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TaxMail

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Regular commentary from our experts on topical tax issues

Issue 2

BEPS nears the finish line

Snapshot

The Taxation (Neutralising Base Erosion and Profit Shifting) Bill (the "Bill") has been introduced. The Bill and its Commentary are available **here**.

Briefly, the Bill reduces interest rates on inbound related party loans, narrows thin capitalisation "safe harbour" protection, changes the transfer pricing rules to give Inland Revenue more time and teeth, widens the Permanent Establishment rules (including adding a new avoidance rule), and denies deductions and taxes income in relation to "hybrid" instruments and entities.

These matters have previously been consulted on and were agreed by the previous Government (see **here**). The Bill implements that policy largely unchanged.

The Bill has been referred to the Finance and Expenditure Select Committee for consideration and public submissions. While it is due to report back by 12 June 2018, the Bill's proposals generally have application for income years beginning on or after 1 July 2018.

It is very unlikely that submissions will change the BEPS policy direction. The main focus will therefore be on ensuring that the rules are clear and have as few unintended consequences as possible. The potential for double taxation is a particular concern.

The inevitable BEPS changes are close to the final stages of implementation.

However, the Bill will repay close review as the proposals go beyond the global consensus and are not as clear as would be ideal. It is likely there will be overreach and uncertainty.

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Overview

Application date – limited decision time

1 July 2018 is the key date. That will be the effective date for those with June balance dates. The new rules will then progressively apply (i.e. from 1 October 2018, 1 January 2019 and 1 April 2019 for balance dates ending on a quarter).

The Bill is due to be reported back by the Select Committee by 12 June 2018, to be enacted by 30 June. This means that very little time will be available to act on the final legislation. That brings risk for those having to make decisions in the meantime.

Technical complexity and certainty

The Bill is very technical. The proposals are not straight forward. The legislation is complex. The Bill does not always clearly do what the Commentary says it does. This should be a focus for review and submissions.

There are also some drafting errors to be corrected. Potentially, some drafting approaches could be simplified to make the legislation more workable, particularly with the hybrid rules.

Despite these, and its complexity, the Bill is of a reasonable quality and Officials are to be commended for their efforts given the short time that was available.

Global consistency

The Bill's proposals arise from the OECD's Base Erosion and Profit Shifting ("BEPS") project. A major driver of that is a global approach to resolving BEPS issues. There are some understandable departures to "New Zealand-ise" the recommendations, particularly with the hybrid proposals.

However, there are departures from the global approach (e.g. the interest rate "cap" proposal). This puts at risk the effectiveness of the measures and may create double taxation. It is not clear from the Bill or the Commentary that these problems are clearly recognised and overcome.

Some initial thoughts on the Bill measures

There are two main interest limitation proposals: "non-debt liabilities" reducing assets (for thin capitalisation "safe harbour" calculation purposes) and therefore allowable debt and an interest rate "cap" for inbound related party debt. They will require existing arrangements and funding structures to be carefully reviewed.

The Permanent Establishment ("PE") changes combine implementing the OECD's widened PE definition with an anti-avoidance rule to capture NZ sales brought about by a NZ related (or dependant third) party. The widened definition will be included in NZ's Double Tax Agreement ("DTAs") through the Multilateral Instrument ("MLI") and in domestic law for non-DTA countries. The new avoidance rule will apply if a DTA does not implement the widened PE definition and tax avoidance is more than an incidental purpose. The Bill and Commentary are unclear as to what exactly is required for the avoidance test to apply.

The transfer pricing changes largely formally align New Zealand's approach to that of the OECD in its 2017 guidance. The proposals to increase the time bar and shift the onus of proof for transfer pricing disputes proceed, notwithstanding the arguments in favour of retaining the status quo.

The hybrids proposals are the most complex and at highest risk of potential overreach. The Bill is drafted in broad language. The effects of that broad approach need to be carefully considered to ensure that the rules apply appropriately.

The rules are complex and there is limited time to understand their impact and make changes.

Some risk is inevitable while the rules are being finalised.

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Detailed analysis

For those interested in some more detailed analysis of the Bill's provisions, read on…

Interest limitation

The Bill has two main measures aimed at limiting interest deductions.

Thin capitalisation "safe harbour" protection narrowed

The current 60% debt:assets "safe harbour" thin capitalisation test will change to a debt:net assets ratio. "Non-debt liabilities" will be deducted from assets. This will, in most cases, reduce the deductible level of debt in New Zealand. Forecasts of the balance sheet should be done so that the appropriate capital structure can be determined and implemented to comply with the rules.

While most non-debt liabilities will be deducted from assets, certain deferred tax liabilities are allowed. Only deferred tax equal to the tax payable on the sale of an asset is intended to be deducted. However, as drafted, it does not appear this carve-out will ever apply. This appears to be a drafting error.

The other major modification is the application of the thin capitalisation rules to "public project" assets. The intention is to allow in full third party debt which has recourse only to the public project's revenue. The trade-off is that related party debt will not be allowed for tax purposes.

There are also changes to related party debt where there is no single non-resident controller in relation to such projects. There are transitional rules intended to spread the effect of this change on existing projects.

Interest rate "cap" under a restricted transfer pricing approach

The more controversial change will limit the interest rate that can be charged on related party debt. This has the effect of "capping" interest rates on inbound loans. The proposed rules are contrary to the global approach to setting interest rates on related party debt.

In brief:

- For insurers, banks and non-bank lenders, related party debt must be priced at the highest credit rating for secured debt for any member of their global group.
- For others, related party debt which is at high risk of being used as part of a BEPS arrangement (this is based on meeting a number of criteria) must be priced at a credit rating of one notch below the highest rated member of the group. (E.g. BBB- if the highest rating is BBB). Where the high BEPS risk criteria are not met, the standalone credit rating of the borrower, adjusted for implicit credit support, can be used for pricing purposes.
- In both cases, the effect of "non-vanilla" loan terms (e.g. subordination or conversion to equity) are to be disregarded for pricing purposes unless they are present in third party loans or are required for regulatory purposes.

These rules are not consistent with the global approach to transfer pricing advocated by the OECD. For example, the Commentary quotes an example from the OECD's transfer pricing guidelines where implicit support is assumed. In that example, the borrower's credit rating is not equal to the highest rating of the group. The borrower's stand-alone rating is used. The proposed rule goes well beyond that guidance. Further, the proposed approach will not apply to outbound related party debt.

This inconsistency means there is room for dispute and double taxation. Our preliminary analysis shows that overseas Revenue Authorities will expect a higher

Capital and funding structures need to be reviewed and changed to deal with the interest limitation proposals.

However, submissions do provide some opportunity to ensure their impact is appropriate.

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interest rate than would be allowed under the "cap". Despite the view of Officials in the **Regulatory Impact Statement** to the Bill, we expect that more challenges will be made under the Competent Authority dispute resolution rules so that taxpayers do not suffer double taxation.

This is neither a fairer nor more certain approach and will lead to increased disputes, in our view.

Permanent Establishment

The BEPS focus on Permanent Establishments ("PE") has shown that there are gaps in New Zealand's domestic rules. They currently focus on "fixed establishments" (a narrower concept than a PE) and business or contracts being carried out or entered into in New Zealand. The Bill introduces a more comprehensive regime for establishing whether there is a PE and corresponding source rules to allow NZ to tax the income.

New PE definitions

For residents of a Double Tax Agreement ("DTA") country, the PE definition is that of the relevant DTA. This will be widened if the PE Multilateral Instrument ("MLI") Articles apply. Specifically, Article 12 expands the PE definition so that the activities of a related (or dependant third) party that help bring about sales in New Zealand would create a PE. Where Article 12 of the MLI does not apply and there is "tax avoidance", amongst other requirements, a PE avoidance rule will apply (see below).

For those not resident in a DTA country, a new comprehensive definition of PE is proposed. This definition is aligned with the new OECD "Model" PE definition.

PE avoidance rule (aka NZ's diverted profits tax)

New Zealand has signed the MLI and has offered to amend its DTAs for Article 12 of the MLI. However, not all of New Zealand's DTA partners have signed the MLI (e.g. the United States) and, of those that have signed, some have not agreed to the Article 12 changes to our DTAs (e.g. Australia).

In order for the widened PE definition to apply, to override the DTA's limitation on New Zealand's ability to tax the relevant income, a PE avoidance rule is proposed for those countries. (There may be a period of time where the PE avoidance rule applies because the MLI is not yet in force for the particular DTA partner country, even if both countries have agreed to implement Article 12).

The key uncertainty and requirement is that the arrangement avoids tax (in New Zealand, or in New Zealand and elsewhere) in a more than merely incidental manner. It cannot be simply that there is sales activity in New Zealand which does not create a PE. That means that where the relevant DTA does not recognise there is a PE, this should not of itself be tax avoidance. It is not clear, from the Bill or Commentary, what that something more is. This contrasts with Australia's detailed examples of scenarios which are and are not subject to their equivalent anti-avoidance rules (the Multinational Anti-Avoidance Law and Diverted Profits Tax). Given the fact that this is a targeted measure, that gap is disappointing and should be corrected by the Select Committee.

There are two interesting technical aspects to this rule:

The Commentary states a new rule has been drafted to prevent the judicial "Parliamentary Contemplation" test being applied. Although that characterisation is debateable, it raises constitutional issues on the role and effect of the Courts, which we touched on in 2017's first **taxmail**.

The PE avoidance rule will be one of the few sections of the Act which are not overridden by a DTA. This seems to eliminate any argument under domestic law that a DTA prevents New Zealand taxing income from the deemed PE. Officials' view is that the rule is an anti-avoidance rule which can override a DTA under accepted DTA interpretation principles. The Bill is unwilling to allow taxpayers to test that proposition.

Cross-border sales activity is targeted with the new PE rules.

Sales structures will need to be reviewed.

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PE source rule

Income attributed to a PE will be deemed to have a New Zealand source. The rule has been deliberately drafted so that the OECD's "Authorised Approach" for attributing profits to PEs does not apply. The Commentary justifies this because New Zealand has reserved its position to follow an earlier version of the OECD's profit attribution method. The rule follows that earlier version.

Technically, this does not alter the potential for double taxation. It is already an issue if the other country follows the Authorised Approach and as a result denies credits for New Zealand tax paid. However, practically, the changes to the PE definition and therefore what can be taxed in New Zealand may extend double taxation situations.

DTA source rule

A new source rule, to deem a source in New Zealand if a DTA allows New Zealand to tax an amount, is also proposed. This is required because a DTA cannot impose tax. A domestic taxing rule is required.

This rule, as well as making clear that income of a PE may have a New Zealand source, will apply for example to:

- Income which is derived offshore but which may be subject to the Royalty Article of a DTA rather than the Business Profits Article.
- Director's fees paid by a New Zealand company. Newer DTAs allow New Zealand to tax such fees. However, if the fees are not earned in New Zealand, the fees do not currently have a New Zealand source and are therefore not taxable here.

Reinsurance (non-)deductibility rule

Under some DTAs, New Zealand is unable to tax reinsurance income if there is no PE. The Bill proposes to counter the effectiveness of these negotiated (by New Zealand and the other country) positions by denying a deduction for NZ insurers (instead of trying to tax the foreign reinsurer).

We consider this change to be unprincipled. The rule has the effect of overriding DTAs unilaterally. If New Zealand has inadvertently allowed this result, the correct approach is to renegotiate the DTA to allow New Zealand to tax the reinsurer. If the result is deliberate, in our view, this shows bad faith.

Transfer pricing

The transfer pricing rule changes have generally been well signalled. The changes are broadly to formally align New Zealand's approach to that of the OECD's 2017 transfer pricing guidelines. In practice, taxpayers have already started to follow the guidance. However, it remains to be seen how these rules will be enforced by Inland Revenue.

There are technical issues which we expect will be the subject of submissions. These should be accepted to ensure the rules work as intended.

A significant change for New Zealand is shifting the onus of proof to taxpayers and allowing Inland Revenue seven years to query transfer pricing matters. Earlier submissions against these proposals have not been accepted. We consider there is a good case for retaining the status quo. The arguments in support of change are unconvincing.

It is notable that the driver for change here is alignment with OECD guidance when the interest rate "cap" proposal, which is framed as a transfer pricing rule amendment, is contrary to that guidance.

The transfer pricing changes will make contemporaneous documentation and good processes more important.

Determining the foreign tax effects of instruments and entities will be critical to the New Zealand tax effect. Unexpected effects may be costly to the New Zealand tax position.

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Hybrids

The rules aimed at addressing double non-taxation or double deductions with "hybrid" instruments and structures have had the most difficult gestation of all of the Bill's proposals. At a high level, the hybrids proposals require consideration of the foreign as well as New Zealand tax effects. That might be understandable if there is a double non-taxation effect. However, the hybrid rules override well understood NZ rules developed for good policy reasons. Further, their complexity means there is potential overreach.

The Bill is drafted in broad language. The effects of that broad approach need to be carefully considered to ensure that the rules apply appropriately.

We have briefly commented below on the hybrid proposals (you can read our submission on the 2016 hybrids consultation **here**).

Commerciality of hybrids and elections

The Bill allows elections to treat hybrid debt as equity and for existing hybrid entities to be treated as companies, for tax purposes. These elections will mean the hybrid rules do not apply. Instead the normal dividend and company tax rules will apply.

The elections recognise there are commercial effects to hybrid instruments and entities. The concern should not be with the hybrid but with its tax effects. If those effects are appropriate for income tax purposes, they should be able to be used. The elections are welcome but, in our view, the ability to make them should be widened.

Interest re-characterisation

The Bill allows NZ withholding tax to be charged where an amount is treated as interest, but which is characterised as a dividend protected from New Zealand tax under a DTA. The Commentary states that Inland Revenue's view is that such an amount is not protected by a DTA. The rule is therefore retrospective to 1 April 2008, with a saving provision for those who have taken a contrary view.

It is not clear that such a rule is required given the hybrids rules. We would expect that the interest deduction would be denied as the dividend would generally be exempt in the foreign country.

Drafting

The hybrids rules are one area of the Bill which we think can be simplified and clarified. For example, there are rules which allow the hybrid rules' effects to be reversed should subsequent events mean there is no longer a hybrid (tax) benefit. These could be redrafted so that they can apply more clearly.

Unilateral changes

The Commentary states consistency with the global consensus is a driver for implementing the BEPS recommendations.

However, the Bill has a number of rules which depart from the global consensus and unilaterally seek to change previously negotiated positions.

The Commentary notes that some of these changes are consistent with Australia and the United Kingdom's approaches. This is said to justify New Zealand's approach. As much as we like our Commonwealth cousins, they are not good role models in this area.

New Zealand should be taking a more principled approach and considering the impact for "NZ Inc".

The hybrid proposals are most at risk of potential overreach and unintended consequences.

Both the NZ and foreign tax effects will need to be considered when evaluating the "hybridity" risk.

Departing from the global approach carries risk which should be carefully considered.

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Finally… a word of caution for the new Minister and the Finance and Expenditure Select Committee ("FEC")

In a recent speech, the new Minister of Revenue, Stuart Nash, recalled his days on the FEC. He said that FEC members were not well qualified to rule on technical disputes between submitters and Officials. Unfortunately, with this Bill, the FEC members are unlikely to be able to avoid the technical disputes.

We will look to clarify, as far as we are able, the issues in our submission on the Bill.

As an example – for interest limitation (and as a first attempt) – consider your mortgage and credit card interest rates. They are significantly different while the bank's average cost of funds is the same. There are good commercial reasons why different lending to the same borrower, who you would say has the same credit risk, carry different interest rates.

The question is why should that same approach, which is the global norm, not apply rather than being assumed away by the law?

What next?

If you have managed to read this far, thank you for your patience and perseverance. We trust it has been rewarded with some enlightenment.

We encourage you to consider how the BEPS proposals affect you and to consider making a submission. The Bill, together with the MLI, will significantly alter New Zealand's taxing approach. There is one final opportunity to influence what that is at the Select Committee stage of the Bill.

The changes go further than the global consensus.

Their highly technical nature will make consideration of the Bill a challenging task for the FEC.

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