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WEEKLY COMMENT: FRIDAY 22 NOVEMBER 2013

1. On 8 November 2013 the Government announced the latest tax policy work programme. As expected, it includes a number of measures relating to international tax reform and addressing base erosion and profit shifting ("BEPS"). These measures were discussed in the *Tax policy report: Taxation of multinationals* ("the BEPS report") released in August 2013. This week I look at the measures discussed in this document to protect the New Zealand tax base from BEPS.

The OECD's action plan

2. New Zealand's current involvement in the OECD tax working parties includes chairing the Aggressive Tax Planning Steering Group. The more significant areas that the OECD is working on are listed on page 7 of the BEPS report as follows:

   (a) Action 1: Considering rules for taxing digital goods and services provided over the internet;

   (b) Action 2: Reviewing hybrid mismatches between countries because of the treatment of debt vs equity or company vs partnership;

   (c) Action 3: Improving rules for controlled foreign companies ("CFCs");

   (d) Action 4: Reviewing domestic rules, such as thin capitalisation rules, for limiting interest deductions;

   (e) Action 6: preventing misuse of tax treaties;

   (f) Action 7: Improving the permanent establishment rules; and

   (g) Actions 4 and 8 to 10: Improving "transfer pricing" rules particularly in relation to debt and brands and intellectual property.

New Zealand initiatives included in the tax policy work programme

3. The following items relating to international tax reform and addressing BEPS have been included in the tax policy work programme announced on 8 November:

   (a) Active income exemption for offshore branches;

   (b) Mutual recognition of imputation credits;

   (c) Profit shifting using related party debt;

   (d) Foreign hybrid instruments and entities;

   (e) Non-resident withholding tax ("NRWT") on related part debt;

(f) Approved issuer levy ("AIL") disclosure requirements;

(g) GST and online shopping; and

(h) Double tax agreements and tax information exchange agreements.

4. Each of these is discussed in turn below.

Active income exemption for offshore branches

5. Officials are currently preparing an issues paper on extending the active income exemption that applies to CFCs and to FIFs (for which the AFI calculation method is used) to offshore branches of New Zealand companies. This would mean that net losses of active branches would become non-deductible in New Zealand.

6. The key base maintenance features that apply under the international tax rules will be extended to the offshore branch rules:

   (a) The "passive" income of offshore business (such as interest, royalties and rent) will remain liable for tax in New Zealand; and

   (b) The "outbound" thin capitalisation rules that apply to New Zealand companies with CFCs will be extended to New Zealand companies with offshore branches.

Mutual recognition of imputation credits

7. This is not a BEPS measure. However, there will be continuing work to progress mtual recognition of trans-Tasman imputation credits, which would result in both New Zealand and Australia recognising company tax paid in the other jurisdiction for imputation purposes.

8. Currently, if double taxation on Australian profits is to be avoided in New Zealand, the Australian business income needs to be earned directly by the New Zealand shareholders – for example through the use of an LTC, or alternatively, through using a complying trading trust with a permanent establishment in Australia. It would be a welcome change to be able to structure trans-Tasman business in a more commercially consistent way.

Profit-shifting using related party debt

9. The taxation of related-party debt has been identified as "the most significant BEPS issue for New Zealand". Multinationals can shift profits offshore by funding New Zealand operations with excessive levels of debt or by setting a very high interest rate.

10. Some measures to tighten up New Zealand's thin capitalisation rules, to apply from the 2015-16 income year, were announced as part of the Government's 2013 Budget:

    (a) The rules are to be extended to apply to situations where multiple non-resident investors, such as private equity investors, act together; and

    (b) Shareholder debt will be excluded from the "worldwide group" test.

11. While transfer pricing rules can be used to challenge excessive interest rates, officials are concerned that:

    "… transfer pricing is a complex and resource-intensive process, which may only be effective for the most egregious cases. Moreover, there are structures that may allow the "arm's

length" price of debt to be artificially inflated, potentially defeating the intent of the transfer pricing rules."

12. A suggested alternative approach to limiting the ability to use high-priced debt is to combine the limit on, and the price of, debt into one test, and base the thin capitalisation rules on the ratio of interest deductions to earnings. Such rules are apparently used in many European countries.

13. New Zealand's involvement in the work being done by the OECD to review the effectiveness of different types of interest limitations should provide some ideas on possible improvements.

14. Officials are also concerned that the transfer pricing rules currently may not apply to foreign investors who are "acting together". A review of the transfer pricing rules is planned, and the scope of the rules could be aligned with the expanded scope of the thin capitalisation rules.

Foreign hybrid instruments and entities

15. Officials have concluded that New Zealand's current rules for hybrid instruments (allowing deductions for some hybrids and no deductions where they are part of a tax avoidance arrangement) are sufficiently strong, however:

    (a) Australia has announced plans to change its tax law for hybrid instruments, and this may warrant a further review in New Zealand if it becomes easier to use hybrid instruments between New Zealand and Australia; and

    (b) Further work being done by the OECD may necessitate further review or tightening of New Zealand's rules.

16. Inland Revenue investigators have identified revenue risks associated with the use of offshore hybrid entities, which are treated as a separate company for foreign tax purposes but are considered to belong to the New Zealand investor (for example, are seen as a partnership) for New Zealand tax purposes. This type of investment could result in a tax deduction in the foreign country and a second tax deduction for the New Zealand investor in New Zealand.

17. Some foreign countries have responded to this by classifying the offshore entity for domestic tax purposes in the same way as the entity is classified in the country where it is formed. Australia, for example, has a rule that treats offshore hybrid entities as partnerships for Australian tax purposes. Officials are keen to ensure that any measures developed by New Zealand are consistent with approaches taken in other countries.

NRWT on related-party debt

18. Inland Revenue has apparently identified "a wide range of arrangements that can be used to defer or circumvent NRWT on related-party interest payments".

19. Officials are concerned that tackling particular arrangements through the disputes process or through specific legislative amendments can be complex and resource-intensive, and may not be effective if taxpayers are able to switch to another technique. Officials have proposed exploring options for dealing with these issues in a comprehensive way, while ensuring that New Zealand companies can still raise funds for investment.

AIL disclosure requirements

20. Taxpayers do not currently file NRWT withholding certificates where they pay approved issuer levy (AIL). Officials have proposed that AIL payers should be required to file an NRWT withholding certificate at the end of each tax year.

21. This will make it easier for Inland Revenue to verify the correct application of the NRWT and AIL rules and to fulfill exchange-of-information requests under tax treaties.

GST and online shopping

22. Inland Revenue, the Treasury and the New Zealand Customs Service are currently preparing an issues paper examining the growth of online shopping, its impacts on the tax system, and the potential options for improving the collection of GST on online sales. The work includes looking at physical goods that are purchased from offshore websites as well as digital goods and services. The issues paper is to be released later this year.

23. The OECD is establishing a special taskforce on the digital economy to look at "how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services".

Double tax agreements and tax information exchange agreements

24. The OECD's action plan includes:
    (a) Collecting aggregate statistical data on the extent of BEPS (Action 11);
    (b) Requiring taxpayers to disclose aggressive tax planning arrangements (Action 12); and
    (c) Requiring multinationals to provide all relevant tax authorities with information on the global allocation of their income as well as transfer pricing documentation (Action 13).

25. Officials have identified a set of initiatives (including the AIL disclosure requirements discussed in paragraphs 20-21 above) that New Zealand could consider to improve the quality and usefulness of tax information collected by Inland Revenue:
    (a) Instead of large corporates providing financial statements with their returns, Inland Revenue envisages a one or two page electronic declaration that would collect only essential information, which could include: key performance metrics, specific high risk items (such as cross-border interest payments) and group membership details.
    (b) Requiring large corporates to file their tax returns earlier than they currently do, which would be consistent with the reduced 5 month period for filing their annual reports under the Financial Reporting Bill; this would allow faster detection of transactions, earlier investigations and quicker remedial law changes.
    (c) Consider introducing a code of practice for large corporates: The *Code of Practice on Taxation for Banks* introduced in the UK in 2009, to which over 250 institutions had signed up by May 2013, asked banks to:
        (i) Adopt adequate governance to control the types of transactions they enter into;
        (ii) Not undertake tax planning that aims to achieve a tax result that is contrary to the intentions of Parliament;
        (iii) Comply fully with all their tax obligations; and
        (iv) Maintain a transparent relationship with HM Revenue & Customs.

Coherence of "look-through" structures and treatment of foreign trusts

26. While not specifically listed in the tax policy work programme, officials have noted:

    (a) A lack of coherence, that officials think should be explored further, across the different sets of rules that apply to different "flow-through" investment vehicles: LTCs, limited partnerships, foreign PIEs and foreign trusts.

    (b) The fact that New Zealand's foreign trust rules continue to attract criticism because the mismatch between New Zealand's rules and those of other countries may result in income not being taxed, which raises the question of whether the foreign trust rules are sustainable.

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