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Global Tax Alert

New Zealand to implement wide ranging international tax reforms

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Executive summary

On 3 August 2017, the New Zealand Government confirmed that proposed changes to New Zealand law in relation to the taxation of international commerce will be implemented. The proposed changes are intended to address base erosion and profit shifting (BEPS) and are largely consistent with the content of Government discussion documents released in March 2017 and September 2016.

The changes are highly complex and may significantly impact global operating models and tax economics for multinationals doing business in New Zealand.

Key changes include:

- Introducing new rules taxing "hybrid mismatch arrangements." These broadly follow the Organisation for Economic Co-operation and Development's (OECD) recommended approach published in 2015.
- Implementation of a permanent establishment (PE) anti-avoidance rule, effectively replicating Australia's multinational anti-avoidance law (MAAL) and elements of the United Kingdom's Diverted Profits Tax.
- A novel "restricted transfer pricing rule" for pricing inbound related party loans, coupled with an interest rate cap.

Building a better working world

- Other wide-reaching transfer pricing changes, bringing New Zealand's transfer pricing regime in line with the recent revisions to the OECD guidelines (BEPS Actions 8 to 10) and specific measures allowing for the reconstruction of transactions to align with the Commissioner of Inland Revenue's view of economic substance.

The reforms are scheduled to take effect for income years beginning on or after 1 July 2018, with limited exceptions.

Detailed discussion

Background

The Government's decisions place New Zealand at the forefront of BEPS implementation. Not only do they point toward robust implementation of many BEPS minimum standards and recommendations, but they go further, with New Zealand effectively replicating Australia's MAAL.

Additional tax revenue from implementation of the proposals is forecast to be in the range of NZ$200 million per year, a small fraction of the annual corporate tax collected of NZ$12 billion.

New Zealand, a small open economy with a population of less than five million, depends on inbound investment, much of which is ultimately sourced from Australia, the United States and the United Kingdom. It already has a robust broad-base, low-rate tax system, modern treaty network, and well-functioning transfer pricing, thin capitalization and source rules.

Multinationals already contribute strongly to the New Zealand tax base. New Zealand is heavily dependent on its corporate tax revenues (19% of total tax revenues in 2016[1]), to which multinationals are a major contributor. At 4.4% of gross domestic product (GDP),[2] corporate tax revenue is among the highest in the OECD. While official statistics are intermittent, the Government has stated that 39% of all corporate tax is paid by foreign-controlled firms, mostly by larger inbound investors.[3] Therefore, it seems unlikely that substantial additional revenue can be raised without a material negative impact on inbound investment and the New Zealand economy. Revenue Minister Judith Collins is on record as stating that most firms are not "gaming the system."

Little, if any, evidence of tax avoidance by inbound investors has been put forward in support of the changes. Public opinion, however, is strongly in favor of measures intended to force multinational enterprises to pay more tax. With a general election due to be held on 23 September 2017, change had become inevitable.

As is often the case in New Zealand, the proposed reforms are heavily influenced by developments in Australia, its nearest neighbor and largest investment and trading partner.

Hybrid mismatch arrangements

The Government will introduce new rules taxing "hybrid mismatch arrangements." These broadly follow the OECD's recommended approach published in 2015.

Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that benefit from differences in the tax treatment of an entity or instrument under the laws of two or more countries.

Hybrid arrangements targeted by the Government include:

- A dual resident company or branch that reports tax losses in two countries
- A limited partnership which may be treated as look through in one country but opaque in another
- A payment which is treated as deductible interest in the paying jurisdiction but as an exempt dividend by the recipient

These rules will be highly complex and broad with specific provisions recommended despite a lack of evidence of the targeted structures being implemented in New Zealand. They will have the effect of eliminating unintended tax benefits primarily by disallowing deductions or by increasing taxable income.

The tax outcomes of hybrid arrangements will be determined by linking rules that adjust the tax treatment of an arrangement in one jurisdiction by reference to its treatment in the counterparty jurisdiction. Consistent with the OECD approach, the linking rules generally operate through the use of primary and secondary rules; the primary rule acting to deny a deduction in the payer jurisdiction, and the secondary (defensive) rule acting to require the payee jurisdiction to tax the income if the primary rule does not apply.

The Government's view is that the complexity and compliance burden is more than compensated for by the reduction in harmful international tax practice and the New Zealand tax revenue base accretion. Commentators have been critical of this broad approach as being unduly complex for the New Zealand market.

Notable points regarding New Zealand's approach include:

- Inclusion of "foreign trusts" within the hybrid rules package (foreign trusts are essentially trusts with New Zealand trustees and non-New Zealand settlors and beneficiaries)

- An exemption from the rules for New Zealand companies with simple foreign branch structures
- Delayed implementation for certain "unstructured" arrangements implemented without a primary purpose of obtaining a tax advantage
- Potential for eliminating nonresident withholding tax (and therefore double New Zealand taxation) in respect of certain types of arrangements that do not comply with the new rules
- "Grandparenting" rules for banks and insurance companies that have entered into hybrid arrangements for regulatory capital purposes
- Targeted towards outbound investments from New Zealand, an election, by taxpayers, for foreign transparent entities to be treated as opaque for New Zealand purposes, potentially removing them from the ambit of the rules

PE anti-avoidance rule

The central theme of the PE and transfer pricing proposals is to align tax outcomes with the economic substance of a transaction. Economic substance involves subjectivity and raises concerns about the uncertainty the rules will likely create, and in particular, the potential for a rise in the level and complexity of cross-border tax disputes.

Full details of the scope of New Zealand's proposed PE anti-avoidance rule are not yet available. The Government will consult further to ensure application is limited to avoidance arrangements.

It is likely the rule will deem a PE in an arrangement under which the following conditions are met:

- The nonresident supplies goods or services to a person in New Zealand
- A related entity carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about
- Some or all of the sales income is not attributed to a New Zealand PE of the nonresident
- The arrangement defeats the purpose of the double tax agreements' PE provisions.

The rule will apply only to multinationals with more than €750 million global turnover.

Restricted transfer pricing rule for inbound related party debt

The Government has expressed concern not only with the volume and price of inbound related party debt. This seems to have developed out of the Inland Revenue's frustration at its ability to address high interest rates on related-party lending through the transfer pricing regime. Thus, it has decided upon a novel "restricted transfer pricing rule" for pricing inbound related party loans.

This rule will adopt the standard transfer pricing methodology for pricing such loans with two additional (restrictive) elements:

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

The restricted transfer pricing rule will be coupled with a safe harbor interest rate cap.

Further details on the design of the restricted transfer pricing rule are expected soon.

Other transfer pricing changes

The Government will strengthen New Zealand's transfer pricing rules to more closely align with the OECD transfer pricing guidelines and Australia's transfer pricing rules. There will be greater emphasis on economic substance – legal form will be disregarded if it does not align with the actual economic substance of the transaction.

It will also increase Inland Revenue's powers to investigate large (turnover in excess of €750 million) multinationals in a variety of ways such as the ability to request information held offshore by a related group member, collection of tax relating to a member of a group from another wholly-owned member of that group, and the introduction of civil penalties of up to NZ$100,000 for failing to provide information.

Other proposals include:

- The power for Inland Revenue to reconstruct transfer pricing arrangements which include unrealistic terms that third parties would not be willing to agree to. This ability will be based on the corresponding test in the OECD's transfer pricing guidelines.

- Shifting the burden of proof on transfer pricing matters from Inland Revenue to the taxpayer. It will be for the taxpayer to prove their related party dealings are consistent with those that would be agreed by third parties operating at arm's length. Contemporaneous documentation will be increasingly important to ensure the onus of proof can be discharged and penalties mitigated.
- Transfer pricing will be subject to a seven year statute bar period compared to the standard four year period for other income tax.
- Extending the transfer pricing rules to those not strictly "associated persons." For example, nonresident investors that "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.

Inland Revenue may not be well placed to judge all the factors involved in an arm's length commercial negotiation. Recharacterizing a transaction based on a subjective view of the economic substance can lead to uncertainty. A rise in the level and complexity of cross-border tax disputes is anticipated.

Tougher thin capitalization rules

Like Australia, New Zealand's thin capitalization regime limits a company's deductible debt based on a debt/assets ratio. Under the proposals, defined "non-debt liabilities" such as trade creditors will be excluded from the asset base, effectively moving the thin capitalization test to a debt/equity test.

This change will impact industries with substantial provisions and/or higher structural levels of debt — insurers, miners, distributorships, utilities and infrastructure providers among others.

Further consultation is proposed in relation to whether specific liabilities, including deferred tax, be excluded from the ambit of non-debt liabilities.

Implications

Given the need for a degree of certainty around international tax, the Government's decision to release extensive background papers together with its final decisions is a positive development.

However, the enactment timeline and ability for business to contribute to detailed design of the final rules may be challenging. Application of complex law, potentially from 1 July 2018, combined with the absence of draft legislation before year end is too short a timeframe to allow businesses to consider changes to their global operations.

Several areas have been specifically identified in the recommendation papers for further consultation notwithstanding the robust submission and discussion process that has already taken place.

The risk remains that measures will be applied to many multinationals with a good compliance and tax paying history, rather than being limited to a small number of highly geared or structured outliers.

EY is engaged in discussions with the Government on the proposals and encourage businesses to do the same. New Zealand operations may well be able to incorporate restructures and BEPS changes being implemented in other jurisdictions. Companies should use this time to consider the shape of their supply chain and financing in New Zealand.

Endnotes

1. Inland Revenue, *2016 Annual Report*.
2. OECD Revenue Statistics 2016, data for the year ended 30 June 2015 (in comparison, the OECD average corporate tax to GDP ratio is 2.8%).
3. Policy and Strategy, Inland Revenue, *BEPS – Strengthening our interest limitation rules*, A Government discussion document, (figure quoted is for the year ended 30 June 2015), March 2017.

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