tax in a cross-border context. *(Corporate Taxpayers Group)*

There appears to be no international precedent for a revenue authority having the power to enforce the tax obligations of one company against another group company (*Russell McVeagh*)

The proposed new power is also unnecessary. For example, the Convention on Mutual Administrative Assistance in Tax Matters to which 116 countries are signatories (including New Zealand and all its major trading and investment partners), provides mechanisms for revenue authorities to cooperate in the collection of tax. (*Russell McVeagh*)

The proposal is an inappropriate lifting of the corporate veil and for which there is little evidence provided in the Commentary to the Bill, or elsewhere, that a significant problem with collecting unpaid New Zealand tax liabilities of large multinationals exists. Such a proposal could, potentially, impose substantial obligations on a New Zealand entity resulting in a significant adverse financial impact for that entity. Proposed section HD 30, has the potential to make New Zealand entities a guarantor of overseas group entities. This would place banks at risk of not satisfying prudential regulations. (*ASB, New Zealand Bankers' Association*)

The proposed rule should not be used in situations where it would put the locally owned group member into financial jeopardy. Normal Inland Revenue debt collection processes should be followed in application of this proposed rule. (*Chartered Accountants Australia and New Zealand*)

If the principal member of the group fails to comply with their tax obligations due to some unexpected circumstances, a grace period could be provided. (*Bryce Jensen*)

Comment

Because many non-resident companies have no direct presence in New Zealand it can be difficult for Inland Revenue to recover tax debts from multinationals. Officials therefore consider the proposed provision is necessary to recover from a New Zealand group member, an amount of tax that is owed, but has not been paid by a non-resident member of the same multinational group. It is reasonable to apply the rule where the non-resident and the New Zealand subsidiary are part of the same wholly-owned group, as they are part of a single economic entity.

Officials note that the UK's diverted profits tax can be collected from any group member that is related (51 per cent or more commonly owned) to the company that owes the diverted profits tax.

Accordingly officials recommend that the proposed rule be retained. However, the rule should only apply if the non-resident fails to pay the tax itself (see recommendations to the following submission). This should mitigate some of the submitters' other concerns about risk assessment and guarantor issues.

The proposed provision will only apply when Inland Revenue notifies the representative group member. This provides flexibility for Inland Revenue to not apply the provision in situations where it would put the locally owned group member into financial jeopardy or to provide a grace period, if necessary.

Recommendation

That the submissions be declined.

Clause 38

Issue: Scope of proposed section HD 30 should be clarified

Submissions

(ASB, Corporate Taxpayers Group, New Zealand Banker's Association, PwC, EY, New Zealand Law Society)

"Tax obligations" is too broad and uncertain; the scope should instead be confined to enforcement of an unsatisfied tax liability of a group member. *(ASB, Corporate Taxpayers Group, New Zealand Banker's Association)*

Section HD 30 should be redrafted so it explicitly limits the Commissioner's power to appointing New Zealand resident group members as agents for the tax owing by another group member (as opposed to non-resident group members). *(PwC)*

Amendments should be made to the Tax Administration Act to ensure that the recipient of the section HD 30 notice has dispute rights. *(EY, New Zealand Law Society)*

If proposed section HD 30 does proceed, its scope should be more focussed and procedural protections included. Its scope should be limited to satisfying a tax liability of a non-resident Entity, which cannot be enforced, that is part of the same wholly-owned large multinational group. A court order should be required as a prerequisite to imposing on one company responsibility for another company's tax liabilities. *(Corporate Taxpayers Group)*

Comment

Officials agree that several drafting changes should be made to narrow the scope of the provision:

- The reference to "tax obligations" is too broad and should be limited to unpaid taxes
- Unpaid taxes should only be collected from a New Zealand resident group members and non-resident group members who have a permanent establishment in New Zealand

The proposed provision is designed to apply in situations where a large multinational group has either refused to pay tax which is owed to Inland Revenue or has liquidated or migrated the relevant company in order to prevent the tax from being collected. In this context, requiring Inland Revenue to secure a court order to collect the tax from another company which is part of the same wholly-owned group could encourage further disputes about whether the proposed collection provision can be applied.

For these reasons, officials do not recommend requiring Inland Revenue to obtain a court order to issue the notice in the first place. However, officials agree that a consequential amendment should be made to the Tax Administration Act 1994 to ensure that that the recipient of the section HD 30 notice can dispute that decision (including in a court).

Recommendation

That the submissions be accepted, subject to officials' comments.

LIFE REINSURANCE

Clause 9

Issue: Unilateral change to DTAs

Submission

(Chartered Accountants Australia and New Zealand, EY, Financial Services Council, KPMG, Teresa Farac)

The proposed amendments should not proceed as they unilaterally affect the operation of, and possible outcome under, some of New Zealand's DTAs.

The changes could result in other countries retaliating by imposing additional overseas tax on New Zealand based businesses (*Chartered Accountants Australia and New Zealand*); give rise to operational difficulties for New Zealand life insurers (*Financial Services Council*); and give rise to double taxation with no ability to rely on the relevant DTAs (*Financial Services Council*).

One submitter was concerned that the proposed amendments involve a domestic law override of a negotiated agreement (*Chartered Accountants Australia and New Zealand*).

The life reinsurance source rules should instead be changed by way of renegotiating the relevant DTAs.

Comment

Officials consider it unlikely that other countries will retaliate by imposing additional tax on New Zealand based businesses as a result of the amendments. The amendments merely ensure that section DR 3 of the Income Tax Act 2007 applies to reinsurance arrangements with Canada, Russia, Japan, and Singapore as intended to deny a deduction where a reinsurance premium is not taxable in New Zealand.

Officials also consider that the proposed drafting change to new section DR 3(2) (see below) will ensure that New Zealand life insurers are not faced with any operational difficulties. As a result of this drafting change, proposed section DR 3(2) will only require New Zealand life insurers to know the non-resident reinsurer's country of residence and whether the non-resident is from Canada, Russia, Japan, or Singapore – which should be clear from the reinsurance contract. New Zealand life insurers should therefore not be faced with any operational difficulties when applying the provision in practice.

Officials disagree with the submission that the amendments could give rise to double taxation with no DTA relief. The proposed amendments are intended to address the possible double non-taxation that could arise where life reinsurance policies are offered or entered into in New Zealand between a New Zealand resident life insurer and a reinsurer resident in Canada, Russia, Japan, or Singapore. While the reinsurance premiums paid to the non-resident reinsurer may have a New Zealand source under our domestic legislation, the application of New Zealand's DTAs with these countries denies New Zealand the right to tax those premiums unless the reinsurer is operating via a permanent establishment (which is often not the case). The proposed amendments therefore ensure that our domestic law life reinsurance rule in section DR 3 of the Income Tax Act 2007 can apply to these countries as intended.

Further, the proposed amendments do not override New Zealand's DTAs with Canada, Russia, Japan, or Singapore. The proposed amendments merely ensure that where a reinsurance premium has a New Zealand source under our domestic law, but a DTA applies to deny New Zealand the right to tax those premiums unless the reinsurer is operating through a PE, we can deny the deduction. There is nothing in these DTAs that prohibits New Zealand from denying a deduction to New Zealand residents.

As the process for renegotiating DTAs is lengthy and it would take many years before the relevant DTAs have all been bilaterally renegotiated, officials consider the Bill to be the appropriate vehicle for implementing the proposed amendments.

Recommendation

That the submission be declined.

Issue: Grandparenting

Submission

(Deloitte, EY, Financial Services Council, KPMG, Teresa Farac)

Life reinsurance agreements are typically long term and New Zealand life insurance companies will usually not be in a position to renegotiate such agreements part way through their term. There is particular concern that the cost of the proposed measures would fall unfairly on New Zealand life insurers (and potentially their policyholders if passed on through premium pricing), given their likely inability to renegotiate their reinsurance contracts. The proposed changes would therefore unfairly penalise New Zealand reinsured life insurance companies and should not proceed.

If the proposed amendments do proceed, however, they should apply only to new life reinsurance contracts entered into on or after 1 July 2018, meaning the life reinsurance contracts entered into prior to 1 July 2018 are grandparented.

Grandparenting should also apply:

- to contracts where the reinsurer, subsequent to entry into the reinsurance contracts, changes its tax status by losing its permanent establishment in New Zealand; and/or
- if a life reinsurer changes tax residence during the term of an existing reinsurance contract to Canada, Russia, Switzerland⁷, or Singapore; and/or
- to new contracts where New Zealand life insurers could not be reasonably expected to have knowledge of the tax residence of the life reinsurers.

Comment

Officials agree that a New Zealand life insurance company may not always be in a position to renegotiate a reinsurance agreement part way through its term. As life reinsurance agreements

⁷ Officials wish to note that the territories affected by the proposed amendments are Canada, Russia, Japan, and Singapore. Switzerland was erroneously listed as an affected territory in the Bill Commentary.

are usually long term (and often open-ended), however, officials do not consider grandparenting an appropriate option. Rather, officials consider the better approach is to delay the application of the proposed rule for a period of 12 months. Officials consider that 12 months is an appropriate length of time for New Zealand life insurers to renegotiate their reinsurance agreements and factor in the tax change.

Recommendation

That the submission be declined, subject to officials' comments.

Issue: Publish detailed commentary on each DTA

Submission

(KPMG)

New Zealand should publish detailed commentary on each DTA so it is transparent why particular Articles have been accepted.

Comment

Consistent with international practice, New Zealand treats its DTA negotiations as confidential. As such, it would not be appropriate for New Zealand to publish commentary on each of its DTAs. Publication of such a commentary would also require agreement from the other jurisdiction which would not always be possible. Instead, submitters should refer to the OECD's Model Tax Convention on Income and Capital and its accompanying Commentary for any detailed guidance on particular Articles, both of which are publically available.

Recommendation

That the submission be declined.

Issue: Lack of knowledge

Submissions

(Corporate Taxpayers Group, Deloitte, EY, Teresa Farac)

The proposed amendment disallows a deduction for a life insurer based on information from another taxpayer's (the reinsurer's) tax position. The proposed changes place an onerous and unfair burden on New Zealand life insurers to have completeness of information regarding a non-resident's tax position, including the place of tax residence and/or whether the non-resident reinsurer has a New Zealand permanent establishment.

Comment

Officials consider that this issue can be fixed by deleting subparagraph (a) of proposed section DR 3(2). This amendment will mean that the New Zealand life insurer will not need to have knowledge of the non-resident reinsurer's tax affairs in New Zealand. All it will need to know

is the non-resident reinsurer's country of residence and whether the non-resident is from Canada, Russia, Japan or Singapore – which should be clear from the reinsurance contract.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Drafting

Submission

(Matter raised by officials)

The current heading of section DR 3 of the Income Tax Act 2007 should be replaced to reflect the proposed amendments in the Bill. Section CW 59C should consequently be amended to cross-reference the proposed new heading of section DR 3.

Recommendation

That the submission be accepted.

Miscellaneous issues

Issue: The cumulative effect of and interaction of changes needs to be considered more

Submission

(PwC)

The cumulative effect of and practical impact that the proposed changes will have on taxpayers and existing law has not been properly thought through. More work is required from the Government to do this.

Comment

Officials consider that the cumulative effect of the proposed changes is to address the problem of BEPS. Officials at Inland Revenue and the Treasury have devoted significant time to developing the proposals and considering the likely technical and practical outcomes. More work will be done to ensure that guidance is provided so that taxpayers may understand and comply with the proposals.

Recommendation

That the submission be noted.

Issue: Proposals do not strike the right balance between compliance costs for businesses and Inland Revenue

Submission

(Corporate Taxpayers Group)

In the Group's view, many of the changes proposed are being driven from a place of reducing compliance costs for Inland Revenue and increasing compliance costs for businesses operating here, and not from a "what is best policy" point of view. Fundamental changes to New Zealand's tax system, such as those proposed in this Bill, should have a clear policy intent behind them and must be for the benefit of New Zealand as a whole.

Comment

The changes proposed in this Bill have been developed from the OECD BEPS recommendations through several rounds of consultation and tailored for the New Zealand environment. While these rules will necessarily increase compliance costs in certain circumstances the rules have been designed to minimise these to the extent possible, especially on taxpayers with less complex structures and those without arrangements entered into to achieve a tax advantage. The policy intent behind all of the proposals is to prevent multinationals benefiting from unintended competitive advantages over more compliant or domestic companies. To the extent the rules in this Bill encourage multinationals to adopt simpler structures, for example ordinary related-party debt instead of debt with equity-like features that makes it more difficult to price and be treated differently in different jurisdictions, many of the rules in this Bill will have little impact and will result in lower compliance costs.

Recommendation

That the submission be declined.

Issue: Engagement with the public before a Bill is introduced to Parliament

Submissions

(OliverShaw, Public Health Association of New Zealand)

Communication with the public on tax issues such as those at the heart of this Bill should be improved. Such communications should go beyond technical details (although of course these are vital and must be included) but also include broad contexts and policy options, neither of which are apparent in this Bill's Regulatory Impact Statements. *(Public Health Association of New Zealand)*

The Bill is complex and the process under which it has been developed is not fully consistent with the Generic Tax Policy Process. Best practice for the development of tax policy requires complex tax legislation to be developed with input from the private sector so that at FEC technical issues are largely resolved. This enables policy issues to be considered at FEC and some fine tuning of drafting. This best practice has not been followed for all of the proposals in the Bill. There has not been enough time for all of the proposals to be understood. *(OliverShaw)*

Comment

Officials consider that context and broad policy options have previously been canvassed with the public in the form of the June 2016 Treasury/Inland Revenue document *New Zealand's framework for taxing inbound investment*, as well as three Government discussion documents on the topics of the Bill (released in 2016 and 2017). Officials also consider that context and policy options for each part of the Bill were provided in the Bill's Regulatory Impact Assessments as per the Treasury's requirements.

Recommendation

That the submission be noted.

Issue: Start-ups should have a chance

Submission

(Bryce Jensen)

The tax system should allow new businesses to have a chance to grow.

Recommendation

That the submission be noted.

Issue: Paying a fair share of tax**Submission**

(Bryce Jensen)

The submitter considers that the use of tax havens and other methods to avoid servicing tax obligations is not appropriate as it means others will disproportionately bear the burden of the tax.

Comment

Officials agree with the submitter and notes that the Bill is intended to ensure that tax obligations are shared more evenly between those who are able to use BEPS strategies to reduce their tax liabilities and those who are not.

Recommendation

That the submission be noted.

Issue: Human Rights should be considered**Submission**

(Human Rights Commission)

The Committee should take account of human rights principles when considering the Bill. The measures in this Bill that address the substantial loss of corporate revenue through BEPS strategies will have a positive impact on human rights.

Comment

Officials consider that human rights principles are taken into account in all legislation passed by Parliament. Officials agree with the submitter that the measures in the Bill that will generate more revenue from multinationals carrying on BEPS activities will have a positive impact on human rights in New Zealand.

Recommendation

That the submission be noted.

Issue: The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) should be ratified**Submission**

(Human Rights Commission)

The Commission recommends that the Government ratifies the MLI.

Comment

Adopting the MLI is a core part of New Zealand's policy response to BEPS and the OECD's recommendations.

As such, officials are currently progressing through the domestic entry into force procedures required before the MLI can be ratified. It is expected that this process will be completed later this year, with the MLI having effect for New Zealand from 2019.

Recommendation

That the submission be noted.

Issue: General determination making power

Submission

(Corporate Taxpayers Group)

A regulatory/determination making power should be introduced to ensure that legislation is applied consistently with the policy intent of the rules.

Comment

The Government has recently consulted on allowing such a power to exist with respect to the provisions of the tax law more generally (see Chapter 6 of the Government Discussion Document *Making Tax Simpler: Proposals for Modernising the Tax Administration Act*). That separate consultation and decision making process, which is currently on track to produce a policy decision in the near term, is the best forum to consider this kind of issue.

Recommendation

That the submission be declined in respect of this Bill.

Issue: Tax avoidance should be fraud and criminal

Submission

(Public Health Association of New Zealand)

Tax avoidance should be recognised as fraudulent and criminal, and strategies and penalties to combat tax avoidance should be adopted from New Zealand law relating to serious fraud.

Comment

Tax avoidance (as distinct from tax evasion) is undesirable, but cannot be criminally penalised. This is because it is difficult to know exactly where legitimate tax planning behaviour ends and where inappropriate tax avoidance behaviour starts. Judging the difference is usually a matter of interpretation of the relevant law by a taxpayer and Inland Revenue.

Tax evasion however, is a crime and a fraudulent act because it has involved some deceit by the taxpayer as to their circumstances.

An objective of this Bill is to introduce new international tax rules to make it more difficult for a taxpayer to successfully avoid tax through the use of particular BEPS strategies.

Recommendation

That the submission be declined.

Issue: Need a comprehensive statutory framework for combating tax avoidance

Submission

(Public Health Association of New Zealand)

New Zealand needs a comprehensive statutory framework for combating tax avoidance.

Comment

Inland Revenue treats inappropriate tax avoidance very seriously and devotes significant time and resources towards discovery of tax avoidance and disputes. New Zealand's current statutory framework for combating income tax avoidance consists of a general anti-avoidance rule (GAAR), which has been used successfully in recent years to challenge complex tax avoidance arrangements, as well as a number of specific anti-avoidance rules interspersed throughout the Income Tax Act 2007. These rules are supplemented by Inland Revenue's existing administrative powers which assist in information gathering and disputes.

The Bill upgrades New Zealand's statutory framework for combating tax avoidance by proposing to introduce new international tax rules to make it more difficult for a taxpayer to successfully avoid tax through the use of particular BEPS strategies. In addition, the Bill proposes that some of Inland Revenue's administrative powers are upgraded so that they may better assist Inland Revenue in its dealings with taxpayers that use BEPS strategies (including foreign-owned multinational groups).

Recommendation

That the submission be declined

Issue: The provision of advertising services and platforms should be tax neutral

Submission

(New Zealand Council of Trade Unions)

CTU is concerned that tax-avoidance by internet-based corporations puts local carriers of advertising (e.g. newspapers, broadcast television and radio) at a competitive disadvantage. The advertising revenue on which the conventional media depend is already undermined by new technologies and new forms of business. It makes it even more difficult if their competition can lower their costs by avoiding paying tax.

Protecting conventional media is in the public interest. Conventional media are still the principal originators of the content on which New Zealand depends for reliable news.

CTU is disappointed that the proposals do not address the tax avoidance of multinational firms which have significant activity in New Zealand but no taxable presence. It submits that New Zealand should ensure that the provision of advertising services and platforms is tax neutral.

Comment

The Bill is not intended to target any particular firms or industries. Instead, it is designed to target specific base erosion and profit shifting activities that can give some multinationals a competitive tax advantage when compared with New Zealand businesses. Officials consider that the measures in the Bill will be sufficient to neutralise this competitive advantage.

Officials also note that the OECD is currently developing some potential measures that would address the taxation of digital services that are provided cross-border. Officials consider that any measures endorsed by the OECD in relation to this issue should be investigated.

Recommendation

That the submission be noted.

Issue: Transparency

Submission

(Oxfam, New Zealand Council of Trade Unions, Public Health Association of New Zealand)

Oxfam urges New Zealand to join the growing momentum for greater tax transparency. Tax transparency is an essential step in fighting global tax avoidance. A lack of transparency over what profits are made and what taxes are paid by MNCs in every country in which they operate makes it hard to identify abusive tax practices. *(Oxfam)*

Most countries require publicly listed companies (i.e. those listed on a stock exchange) to publish audited annual reports and accounts, although these are often on a consolidated basis for the entire group, rather than separating out individual subsidiaries. However, for private companies, there are often no public reporting requirements at all. The structure of MNCs, with a parent company and multiple subsidiaries, makes collecting and assessing all relevant information hard, especially when subsidiaries are based in tax havens that do not require the publication of financial information. *(Oxfam)*

IRD should publish regular summary info on the taxation of multinationals. *(New Zealand Council of Trade Unions)*

The public should have access to information resulting from comprehensive disclosure to tax authorities of information relating to business activities. This would involve details of names (of the entity, and principal owners and officers) and financial statements and tax rates. *(Public Health Association of New Zealand)*

Information obtained through the Automatic Exchange of Financial Account Information in Tax Matters (the Automatic Exchange of Information or “AEOI”) in accordance with common reporting standards should be made available to the public. (*Public Health Association of New Zealand*)

Public access to information on foreign trusts registered in New Zealand should be available on request. (*Public Health Association of New Zealand*)

The Committee should review the Australian Tax Transparency Code to identify proposals that could be usefully incorporated into this Bill. (*Public Health Association of New Zealand*)

Comment

Officials consider these submissions to be outside the scope of the Bill which is intended at improving the technical aspects of New Zealand’s international tax law and strengthening some of Inland Revenue’s administrative powers.

Recommendation

That the submissions be declined.

Issue: End Tax Havens: New Zealand to support Pacific Island Nations to establish alternative sources of revenue and implement BEPS

Submission

(*Oxfam*)

The New Zealand Government should support Pacific Island nations cited in the recent publication of the ‘*EU list of non-co-operative jurisdictions for tax purposes*’ to establish alternative sources of revenue and to implement BEPS measures. Oxfam also urges the Government to explore the role it can play in actively supporting the Cook Islands and Vanuatu, who have committed to implementing the BEPS minimum standards by 2018.

Comment

New Zealand does provide support through participation in forums including the Pacific Island Tax Administrators Association through attendance at its annual meetings. New Zealand hosted SGATAR in 2016 and held sessions to raise awareness on BEPS. Historically New Zealand has assisted Pacific Island countries to navigate new standards on Exchange of Information promoted by the Global Forum on Transparency and Exchange of Information. Capacity building and support is also provided for all developing countries through international organisation including the United Nations, the World Bank, the International Monetary Fund (IMF) and the OECD’s inclusive framework. A particular example is New Zealand’s support as one of five donors to the Pacific Financial Technical Assistance Centre, established by the IMF to promote macro-financial stability in Pacific Island Countries. More recently, these agencies have started to coordinate their engagement with developing countries under an umbrella group called the Platform for the Collaboration on Tax. New Zealand officials have actively worked to bring issues affecting the Pacific to the attention of these organisations. We are also providing an assessor to the Global Forum for Micronesia as we are committed to helping out in the Pacific.

Recommendation

That the submission be noted.

Issue: New Zealand to actively support the creation of a new global tax body

Submission

(Oxfam)

New Zealand should co-operate internationally and work with political leaders globally and call for a new generation of international tax reforms. This will be most easily done through a new United Nations based global tax body, such as updating the UN Tax Committee. This second-generation reform process should include all countries on an equal footing and tackle a number of key issues that have not been sufficiently addressed by the recent global tax reform led by the OECD BEPS process, including:

- corporate tax incentives and lowering of corporate rates;
- tackling corporate tax havens and harmful tax practices;
- reallocation of taxing rights between countries e.g. revising tax treaty terms, transfer pricing and permanent establishment rules; and
- preventing manipulation of internal transaction prices within MNC groups.

Comment

New Zealand already co-operates intentionally on international tax reforms, and is well represented within international tax policy organisations such as the OECD, Global Forum and United Nations.

Unlike the OECD, members of the United Nations Tax Committee (the Committee of Experts) are selected in their personal capacity, and not as government representatives. However, since 2013 New Zealand has had a member on the panel who has contributed to the specific work undertaken by the United Nations to address BEPS issues. Specifically, the Committee of Experts has been actively working towards publishing an updated *United Nations Model Double Taxation Convention between Developed and Developing Countries* which will contain measures that address BEPS that are in line with the OECD reforms, and other measures which go further or address issues specific to developing nations. It is expected that this will become publically available later in 2018.

Officials consider that these international tax policy organisations, including the UN, are performing effectively and that New Zealand's engagement on the issues discussed is strong. The submitter's request for a new organisation to replace the existing architecture is unfounded.

Recommendation

That the submission be declined.

Issue: Remove tax on wages, salary, and superannuation benefits

Submission

(Michael Robinson)

The submitter has suggested that tax should be collected from savings, such as Kiwisaver (which should be made compulsory), and assets such as investment properties. The submitter also thinks business tax compliance should be simplified and tax breaks and loopholes should be closed.

Comment

Officials consider that the submission is outside of the purpose of what the Bill is intended to achieve.

Recommendation

That the submission be declined.

Issue: No interest payments to a related party should be deductible regardless of the rate

Submission

(William Sheat)

The submitter is concerned with a particular situation where a particular company's operating surpluses are absorbed by interest paid to related party lenders overseas. They consider that the issue will not be fixed by the proposed interest limitation rules because there is no reason to believe the interest rates on the borrowing are artificially high, despite no significant income tax being paid.

It is submitted that no interest payments to a related party should be deductible, regardless of the interest rate.

Comment

Officials consider that the various measures contained in the Bill to limit interest deductions, in conjunction with existing measures, are sufficient to prevent related parties from stripping profit out of New Zealand using debt.

Officials consider that denying interest deduction on all debt between related parties would be an over-reach that unduly punishes taxpayers that are not involved in BEPS and would put New Zealand out of step with international norms.

Recommendation

That the submission be declined.

Issue: Henry George “one tax solution”

Submission

(Phil Carver)

The submitter has asked the Committee to endorse the views of Henry George as to a “one tax solution” to the business cycle and various other economic problems.

Comment

Officials consider that the submission is outside the scope of the Bill. The submission would be better targeted at the Government’s Tax Working Group who have called for submissions on the future of the New Zealand tax system.

Recommendation

That the submission be declined.

Issue: Bill will change how businesses operate in New Zealand

Submission

(Google)

The submitter expects that the Bill will change how overseas companies operate in New Zealand in respect of whether they have a permanent establishment. The Bill also sends a clear signal to the corporate community that their behaviour is expected to change.

The submitter is also planning on altering its operating model in New Zealand in a way that will result in its customers entering into contracts with the submitter’s New Zealand entity. This New Zealand entity will pay tax on the profit from these contracts in line with its role in the transaction. This new operating model will increase transparency on the revenue generated by the submitter in New Zealand.

Comment

Officials agree with the submitter that the Bill is expected to change how overseas companies operate in New Zealand. Officials acknowledge the changes the submitter has outlined to their operating model.

Recommendation

That the submission be noted.