Base erosion and profit shifting

Policy reports, Cabinet papers and regulatory impact assessments

August 2017

Prepared by Policy and Strategy, Inland Revenue, and the Treasury

First published in August 2017 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington 6140.

BASE EROSION AND PROFIT SHIFTING DOCUMENTS

#	Date	Type	Title and description
01	9 March 2017	Policy report	**Consultation on addressing hybrid mismatch arrangements** Report on submissions received for the Government's discussion document *Addressing hybrid mismatch arrangements* (September 2016) – for the submissions see document #21. Report number: IR2017/133, T2017/0406
02	6 April 2017	Policy report	**Cabinet paper – Foreign hybrid entity double deductions and BEPS reforms** Covering report for Cabinet paper (document #03). Report number: IR2017/237, T2017/949
03	6 April 2017	Cabinet paper	**Foreign hybrid entity double deductions and BEPS reforms** Cabinet paper with recommendations for foreign hybrid entity double deductions and BEPS reforms.
04	18 April 2017	Policy report	**New Zealand's adoption of the OECD's Multilateral Instrument** Report covering: • submissions received for the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (March 2017) – for the submissions see document #23; and • the Multilateral Instrument Cabinet paper (document #05). Report number: IR2017/260, T2017/1004
05	18 April 2017	Cabinet paper	**Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting: Approval for Signature and Ratification** Cabinet paper with recommendations on the text and agreement to sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Reference: CAB-17-SUB-0241
06	18 April 2017	Policy report	**Update on Multilateral Instrument** Report with recommendations to add additional countries to New Zealand's list of double tax agreements covered by the Multilateral Instrument. Report number: IR2017/320, T2017/1363
07	15 June 2017	Policy report	**BEPS – summary of submissions on March 2017 discussion documents** Report on the submissions received for the Government's discussion documents *BEPS – Transfer pricing and permanent establishment avoidance* (March 2017) and *BEPS – Strengthening our interest limitation rules* (March 2017). Report number: IR2017/361, T2017/1630

#	Date	Type	Title and description
08	22 June 2017	Policy report	**Base erosion and profit shifting – overview of current reports** Report with an overview of the 22 June 2017 reports about base erosion and profit shifting (documents #09, #10, and #11). Report number: IR2017/329, T2017/1578
09	22 June 2017	Policy report	**BEPS – interest limitation submissions and policy decisions** Report on submissions and policy changes resulting from the Government's discussion document *BEPS – Strengthening our interest limitation rules* (March 2017) – for the submissions see document #22. Report number: IR2017/325, T2017/1576
10	22 June 2017	Policy report	**BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions** Report on submissions and policy changes resulting from the Government's discussion document *BEPS – Transfer pricing and permanent establishment avoidanc*e (March 2017) – for the submissions see document #24. Report number: IR2017/330, T2017/1577
11	22 June 2017	Policy report	**BEPS – Recommendations on addressing hybrid mismatch arrangements** Report with recommendations on policy changes for addressing hybrid mismatch arrangements. Report number: IR2017/353, T2017/1604
12	6 July 2017	Policy report	**Cabinet paper – tax measures to prevent base erosion and profit shifting** Covering report for Cabinet paper (document #13). Report number: IR2017/410, T2017/1847
13	13 July 2017	Cabinet paper	**Tax measures to prevent base erosion and profit shifting** Cabinet paper with an overview of the three Cabinet papers recommending measures to address base erosion and profit shifting in New Zealand (documents #15, #17, and #19).
14	13 July 2017	Policy report	**BEPS Cabinet papers** Covering report for the three BEPS Cabinet papers: strengthening our interest limitation rules, transfer pricing and permanent establishment avoidance, and addressing hybrid mismatch arrangements. Note: This document includes the Cabinet papers and signed regulatory impact assessments – these are also listed individually (documents #15–#20). Report number: IR2017/429, T2017/1901
15	13 July 2017	Cabinet paper	**BEPS – strengthening our interest limitation rules** Cabinet paper on proposals for strengthening our interest limitation rules.

#	Date	Type	Title and description
16	13 July 2017	Regulatory impact assessment	**BEPS – strengthening our interest limitation rules** Regulatory impact assessment on proposals for strengthening our interest limitation rules.
17	13 July 2017	Cabinet paper	**BEPS – transfer pricing and permanent establishment avoidance** Cabinet paper on proposals for transfer pricing and permanent establishment avoidance rules.
18	13 July 2017	Regulatory impact assessment	**BEPS – transfer pricing and permanent establishment avoidance rules** Regulatory impact assessment on proposals for transfer pricing and permanent establishment avoidance rules.
19	13 July 2017	Cabinet paper	**BEPS – addressing hybrid mismatch arrangements** Cabinet paper on proposals for addressing hybrid mismatch arrangements.
20	12 July 2017	Regulatory impact assessment	**BEPS – Hybrid mismatch arrangements** Regulatory impact assessment on proposals for hybrid mismatch arrangements.
21	September to November 2016	Submissions	**Addressing hybrid mismatch arrangements** 20 submissions received for the Government's discussion document *Addressing hybrid mismatch arrangements* (September 2016).
22	March to May 2017	Submissions	**BEPS – Strengthening our interest limitation rules** 27 submissions received for the Government's discussion document *BEPS – Strengthening our interest limitation rules* (March 2017).
23	April 2017	Submissions	**New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS** 5 submissions received for the officials' issues paper New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (March 2017).
24	April to May 2017	Submissions	**BEPS – Transfer pricing and permanent establishment avoidance** 16 submissions received for the Government's discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (March 2017).

POLICY AND STRATEGY

RECEIVED
4 MAR 2017
MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Consultation on Addressing Hybrid Mismatch Arrangements

Date:	9 March 2017	**Priority:**	**Medium**
Security Level:	In Confidence	**Report No:**	T2017/406 IR2017/133

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Note** the content of this report **Agree** to the recommendations in this report	21 March 2017
Minister of Revenue	**Note** the content of this report **Agree** to the recommendations in this report	21 March 2017

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Matthew Gan	Tax Specialist, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982
Paul Kilford	Policy Manager, Inland Revenue	
Casey Plunket	Special Policy Advisor, Inland Revenue	

9 March 2017

Minister of Finance
Minister of Revenue

Consultation on Addressing Hybrid Mismatch Arrangements

Executive summary

Discussion document
On 6 September 2016 the Government released a discussion document seeking feedback on proposals to address hybrid mismatch arrangements in line with the recommendations in Action 2 of the OECD BEPS programme (T2016/1319 IR2016/342 refers).

Submissions and subsequent meetings
20 submissions were received on the discussion document. 6 were from corporates and financial institutions, 4 were from industry bodies, 2 were from private individuals and 8 were from professional services firms. A list of submitters is included as Appendix 1 to this report.

Following the submissions, Inland Revenue and Treasury officials have:

- met with a number of submitters to further discuss their submissions; and
- embarked on a series of five monthly workshops with Chartered Accountants Australia New Zealand and the Corporate Taxpayers Group.

We have also been discussing hybrid issues with the Australian Tax Office, the Australian Treasury and the OECD secretariat. This report summarises the submissions received and (where relevant) our initial responses to those submissions, noting that consultation is ongoing with some of these matters yet to be covered. It also seeks your agreement to the timeframes for the remainder of the policy process.

Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. However, a greater number were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

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

Officials' response to submissions
Nothing compelling has emerged in the course of consultation to date to suggest that full implementation of the hybrid rules generally as envisaged in the discussion document should not be pursued. We remain of the view that the proposals are likely to be in New Zealand's best interests.

Post-discussion document developments outside New Zealand
We note that since the discussion document was released, the UK hybrid rules have come into force (1 January 2017), the EU has released a binding directive which requires EU members to expand their hybrid rules so that they apply to transactions with non-EU countries (effective 1 January 2020), and Australia remains committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment). In all cases the rules as enacted or proposed are broadly those contained in the OECD's Final Report on Action 2. No other jurisdictions have proposed implementing the OECD recommendations at this stage so New Zealand may well be within the first wave of adopters. However, the countries that are adopting the rules are significant for New Zealand. For instance, they are the source of approximately 62% of foreign direct investment into New Zealand.

Just before the discussion document was released, the OECD released a Public Discussion Draft titled *BEPS Action 2: Branch Mismatch Structures*. This document discusses cross border tax mismatches arising in the context of branches. As the title suggests, the OECD sees these mismatches as part of the hybrids project (BEPS Action 2). Accordingly, although most of these mismatches were not discussed in the Government's discussion document, we seek your approval to consult with the original submitters on them as part of this project, and we expect that submitters will be comfortable with that.

Proposed path for development of policy and legislation
A number of submissions sought further consultation on the content of the hybrid rules ("what" rather than "whether"). Given the novel nature of the proposals and the fact that they will need to cover a wide range of situations and provisions, we agree that further consultation on their content would be useful. We have therefore agreed to conduct the workshops referred to above, which are currently scheduled to occur between now and June. This will help ensure that the proposals are implemented in a manner appropriate to the New Zealand context that minimises additional compliance and administration costs without discouraging productive foreign direct investment. We will prepare materials to facilitate discussion at the workshops, and to record their outcomes.

The timetable for these workshops was set before the date of the pre-election period was known. We therefore seek your views on whether we should:

- keep to the current timeframe, which would involve seeking final Cabinet approval for policy decisions during the pre-election period – probably in mid-July; or

- shorten the planned consultation timeframe so that final policy decisions can be made before 23 June. This would inevitably reduce the scope and quality of the consultation, but it would remain a useful exercise.

Officials currently consider that, if final policy decisions are made before the election (irrespective of whether this is just before or after the pre-election period commences), consulting on draft legislation over the election period would be a useful exercise. We currently envisage that the relevant legislation will form part of the first Omnibus Tax Bill following the election. Given the inevitable complexity of legislation on these issues, consultation on draft legislation would likely result in a smoother select committee process after that bill is introduced to Parliament. If you indicate you are comfortable with consultation on draft legislation, we will include a request to that effect in the Cabinet paper seeking final policy decisions.

Recommended action

We recommend that you

(a) **Note** the contents of this report.

Noted Noted ✓

(b) **Agree** either that:

1. officials should continue to consult with submitters on the current scheduled timelines, which would result in a Cabinet paper being prepared for submission during the pre-election period;

note my comments

Agreed/Not agreed Agreed/Not agreed

OR

2. officials shorten the current consultation timeframe so that a paper seeking final policy decisions can be considered by Cabinet before 23 June.

see my comments

Agreed/Not agreed Agreed/Not agreed

(c) **Agree** that officials should consult with the original submitters on the content of the OECD's discussion draft on branch mismatch structures under Action 2 of the BEPS Action Plan.

Agreed/Not agreed

Agreed/Not agreed

(d) **Agree** that officials should plan to use the election period as an opportunity to consult on draft legislation.

Agreed/Not agreed

Agreed/Not agreed

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

Matthew Gan
Tax Specialist
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy
Inland Revenue

Please proceed with consultation with an announcement in mid July.

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Please note that government continues & doesn't stop working. No such legal concept of pre-election that I'm aware of. J

Background

1. On 6 September 2016 the Government released a Discussion Document seeking feedback on proposals to address hybrid mismatch arrangements in line with the recommendations in Action 2 of the OECD BEPS programme (T2016/1319 IR2016/342 refers).

2. This report summarises the major themes of the submissions and our responses. The submissions are generally ordered from the more general and high level to the more specific.

3. Although the expected effect of the hybrid rules will generally be to simplify commercial transactions (because they will remove the incentive to undertake transactions in a more complex tax-motivated fashion), as a technical matter, their interaction with the existing tax legislation raises an unusually large number of issues, some of them very technical. Because we are continuing to consult on those technical issues, we have not dealt with most of them here. However, they will be put before Cabinet in the process of seeking final policy approval.

General submissions

4. Submissions varied significantly in responding to the proposals. Some submitters were generally supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. However, a greater number were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand. The principal reasons for this were as follows:

- The rules will increase the effective tax rate on inbound investment which is currently enjoying hybrid tax benefits, they will raise the required return from that investment, and therefore reduce investment in New Zealand.
- In many cases, these negative effects will arise with no increase in New Zealand's tax revenue. This is the case where hybrid investment into New Zealand is replaced by debt investment into New Zealand.
- The rules may change the tax treatment of genuine commercial transactions inappropriately.
- Our international tax rules are relatively robust and New Zealand is not as exposed as other countries to hybrid mismatches.
- Abusive transactions can be dealt with effectively with simpler and more targeted rules.
- New Zealand should not enact hybrid rules before international acceptance of the rules has been evidenced by enactment in other countries.

5. A submission which was made in discussions against adoption of the rules is that their effect will be to replace hybrid arrangements with funding from countries with very low tax rates, or which do not tax foreign source interest. Such arrangements will not be subject to the hybrid rules. Generally these countries are what are commonly referred to as tax havens, but they could also include more established countries with which New Zealand has a double tax treaty, such as Hong Kong and Singapore (which have territorial tax systems).

6. Officials are not convinced by the argument that the rules should not apply to inbound hybrid investment for the following reasons:

- We consider that in some instances a disallowed hybrid instrument may be replaced with equity, resulting in higher tax payments in New Zealand.
- Revenue may be raised even when the counterfactual investment is debt as hybrids often have a higher interest rate compared to ordinary debt.
- Countries that are some of our most significant inward investment sources are also implementing anti-hybrid rules. The advantages of using hybrids to invest in New Zealand will be eliminated for investors from these countries, regardless of our course of action.

7. There is some force in the argument that double non-taxation, or close to it, can be achieved using debt funding through low or no tax countries, or countries with pure territorial tax systems, and enacting anti-hybrid legislation is therefore pointless. However, in most cases there will be an additional cost to routing funding through these countries, because the interest paid will be subject to 15% rather than 10% New Zealand withholding tax. Perhaps more importantly, by pushing companies into using such countries, the negative effect of low tax jurisdictions on corporate tax revenues becomes more visible than it does with hybrids. Residence countries are able to neutralise this form of tax planning using controlled foreign company rules if they wish to do so (as New Zealand already does, and as the OECD recommends). The hybrid rules will not put an end to all tax planning using cross border transactions. But they make useful progress towards that objective.

8. The remainder of this report is dedicated to the more specific submissions received and officials' initial responses to them.

National sovereignty/loss of coherence concerns

9. A number of submitters were concerned about national sovereignty aspects of the proposals. These concerns were based on the fact that the rules mean that the New Zealand tax treatment of a cross border transaction can vary, depending on how that same transaction is treated in another country. Submissions objected to this, on the basis that it means a loss of sovereignty and that it reduces the coherence of the New Zealand tax system.

10. The first objection is without foundation. New Zealand is free to enact laws implementing the OECD hybrid rules or not as it sees fit, and is equally free to repeal them. No national sovereignty is ceded. New Zealand's tax system already contains numerous

provisions which allow foreign tax systems to affect the amount of New Zealand tax imposed on a person. Examples are the foreign tax credit rules and the rule which taxes dividends derived from foreign direct investment by New Zealanders if the dividends are deductible in another country.

11. The second objection has more substance. However, it is axiomatic that the hybrid rules will have this outcome. For the conceivable future, countries will have different rules for taxing instruments, transactions and entities. These rules will generally exhibit a high degree of coherence domestically. For example, a dividend paid by one domestic resident to another will be taxed as dividend by both parties. However, because the rules are different, they cannot be coherent in a cross border context, without some form of co-ordination such as the hybrid rules. Some payments which New Zealand treats as dividends will be treated as interest by another country, and vice versa. The effect of the hybrid rules is to introduce a different set of rules for certain cross border transactions, which increase global tax coherence by reducing double non-taxation outcomes. There is a loss of domestic consistency (since the same instrument may be taxed differently depending on the tax treatment of the foreign counterparty), but in a cross-border transaction, this is a less important concern than cross-border coherence.

12. Most importantly, the hybrid rules do not affect coherence in a purely domestic context. They will only apply in a cross border context, and only where the outcome of applying the two domestic tax systems involved produces double non-taxation. In a world where more and more business is done across borders, cross-border tax mismatches are likely to become an increasingly significant problem.

Rules will raise the cost of capital in New Zealand, in many cases without raising revenue in New Zealand

13. This submission was made by a number of submitters. It primarily focuses on the effect of the rules on inbound debt/equity hybrids, where the return on an investment in New Zealand is properly deductible in New Zealand, and properly treated as an exempt dividend or otherwise not subject to tax in the investor country. The hybrid rules will deny a deduction for the return in this case.

14. Submissions argued that this would:

- Make no difference to New Zealand's tax take. The theory is that all foreign firms wish to minimise their New Zealand tax. Accordingly, they all have the maximum amount of debt they are allowed under the thin capitalisation rules (60% of their gross assets). This being so, the response to the introduction of the hybrid rules will be to replace hybrid debt with ordinary debt, the return on which would generally be taxed in the other jurisdiction, but still deductible in New Zealand.
- Push up the cost of capital in New Zealand, because it would increase the tax imposed on the return, and therefore decrease the amount investors are prepared to invest in New Zealand.

15. As to the first submission, this theory does not seem to be supported by the facts. The average debt to asset ratio of large foreign-controlled firms in Inland Revenue's International Questionnaire database in 2015 was 26 percent (with a median of 18 percent).[1] Only 64 firms in the database, or 20 percent of the total, had a debt to asset ratio higher than 50%.

16. It does not appear to be the case that, in response to the introduction of the hybrid rules, all hybrids will be replaced with ordinary debt. Given how foreign-owned firms are currently capitalised, we consider it more likely that some portion of hybrid capital will be replaced by ordinary equity, the return on which is taxed in New Zealand.

17. Moreover, if the Government does not enact anti-hybrid rules, this could signal to the private sector that the Government has a permissive attitude towards hybrids. There is therefore a risk that some firms currently operating in New Zealand will replace part of their equity with hybrid capital because of the available tax advantages. This could have a reasonably large fiscal cost.

18. It is not necessarily the case that foreign firms do wish to minimise their New Zealand tax. The data above, showing that typical debt levels of large foreign-controlled firms are far below the New Zealand-tax minimising level of 60 percent, demonstrates this. For example, some Australian firms may prefer to pay tax in New Zealand instead of Australia. As stated in the recent Financial System Inquiry in Australia,[2] the share price of Australian firms is increasingly being set by non-resident investors, who do not benefit from franking credits, so may prefer paying tax in New Zealand, where the corporate tax rate is lower.

19. As to the second submission, submitters are correct that, in some instances, the total tax impost (i.e. New Zealand tax plus foreign tax) on investors currently using hybrids will increase. This will make New Zealand a less attractive investment location to these investors. We do not think this is a significant concern for several reasons.

20. As discussed above, we consider that if hybrid mismatches are eliminated, some hybrid capital would, be structured as equity. In these cases, the effect of the hybrid is to eliminate New Zealand tax on the investment. Neutralising hybrid mismatches will increase the total tax on investors because New Zealand tax would be payable. We do not consider that this is a problem. This treatment is in line with our general taxation settings, where we do impose a reasonable level of tax on foreign investment here. We think these settings serve New Zealand well.[3]

21. In some cases the alternative to a hybrid investment is debt, where the effect of the hybrid is to eliminate foreign tax on the investment. In this situation submitters' concern that these changes will push up the cost of capital in New Zealand has more force, as there would be no accompanying increase in New Zealand tax payments.

---

[1] Based on the International Questionnaire for the 2015 income year, which has data on all foreign-controlled firms (excluding banks) with turnover of more than $80m – 314 firms in total.
[2] Financial System Inquiry Final Report (2014), available from http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf
[3] The reasons for this are discussed in the joint IRD/Treasury paper *New Zealand's taxation framework for inbound investment* (June 2016).

22. However, in many situations submitters' contention that these changes will push up the cost of investing in New Zealand is incorrect. Several other countries are also enacting anti-hybrid rules, including two of our largest trading partners (Australia and the UK). Collectively, these countries account for 59 percent of total FDI into New Zealand.[4] Our own enactment of anti-hybrid rules will have no impact on the total tax impost on hybrid capital originating from these countries, as the mismatch will be neutralised regardless through the primary/defensive hybrid rules structure.

23. Even when an investor is from a country that is not enacting anti-hybrid rules, and the counterfactual investment is debt, the enactment of anti-hybrid rules is not an unambiguous loss for New Zealand. Hybrid elements frequently increase the interest rate on a financial instrument, so a switch to ordinary debt may reduce interest deductions here and accordingly increase New Zealand tax payments.

24. Nevertheless it remains the case that, in some instances, the cost of investing in New Zealand will be pushed up because of this reform without any change in New Zealand tax revenues. We consider this to be a less pressing concern for New Zealand than it would be for other countries. While FDI is generally considered highly sensitive to company taxation, we argue in our inbound investment framework that tax is much less likely to play a critical factor in investment decisions into New Zealand. This is because New Zealand is an island nation, far away from the rest of the world. Much FDI here is likely to be associated with the supply of goods and services to the domestic market, which would be difficult to do without establishing a base here.

25. In any event, there are potential indirect benefits to New Zealand from eliminating the inefficiencies that result from hybrid mismatches and the associated double non-taxation. This argument is dealt with in detail in the 2016 joint Treasury/IRD paper *New Zealand's taxation framework for inbound investment*. It is worth setting out the key passage here (see p21):

> *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 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*

[4] Based on 2016 data on the stock of direct investment by country, from Statistics New Zealand.

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.

26. Moreover, quite random reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment in New Zealand and lead to complex arrangements that are themselves a source of inefficiency. Identifying these situations, or designing rules that turn off our anti-hybrid rules in them, would be difficult. Such an approach could also be questioned by our trading partners – the tax advantages conferred by hybrids are, by definition, not intended by either country.

27. There is a broad public concern that BEPS is unfair. Large companies escaping tax while earning substantial profits in a country has been the subject of considerable public controversy. Overall there are strong arguments for considering initiatives in this area. An important priority for the Government is considering rules to address BEPS.

28. Given all of this, we remain of the view that implementing anti-hybrid rules with a general application remains in New Zealand's best interests.

Rules should be limited to deal with NZ-specific hybrid concerns

29. In favour of this submission, submitters pointed to the fact that the rules are relatively complex and have the potential for overreach. They said that many of the structures considered in the Final Report have not been seen in New Zealand, and therefore do not need to be counteracted.

30. We agree that the rules are complex, which is part of the reason we are conducting a series of workshops on technical aspects of the rules to minimise the risk that they reach further than they should. However, on balance, we do not think a partial approach would serve New Zealand well. The rules are a coherent package. Indications from other countries adopting the rules are that they will adopt all of them, subject only to relatively minor modifications. It will be preferable for New Zealand to do the same. This should reduce the need to make subsequent piecemeal amendments. It will also ensure our rules are internationally comparable. If an element of the rules were deliberately omitted from New Zealand's response, this might be seen as a tacit blessing of that type of mismatch, inviting undesirable tax planning, with all the attendant risk of disputes and law changes.

31. Lastly, while New Zealand almost certainly has not experienced all of the types of transactions considered in the Final Report, there is no doubt that New Zealand taxpayers have engaged in complex cross border tax planning, and that the structures entered into would have engaged most, if not all, of the proposed rules if they had been in force.

Rules should not be enacted until more widely adopted

32. Some submitters suggested that it would not be sensible for New Zealand to be an early adopter of the hybrid rules, and that we should wait for other countries, in particular Australia, to adopt them first. It was not altogether clear in some cases why early adoption was seen as undesirable. It could be because:

- If another country already has the rules, their adoption by New Zealand will have no impact on the taxation of hybrid arrangements between New Zealand and that country. If another country does not, then adoption of the rules by New Zealand will be the event that eliminates the tax benefit of such arrangements. This is simply an argument against the adoption of the rules, and is dealt with in the remainder of this report.
- If another country does not have the rules, it may be a more attractive investment destination than New Zealand, at least for investment from other countries that do not have the rules.
- Even if another country has the rules, they may not be implemented in a pure and consistent way based on the OECD recommendations and/or other countries will have other features in their overall tax regimes so that they remain internationally attractive to multinational groups. New Zealand will benefit from waiting and seeing how the rules are adopted in larger economies.
- If New Zealand waits to introduce the rules until they are more globally adopted, businesses will be more familiar with them, and New Zealand will be perceived as less of a special case.

33. The most obvious response to this submission is that in fact, 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.

34. Leaving that aside, officials note that:

- The hybrid rules work to neutralise mismatches involving the tax base of a country that adopts them regardless of their adoption by any other country.
- Since Australia is also adopting the rules, there is less downside, from a "favourable destination for investment" perspective for New Zealand from doing so. Adoption of the rules will not make New Zealand a less favourable destination for our largest source of direct investment, nor will it make New Zealand a less favourable investment jurisdiction than Australia.
- In relation to certain double deduction structures involving Australia[5], if Australia adopts the rules and New Zealand does not, that might well be to the detriment of the New Zealand tax base. This might also be the case in other situations.
- There is no evidence that the existence of hybrid mismatches has led to any investment in New Zealand that would be at risk if they were eliminated.

---

[5] Double deduction Australian limited partnership structures.

- While acknowledging it may be safer to see how the detail of the rules is implemented in other jurisdictions, there is an advantage to New Zealand in being in the leading group of adopters, particularly with Australia. New Zealand has the chance to have some influence in how the rules are implemented around the world, we are able to benefit from engaging with other countries who are also actively engaged in developing their rules (particularly the case with Australia) and it may also prove possible to introduce our rules in a more co-ordinated fashion with Australia.

35. We note that since the discussion document was released, the UK hybrid rules have come into force (1 January 2017), the EU has released a binding directive which requires EU members to expand their hybrid rules so that they apply to transactions with non-EU countries (effective 1 January 2020), and Australia remains committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment). In all cases the rules as enacted or proposed are broadly those contained in the OECD's Action 2. No other jurisdictions have proposed implementing the OECD recommendations for hybrids at this stage.

Compliance cost concerns

36. There is no doubt that the need to comply with the hybrid rules will involve some additional cost for business. There will be the initial cost of helping to develop and understanding the rules, and then the cost of ensuring that they are complied with. However, in the vast majority of cases, compliance costs can be minimised by not entering into, or unwinding, hybrid structures, and replacing them with structures that in most cases are commercially much simpler and cheaper, albeit less tax effective.

37. The imported mismatch rule was a particular target of this submission. We appreciate the concerns raised here as the imported mismatch rule applies where the hybrid mismatch does not directly involve New Zealand, and serves as an integrity measure for some of the other OECD recommendations for hybrids. Prima facie it will require corporate groups to identify hybrid mismatches which are not subject to direct counteraction, and then to determine how the benefit of such mismatches should be apportioned between payments that are subject to the imported mismatch rule, which could involve multiple jurisdictions.

38. The cost of compliance with this rule is reduced by the fact that it does not apply to payments made to other countries which have hybrid rules. Accordingly it will not apply to payments by a New Zealand resident to (for example) an Australian one (assuming Australia adopts the rules), and adoption of the rules in New Zealand will ensure that compliance costs in respect of this rule do not arise in respect of payments from countries which have hybrid rules to New Zealand. If New Zealand is within the first wave of adopters, there will be additional compliance costs as it waits for other countries to come on board, particularly so if New Zealand introduces the rules before Australia (although this is not expected on current timelines).

39. We envisage that as a practical matter, the kinds of multinational groups where imported mismatches might conceivably apply will employ skilled tax managers, one of

whose tasks will be to review the existence of mismatch arrangements throughout the group. The introduction of hybrid rules by other countries means that this task will be required to be performed regardless of whether or not New Zealand has hybrid rules.

40. The workshops with submitters on technical aspects of the rules are intended to ensure that compliance and administrative costs do not become an undue burden on businesses or Inland Revenue. Imported mismatches will be covered through the upcoming workshops and we will report back on this matter as part of final policy recommendations.

Effect on taxation of foreign branches of New Zealand companies

41. A number of submitters argued that the adoption of recommendation 6, denying the ability of New Zealand companies to use foreign branch losses to reduce New Zealand taxable income, meant that New Zealand should revisit its current system of taxing the business income of foreign branches. Indeed, some submissions argued that an exemption for active income of a foreign branch should be enacted regardless of whether the hybrid rules proceed.

42. This proposal was considered and rejected in an earlier Cabinet paper (T2013/2166 PAS2013/162). If the hybrid rules were to proceed on the basis set out in the preceding paragraph, there would be a good argument in favour of revisiting the proposal.

43. However, the OECD is in the process of modifying its published position on this point. It now recommends that foreign branch losses be non-deductible in the head office country only if the losses are used in the branch country to reduce the tax on income which is not taxed in the head office company. For many ordinary businesses, this will not be the case, and therefore the adoption of the modified recommendation 6 will not affect their ability to use their foreign losses against New Zealand taxable income.

44. Accordingly, we recommend at this stage that the hybrid project proceed without considering the general tax treatment of foreign branch income and losses. However, this issue could be considered in the near future if the Government wished to revisit it, subject to resource constraints.

Branch mismatches

45. On 22 August, the OECD released a Public Discussion Draft titled *BEPS Action 2: Branch Mismatch Structures*. This document discusses cross border tax mismatches arising in the context of branches. As the title suggests, the OECD sees these mismatches as part of the hybrids project (BEPS Action 2).

46. The branch mismatches in the Discussion Draft are analogous to those considered in the Government's September discussion document. They involve deductible/non-includible, double deduction, or imported mismatches. The only difference is that these mismatches arise

because of differences in countries' rules for taxing branch income, rather than because of differences in how countries tax entities or instruments.

47. The counteractions proposed in the Discussion Draft are also of the same nature as those proposed in relation to hybrid mismatches.

48. Officials are of the view that these mismatches also need to be considered. We note that the UK's hybrid rules deal with branch mismatches, and that UK officials have stated that without this, the rules would have been much easier to circumvent.

49. Officials believe it will be much better to consider branch mismatches in the context of the current consultation. Accordingly, we propose to discuss them at our meetings in mid/late March with the Corporate Taxpayer Group and Chartered Accountants Australia and New Zealand. We will also approach the New Zealand Law Society and the New Zealand Bankers' Association and offer them the opportunity to consider the branch mismatch issues. Apart from some individuals who submitted on the Government discussion document, these four groups represent all of the original submitters. We expect submitters will be comfortable with this approach.

De minimis rule

50. Four submissions supported a de minimis rule either generally, or specifically for the imported mismatch rule, to reduce compliance costs. One supported consideration of a general de minimis rule, but was concerned about possible complexity in the rules to show that that the de minimis could be relied upon. The submitter noted the imported mismatch rule (recommendation 8) as a place where a de minimis might be particularly useful. Two suggested a general de minimis so the rules would only be targeted at higher value transactions (e.g. $1m of relevant income/expenditure) or would not apply to smaller taxpayers (e.g. turnover under $80m). The fourth was supportive of a de minimis rule for the imported mismatch rule.

51. Other than where the rules apply to timing mismatches, officials do not support a de minimis at this stage, but this will be discussed further as part of the private sector workshops. The OECD Final Report does not have a de minimis. For many of the rules, e.g. recommendations 3 and 6, it would be very complex to have a de minimis 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. Within that context, even smaller taxpayers can be expected to understand how they are taxed in the countries in which they operate, recognizing that in most cases the rules only operate within control groups or related parties.

52. In relation to the imported mismatch rule, presumably the de minimis would generally be based on the level of a New Zealand company's interest expense. This could be a workable rule, though if a group has operations in, for example, the UK, the group will have identified possible imported mismatches in any event.

53. Officials will keep this matter under review, with a particular eye to whatever measures are adopted in Australia.

Regulatory capital (banks and insurance companies)

54. A number of submissions addressed the question of whether regulatory capital required to be issued by banks and insurance companies should be subject to the hybrid regime. Capital adequacy regulations may lead, if not inevitably then without apparent effort, to the issue of cross border hybrid arrangements. A significant amount of hybrid capital has been issued by the New Zealand branches of the Australian trading banks with New Zealand operations. This capital is hybrid because it is treated as debt by New Zealand (and is therefore deductible) and as equity by Australia (and can therefore have franking credits attached to it, which can reduce or eliminate an Australian holder's Australian tax liability on the dividend).

55. Submissions made the following arguments:

- Deductible/frankable instruments should not be regarded as hybrids at all, because franking credits are a limited resource and represent tax actually paid in Australia.
- Bank regulatory capital should be excluded from the hybrid rules, given that the legal terms which give rise to its hybridity (subordination to other debt, conversion to equity in the case of distress etc.) are often the result of regulatory requirements.
- Bank regulatory capital should be excluded from the hybrid rules because it is economically important.
- Banks do not have a choice as to whether or not to attach franking credits to the return paid on deductible/frankable instruments – attachment of credits is a requirement of Australian law. Accordingly it would not be appropriate to apply the hybrid rules to the tax treatment of that return.
- Bank regulatory capital should be excluded from the hybrid rules because the effect of including it will be that it is replaced with debt having a higher rate of interest, which would reduce the New Zealand tax base. Currently the hybrid debt has a lower rate of interest, because the third party lenders (mostly Australian individuals and investment entities) are prepared to take a lower cash return given that they receive franking credits on top of the interest.
- Bank regulatory capital should be grandparented if issued before a certain date, especially because it is often publicly issued and refinancing it would not be straightforward.

56. With the exception of the sixth point, and possibly the fifth point, officials do not believe that these submissions have much force for the following reasons:

- In relation to deductible/frankable instruments, there is a hybrid mismatch. It is true that the nature of the imputation system means that this mismatch cannot be inexhaustibly tapped. However, so long as a company is not otherwise

distributing all of its tax-paid profits (which is relatively unusual), the mismatch can be profited from in a similar way as a deductible/non-assessable mismatch.

- As to the second and third submission, applying the hybrid rules to bank regulatory capital does not prevent such capital being issued cross border. It simply ensures that it does not enjoy an unintended tax benefit. The banking regulators have no interest in whether regulatory capital gives rise to tax benefits or not, and the removal of such benefits will in no way undermine their work. The result of applying the hybrid rules is simply that regulatory capital instruments are treated the same way as they would if both the issuer country and the investor country had the same tax rules.
- As to the fourth submission, the Australian requirement to attach franking credits to the distribution is entirely consistent with New Zealand denying a deduction for the distribution. The distribution will then be treated as a payment of a dividend by both Australia and New Zealand. There is more of a difficulty for Australia in determining how it should apply the hybrid rules. It might, for example, be difficult for Australia both to require a franking credit to be attached to the dividend, and deny the shareholder a credit for that imputation credit. However, this is an issue for Australia to determine.
- As to the fifth submission:
  - When the deductible/frankable instruments were first issued, to some extent they did replace equity, rather than debt, financing. It is possible that if they are cancelled, they will be partly replaced with equity.
  - The banks issuing these instruments are currently operating with more equity than "required" by the thin capitalisation rules, and accordingly the hypothesis that they will always minimise their New Zealand equity is not correct.
  - Because they bear a higher risk, deductible/frankable instruments have a higher funding cost than ordinary debt. This helps counter the rate reduction achieved by the tax arbitrage.
  - Not all deductible/frankable instruments are issued to third parties. There are also structures involving intra-group issuances which support third party issuances. The return payable on some instruments issued in these structures have been sufficiently high to raise transfer pricing concerns.

  However, in the event that Australia decides not to deal with the treatment of deductible/frankable regulatory capital, officials would wish to consider more closely the effect on the New Zealand tax base of applying the hybrid rules to it.

57. New Zealand's stance in this matter will not be relevant if Australia acts, in accordance with hybrids recommendation 2, to tax the return on deductible/frankable instruments as interest (and therefore not frankable). A decision on this has been expected for some time, but has not yet been made. Officials intend to meet with submitters on this point once the Australian decision on regulatory capital has been announced. Officials will also consult with the Reserve Bank of New Zealand before final policy recommendations are made.

58. Officials are sympathetic to the arguments in favour of grandparenting regulatory capital issued before the release of the Government discussion document on 6 September 2016. The finer details of grandparenting are likely to be clearer in our next report on this

matter. Officials also hope that any grandparenting will be co-ordinated and consistent with whatever decision is made by Australia.

Effect on New Zealand foreign trusts

59. The discussion document on hybrid mismatch arrangements proposes to apply the hybrid rules to tax the foreign source income of New Zealand foreign trusts (i.e. trusts with a New Zealand trustee but no New Zealand settlor) if that income is not being taxed to:

- the beneficiary, in the case of beneficiary income;
- the settlor, in the case of trustee income,

in the beneficiary/settlor's country of residence, if the non-taxation in the residence country is the result of the trust being a reverse hybrid. We received one submission in favour of this proposal and 7 not in favour.

60. Many of the submissions referred to the fact that the 2016 report of the Government Inquiry into Foreign Trust Disclosure Rules (the Shewan Report) recommended no change to the current trust tax regime. They argued that this recommendation supported not applying hybrids recommendation 5.2 to New Zealand foreign trusts. However:

- the terms of reference of the Inquiry were directed solely at trust record keeping and disclosure, not trust taxation;
- the comments which were made in the Shewan Report on trust taxation were not made having any regard to the double non-taxation issue which is central to the hybrid rules. The Shewan Report was considering the appropriateness of the trust tax regime as a matter of the coherence of the New Zealand tax base on a stand-alone basis. It correctly stated that the non-taxation of non-residents on non-New Zealand source income was and remains orthodox international tax policy (paragraph 4.15). Leaving aside the hybrid rules, the Report recognized that it is reasonable for New Zealand not to tax such income when it is derived by the New Zealand resident trustee of a trust with no New Zealand settlor. However, the Shewan Report did not consider the impact of BEPS Action 2 on international tax policy. In particular, it did not consider whether a New Zealand foreign trust is a reverse hybrid (as defined for purposes of the hybrid rules) and whether, if it is, New Zealand tax should be imposed on its income.

61. The Inquiry concluded that the changes to trust disclosure rules and practice which it recommended would deal adequately *with the problems identified, including reputational risk.* It was not asked to, nor did it, consider the problem of double non-taxation, and accordingly no conclusions were reached or recommendations made that are relevant to this issue.

62. Officials have discussed the preceding paragraphs with John Shewan, who agrees that we have accurately reflected the scope and conclusions of his report.

63. Submissions against our proposal raised a number of other points which, along with our responses, are summarised below.

- A New Zealand trust is not a reverse hybrid, since it is not tax transparent in New Zealand. That is because the trustee is always taxable on New Zealand source trustee income. This submission is not correct. An entity can be partially tax transparent. The Final Report states (paragraph 140) that a person will be treated as tax transparent in respect of a payment where the reverse hybrid attributes or allocates a payment that it has received to an investor, and the effect of such attribution or allocation is to treat the payment as it would have been treated had it been paid directly to the investor. Clearly then a New Zealand foreign trust is tax transparent with respect to income allocated to beneficiaries. As the Government's discussion document stated, this is not the case for trustee income. The argument for New Zealand taxation of foreign source income in that situation rests on the New Zealand principle that the residence of the settlor determines whether or not the trust's foreign source income is subject to New Zealand tax.
- The current tax treatment of New Zealand foreign trusts is appropriate and should be maintained. We agree that the current tax treatment makes sense on a single jurisdiction basis. However, it can lead to double non-taxation as a result of a hybrid mismatch. If the jurisdiction of the settlor (in the case of trustee income) or the beneficiaries (in the case of beneficiary income) would ordinarily tax the income, but is not doing so because it regards the income as derived by the New Zealand trustee, then there is double non-taxation as a result of differing treatments of the trust. This is an issue which the hybrid rules are trying to address.
- Determining whether a New Zealand foreign trust and the settlor are in the same "control group" is not possible. Some work may need to be done in this respect, but our current associated person rules will provide a good foundation.
- The fact that the foreign settlor of a trust is not taxed in another country on foreign source trustee income does not justify New Zealand taxing the New Zealand trustee on that income. The settlor is not taxed because the income is not theirs. Indeed, the settlor may be dead when the income is derived. This submission ignores the fact that the basis for New Zealand not taxing this income is the residence of the settlor. The logical extension of this approach is that the settlor's residence country should regard the income as that of the settlor.
- It might be more logical to tax the New Zealand trustee on its foreign source trustee income if it can be determined that the beneficiaries who will receive the income are not taxable on the income. However, in a discretionary trust this is not possible, because it is not known which beneficiary will receive the income. We do not agree that the foreign tax treatment of the settlor should not be taken into account. We do agree though that, if it can be shown that a beneficiary is subject to tax on foreign source trustee income, that would mean there is no hybrid mismatch to counteract in New Zealand.
- Non-taxation of the settlor or a beneficiary might be a result of the person being resident in a country with no income tax, or with a territorial tax system, rather than because the person is resident in a jurisdiction which treats the income as derived by the trustee. We agree that in this case, double non-taxation is not a result of a hybrid mismatch, and there should be no hybrid counteraction.

Applying the rules only to cases where mismatches result from hybridity will be required generally, and this is not a special case.

- Difficulties would arise from the proposal where the trust holds foreign shares which are taxed under the fair divided rate (FDR) method. The FDR method is unique to New Zealand. Since the settlor residence country will not be taxing on the same basis, the reason that the trust's income (calculated under New Zealand law) is not taxable in the settlor country is that that country will not see the settlor as having such income. We agree that differences of this kind will create complexity. However, this complexity will be an issue for other aspects of the rules as well, and will need to be dealt with. As a matter of principle, the issue would be resolved by determining, in the year the New Zealand income is derived whether the beneficiary or trustee would be taxed on that income if it also arose in their residence jurisdiction.
- Compliance costs from this proposal would be substantial and in most cases no tax would be generated. There would no doubt be some compliance costs from this proposal, though in the main they would revolve around the need to communicate information already known by one of the parties or its advisors to the other parties or advisors. An assumption that this sort of "intra-group" communication is possible underpins many of the proposed rules and we do not consider there are any good reasons for treating trusts differently. It is possible that no or little New Zealand tax would be generated. However, the proposals would assist in the general move towards shutting down hybrid-mismatch-driven double non-taxation, the aim of which is to increase global tax revenues.
- The proposal goes well beyond the ambit of the hybrid proposal, and appears to be advanced to support New Zealand tax applying when none would ever arise apart from the existence of a New Zealand resident trustee. This submission misses the point that the effect of the rules will only be to rectify double non-taxation arising from the existence of the New Zealand resident trustee. For example, if the settlor would not be taxed on the foreign source income if it derived the income directly, there is no suggestion that the hybrid rules would impose New Zealand taxation on that income if derived by a New Zealand tax resident trustee on whom the settlor has settled the income producing property.

64. Since New Zealand trusts can give rise to double taxation due to hybrid mismatches, we intend to continue to develop our proposals in this respect, though we agree that applying New Zealand tax to trustee income on the basis of the existence of a hybrid mismatch will present some challenges.

Interaction with withholding tax

65. A number of submissions were concerned by the proposal in the Discussion Document that where an interest payment is disallowed under the hybrid rules, withholding tax would still be imposed as if that payment were interest. They were concerned that this would constitute double taxation. If the payment were treated as a dividend and fully imputed, it would not be subject to withholding tax.

66. This is a complex issue. It may well be the case, at least with respect to recommendations 1 and 3, that ideally, the withholding tax treatment would match the deductibility status. However, we have assumed that this might not always be possible, particularly if the payer is not aware at the time of making the payment that the hybrid rules deny a deduction. Officials are continuing to review this question.

Transitional

67. The OECD Final Report recommended no grandparenting of existing transactions and an effective date based on the tax year which gives taxpayers sufficient time to restructure their transactions, which will all be either between related parties or within a control group.

68. The Discussion Document proposed to follow this approach, with the effective date being the first balance date after enactment of the legislation.

69. A number of submissions were in favour of grandparenting existing transactions, either without limit, or for 3-5 years. This was on the basis that taxpayers should be entitled to retain tax benefits that existed when transactions were entered into.

70. As set out in paragraph 58, we now propose to consider limited grandparenting for frankable/deductible instruments issued before the release of the Discussion Document. Consistent with the OECD, and the approach in the UK, we do not propose any further grandparenting. The hybrid rules are doing no more than removing tax benefits which were not, in aggregate, intended by either country, and restoring a more "normal" result. The hybrid rules apply generally to transactions between related parties, which can generally be undone with relative ease. If there are any situations where this is not so, as with the frankable/deductibles, they have not emerged in consultation to date. If any emerge, we can consider them on a case by case basis.

71. Many submitters supported New Zealand having the same effective date for the rules as Australia. Others submitted that New Zealand should not enact its rules until after the Australian rules have become effective, in order to give more clarity.

72. Officials are sympathetic to the submissions for co-ordination on this point with Australia, but continue to believe at this stage that the core proposal (effective for balance dates after enactment) is a reasonable one.

Consultation process

73. A number of submissions sought further consultation on the proposals. Officials are sympathetic to these submissions, and are currently engaged in a consultation programme that is scheduled to take place between now and June. As mentioned above, we anticipate this process will also include consultation on the OECD's discussion draft on branch mismatches.

This timeline could be altered to allow for final Cabinet decisions to be made before the pre-election period commences on 23 June. However, this would inevitably reduce the scope and/or depth of the consultation. The private sector may also be disappointed by such a change. We welcome your views on the timing of this process.

74. Some submitters also sought the opportunity to review draft legislation. Draft legislation was released for comment in the UK, and Australia is likely to do the same. Officials currently consider that, if final policy decisions are made before the election (irrespective of whether this is just before or after the pre-election period commences), consulting on draft legislation over the election period would be a useful exercise. Given the inevitable complexity of legislation on these issues, consultation on draft legislation would likely result in a smoother select committee process when final legislation is introduced to Parliament. If you indicate you are comfortable with consultation on draft legislation, we will include a request to that effect in the Cabinet paper seeking final policy decisions.

Appendix 1: List of submitters to Government discussion document Addressing Hybrid Mismatch Arrangements

Andrea Black
ANZ Bank New Zealand Limited
ASB Bank Limited
Bank of New Zealand
Baucher Consulting Limited
Chapman Tripp
Chartered Accountants Australia and New Zealand (CA ANZ)
Corporate Taxpayers Group (CTG)
Deloitte
Ernst & Young Limited
Fisher & Paykel Healthcare Limited
Insurance Australia Group Limited (IAG)
JJL Hoogenboom
KPMG
New Zealand Bankers' Association (NZBA)
New Zealand Law Society
Olivershaw Limited
PricewaterhouseCoopers
Russell McVeagh
Westpac New Zealand Limited

POLICY AND STRATEGY

Tax policy report: Cabinet paper - foreign hybrid entity double deductions and BEPS reforms

Date:	6 April 2017	**Priority:**	**High**
Security level:	Sensitive - Budget	**Report no:**	T2017/949 IR2017/237

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations of this report. **Authorise** the lodgement of the attached Cabinet paper.	Either: • 10:00 am Wednesday 12 April 2017 for Cabinet on 18 April 2017; or • As soon as possible as a late paper for EGI on 12 April 2017.
Minister of Revenue	**Agree** to the recommendations of this report. **Authorise** the lodgement of the attached Cabinet paper.	Either: • 10:00 am Wednesday 12 April 2017 for Cabinet on 18 April 2017; or • As soon as possible as a late paper for EGI on 12 April 2017.

Contact for telephone discussion (if required)

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

6 April 2017

Minister of Finance
Minister of Revenue

Cabinet paper - foreign hybrid entity double deductions and BEPS reforms

1. This report asks you to refer the attached Cabinet paper to Cabinet Office so that it may be considered either by:
   - The Economic Growth and Infrastructure Committee (EGI) at its meeting on 12 April 2017; or
   - Cabinet at its meeting on 18 April 2017.

2. The paper proposes that Cabinet:
   - Agree to tax law changes to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships, to reduce their tax liabilities in New Zealand; and
   - Note the progression of proposals contained in three BEPS discussion documents (*Addressing hybrid mismatch arrangements*, *BEPS – transfer pricing and permanent establishment avoidance,* and *BEPS - strengthening our interest limitation rules*), subject to modification in consultation.

3. If Cabinet agrees to these recommendations, the Budget 2017 revenue forecasts will be adjusted by $100 million per year from 2019/20 (with $50 million forecast in the preceding year).

Recommended action

We recommend that you:

Authorise lodgement of the attached Cabinet paper either:

a. by 10:00 am, Wednesday 12 April 2017 for Cabinet on 18 April 2017.

Authorised/Not authorised

Authorised/Not authorised

OR

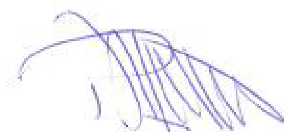
b. as soon as possible as a late paper for EGI on 12 April 2017.

Authorised/Not authorised

Authorised/Not authorised

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

Steve Mack
Principal Advisor
The Treasury



Paul Kilford
Policy Manager
Policy and Strategy
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Budget Sensitive

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

Cabinet Economic Growth and Infrastructure Committee

FOREIGN HYBRID ENTITY DOUBLE DEDUCTIONS AND BEPS REFORMS

Proposal

1. This paper seeks Cabinet agreement to tax law changes to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships, to reduce their tax liabilities in New Zealand. In addition, this paper seeks Cabinet's approval for the proposals of three BEPS discussion documents to be progressed, subject to modification in consultation.

Executive summary

2. In September 2016, the Government released the discussion document *Addressing hybrid mismatch arrangements* [CAB-16-Min-0442]. This was followed by the release of two further discussion documents for public consultation in March 2017; *BEPS – transfer pricing and permanent establishment avoidance,* and *BEPS - strengthening our interest limitation rules* [CAB-17-MIN-0041]. These three documents are a substantial part of the Government's ongoing response to the OECD's project to address base erosion and profit shifting (BEPS). BEPS is a term that describes the various international tax planning techniques that some multinational businesses use to minimise their tax liabilities.

3. The *Addressing hybrid mismatch arrangements* discussion document proposed a comprehensive response to hybrid mismatches, including the use of double deductions by hybrid entities. Officials are currently consulting with the private sector on specific design issues relating to the proposals in the discussion document.

4. Before then, it is important to confirm that the Government is willing to act on the most prevalent hybrid structure involving outbound investment by New Zealand-based groups by restricting the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships (ALPs), to reduce their tax liabilities in New Zealand.

5. This paper also seeks Cabinet's approval for the other BEPS reforms proposed in the September 2016 and March 2017 discussion documents to be progressed, subject to modification in consultation, for implementation from 1 July 2018. When combined with the decision on foreign hybrid entity double deductions, this will result in an adjustment to the revenue forecasts of $100 million per year from 2019/20 (with $50 million forecast in the preceding year). Given this is a conservative estimate, we note there is an accompanying positive fiscal risk that the revenue may be higher than estimated.

6. We currently anticipate that final policy recommendations on these BEPS reforms will be considered by Cabinet later this year.

Background

BEPS

7. The New Zealand Government's ongoing BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan, which was finalised in October 2015. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

8. Part of the OECD/G20 BEPS Action Plan is *Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements* (the OECD recommendations), under which the OECD has designed a set of hybrid mismatch rules for countries to incorporate into their own tax systems. While it is not mandatory to adopt the OECD recommendations, OECD and G20 countries have agreed a general tax policy direction in respect of Action 2. This means that they are expected to converge over time in their treatment of hybrid mismatch arrangements following the agreed common approaches.

9. The OECD has also recommended actions on *limiting base erosion involving interest deductions and other financial payments* (Action 4), *preventing the artificial avoidance of permanent establishment status* (Action 7) and *aligning transfer pricing outcomes with value creation* (Actions 8-10). The Government's March 2017 discussion documents outline a package of proposed law changes intended to address the OECD's concerns and recommendations in these areas, although the specific proposals are tailored for the New Zealand environment and so differ in some respects from the OECD's recommendations.

Hybrid mismatch arrangements

10. Hybrid mismatch arrangements arise when countries classify transactions and entities differently from each other under their domestic laws. For example, fixed rate shares may be treated as debt in one country and shares in another. This is inevitable. However, differences in classification provide multinational groups with opportunities to arbitrage between tax systems in two or more jurisdictions to create tax advantages. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

11. The Government's discussion document *Addressing Hybrid Mismatch Arrangements* proposed that New Zealand adopt the OECD recommendations by enacting a specific set of rules that remove the tax advantages of hybrid mismatch arrangements. The proposals apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of having hybrid mismatch rules is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

12. The global response on adopting the OECD recommendations on hybrid mismatch arrangements is as follows:

- a. The United Kingdom enacted rules earlier this year to counter hybrid mismatch arrangements (effective 1 January 2017).
- b. The EU has released a binding directive which requires EU members to introduce hybrid rules (effective 1 January 2020).

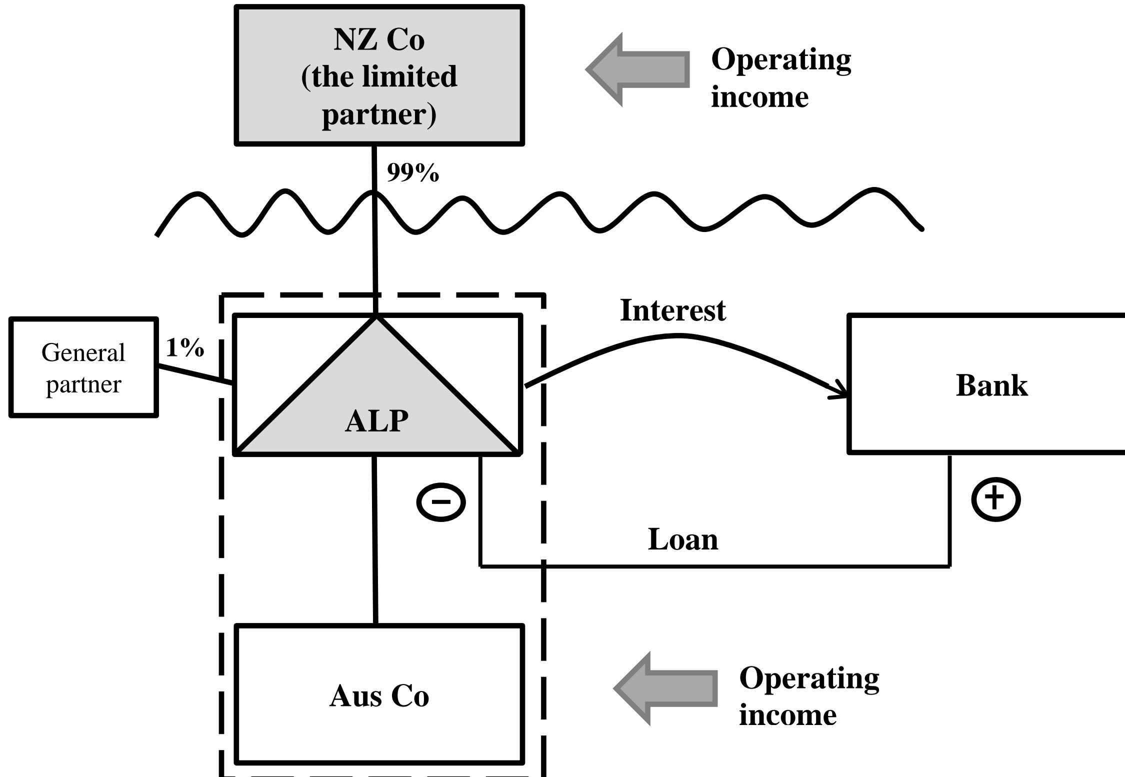
c. Australia is committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment).

Foreign hybrid entity double deductions

13. A type of hybrid mismatch featured in the OECD recommendations and featured in the *Addressing hybrid mismatch arrangements* discussion document is the double deduction mismatch, whereby a multinational group claims a tax deduction in two different jurisdictions for what is in substance one item of expenditure. This is most commonly achieved through the use of a hybrid entity – an entity that is treated for tax purposes as transparent (its income and expenditure is attributed to its owners) in the jurisdiction of its parent and opaque (it is taxed as a separate entity on its income and expenditure) in the jurisdiction it was established in. If that hybrid entity makes a loss it can be grouped against the profits of a related party in its establishment jurisdiction. Additionally, the hybrid entity's parent is attributed the losses of the hybrid entity under the parent jurisdiction's laws which can then be offset against its own profits. Each of these entity characterisations is valid when viewed in isolation, but in combination the hybrid entity allows the group to reduce its taxable income in two countries where there is only one economic loss.

14. This double deduction effect can be achieved through the use of an Australian Limited Partnership (ALP), which is a type of hybrid entity that can be established in Australia with a New Zealand company as the 99% parent/limited partner. The diagram below sets out this structure and assumes that the ALP borrows money from a third party bank (and pays interest on that loan) to help fund the wider group.

Figure 1 – ALP double deductions structure



15. The ALP is treated akin to a company in Australia, such that its deductions resulting from its interest payments can be grouped with the operating income of Aus Co to reduce tax payable in Australia. However, the ALP is treated as a partnership in New Zealand, so (99%

of) its deductions are attributed to NZ Co (the limited partner) and can be offset against New Zealand operating income. In this example, the expenditure of the ALP, and its ability to claim deductions, is uncontentious – it is interest payable at an arm's length rate to a bank. Nevertheless, the tax revenue collected on two sources of operating income in two countries is reduced by using the ALP as the paying entity.

16. This paper seeks Cabinet agreement to introduce tax law changes to restrict the ability of a New Zealand business to use double deductions of foreign hybrid entities, such as ALPs, to reduce its New Zealand tax liability. This restriction may be limited, so it applies only to the extent that the double deductions are used to reduce the foreign tax liability of a related party.

17. Alongside rules to achieve this effect, an option being considered to reduce compliance costs is to develop an elective regime whereby the New Zealand parent of a foreign hybrid entity could elect to treat that entity as opaque in order to match the foreign jurisdiction treatment. This may achieve a slightly harsher outcome to the hybrid rule proposal, with reduced compliance costs. The purpose of such a rule would be to allow taxpayers a path to removing the tax advantage of their foreign hybrid entities while avoiding the scope of the proposed hybrid mismatch rules which carry a higher degree of complexity.

18. Final policy and design proposals on how the rule countering double deductions would be given effect, along with the remaining parts of the hybrid mismatch arrangements project, will be considered by Cabinet later this year. We currently anticipate this paper will be contemporaneous with a paper detailing the response to the other BEPS proposals mentioned below.

Other BEPS initiatives

19. The *BEPS – transfer pricing and permanent establishment avoidance* discussion document consults on proposals to counter permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue deal with uncooperative multinationals. These proposals are aimed at large multinationals that are able to report low taxable profits in New Zealand despite significant economic activity here. The main proposals are:

- An anti-avoidance rule that will prevent multinationals from structuring their operations to avoid having a permanent establishment (a taxable presence) in New Zealand where one exists in substance.

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

- Stronger transfer pricing rules which will adjust related party transactions if they don't align with the actual substance of the multinational's economic activities and shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arms-length.

- A range of administrative measures that will strengthen Inland Revenue's powers to deal with large multinationals (with at least EUR €750m of global revenues) that do not co-operate with a tax investigation.

20. Many of these proposals are based on similar tax reforms that Australia has introduced in recent years.

21. The *BEPS – strengthening our interest limitation rules* discussion document consults on proposed law changes that will limit the ability of multinationals to use interest payments to shift their New Zealand profits offshore. The main proposals are:

- A proposal to limit high-priced related party debt by introducing an interest rate cap. The proposed cap would base the allowable interest rate on the market interest rates that the particular multinational group would actually use when borrowing from a third party such as a bank. The cap would be based on the credit rating of the multinational group as a whole, rather than their New Zealand subsidiary.

- A proposal to tighten our existing thin capitalisation rules which limit debt as a percentage of total assets. The proposed rule would remove assets funded by non-debt liabilities from the measure of a firm's total assets. Examples of non-debt liabilities are trade credits, provisions and out-of-the-money derivatives. This change would bring New Zealand's rules more in line with other countries with thin capitalisation rules, including Australia.

Consultation

22. Inland Revenue and Treasury officials have discussed the foreign hybrid entity double deductions issue with interested private sector groups as part of ongoing consultation workshops on the wider hybrids project. Officials have also been in contact with the Australian Tax Office, the Australian Treasury, and the OECD secretariat in relation to this particular issue and the wider project.

23. In relation to the two March discussions documents, Inland Revenue has also consulted with the Treasury, the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment. Officials have also been in contact the Australian Treasury and the Australian Taxation Office. Officials have started to meet with key stakeholders to discuss these proposals but submissions are not due until 18 April.

Financial implications

24. The proposed rule on foreign hybrid entity losses derived from the *Addressing hybrid mismatch arrangements discussion document* is estimated to increase tax revenue by $50 million per annum once fully implemented. In the first year of application 2018/19, approximately half ($25 million) of that estimated revenue will be captured.

25. That rule may influence taxpayers to restructure their arrangements so that they fall out of the scope of the rule. This should not alter the estimated revenue effect. Further, specific design issues relating to the proposed rule (such as the opaque election to ease compliance costs) should not affect the estimated revenue.

26. A total of $140 million in additional BEPS revenues was estimated at the time the March discussion documents were released - assuming all of the proposals are implemented.

27. We seek Cabinet's approval for the BEPS reforms to be progressed, subject to modification in consultation, for implementation from 1 July 2018. When combined with the decision on foreign hybrid entity double deductions, this will result in an adjustment to the revenue forecasts of $100 million per year from 2019/20 (with $50 million forecast in the preceding year). Given this is a conservative estimate, we note there is an accompanying positive fiscal risk that the revenue may be higher than estimated.

28. These estimates assume that the Government will introduce a BEPS taxation bill following the general election which includes the proposed foreign hybrid entity rule and other proposed BEPS measures and that the bill is enacted as legislation and is in force by 1 July 2018.

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

Human rights

29. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative implications

30. Primary legislation would be required to implement the proposals in this paper. At this stage, it is feasible for legislation to be introduced to Parliament that will encompass all the BEPS measures (including the hybrids mismatch arrangements project) in an omnibus taxation bill following the September general election.

Regulatory impact analysis

31. The Regulatory Impact Analysis Team at Treasury has advised that Inland Revenue is not required to prepare a Regulatory Impact Statement (RIS) at this stage of the policy process. The merits of the "in principle" decisions being taken at this stage can be made based on analysis already provided in the public consultation papers released last year (on hybrids) and in March (for the balance of the BEPS proposals). A RIS will be provided when Cabinet is asked to make final policy decisions on these measures.

Publicity

32. The offices of the Minister of Finance and the Minister of Revenue will arrange for the announcement of this decision if necessary, whether as part of Budget 2017 or otherwise.

Risks

33. There are risks associated with including the revenue from these changes in the Budget documents. Particularly in respect of the issues covered by the March discussion documents, the Government could be accused of making decisions before the consultation period has closed, effectively circumventing the generic tax policy process. Equally, the private sector may see the relatively conservative estimate of $50m for these changes as an indication that the Government does not intend to implement the full suite of changes being consulted on.

34. In any event, we consider risks can be mitigated through clear communication of the process by which the estimates are included in the Budget process.

Recommendations

35. We recommend that you:

1. **Agree** to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships (ALPs), to reduce their tax liabilities in New Zealand;

2. **Note** that the reforms proposed in the three BEPS discussion documents *Addressing Hybrid Mismatch Arrangements, BEPS – transfer pricing and permanent establishment avoidance* and *BEPS – strengthening our interest limitation rules* will be progressed, subject to modification in consultation, for implementation from 1 July 2018;

3. **Note** that as a result of agreeing to the foreign hybrid entity double deductions measure and progressing the hybrid mismatch arrangements project and the other BEPS proposals, the Budget 2017 revenue forecasts will adjusted as follows:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

4. **Note** that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later this year.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: New Zealand's adoption of the OECD's Multilateral Instrument

Date:	18 April 2017	**Priority:**	**High**
Security level:	Restricted	**Report no:**	T2017/1004 IR2017/260

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to the recommendations of this report **Sign** the attached Cabinet paper	26 April 2017
Minister of Revenue	**Agree** to the recommendations of this report **Refer** the attached papers to the Minister of Foreign Affairs for consultation **Sign** and **refer** the attached Cabinet paper and accompanying documents to Cabinet Office	10am, 27 April 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Carmel Peters	Policy Manager, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Jess Rowe	Senior Policy Advisor, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	

18 April 2017

Minister of Finance
Minister of Revenue

New Zealand's adoption of the OECD's Multilateral Instrument

Executive summary

1. New Zealand's adoption of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("the Multilateral Instrument" or "MLI") is one of the core parts of the Government's base erosion and profit shifting (BEPS) reform package.

2. The MLI will modify a significant number of New Zealand's existing double tax agreements (DTAs) in order to bring them into line with OECD recommendations to address BEPS. The New Zealand Government has committed to signing the MLI on 7 June 2017 at the OECD signing ceremony in Paris.

3. This report recommends that you sign and submit the attached Cabinet paper to the Cabinet Office by 10am, Thursday 27 April 2017 for consideration by the Cabinet External Relations and Defence Committee at its meeting of 2 May 2017.

4. The Cabinet paper seeks authority for New Zealand to sign the MLI. The Cabinet paper also seeks approval for the steps necessary to give effect to the provisions of the MLI under New Zealand law. As one of the steps involves Parliamentary treaty examination, the Cabinet paper seeks approval of an extended National Interest Analysis ("NIA").

5. The Ministry of Foreign Affairs and Trade has been consulted during the preparation of the attached Cabinet paper and NIA.

6. An officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. The issues paper sought feedback on possible implementation issues associated with New Zealand's signature and ratification of the MLI. Submissions closed on 7 April 2017 and five were received. Two stakeholder workshops (with representatives from Chartered Accountants Australia and New Zealand (CA ANZ) and Corporate Taxpayers Group (CTG)) were held on 27 and 28 March 2017 to enable officials to better understand practitioners' concerns.

7. This report provides you with an overview of the submissions received and alerts you to aspects of the MLI considered to be the most controversial by submitters.

Withheld under section 6(a) of the Official Information Act 1982

Recommended action

We recommend that you:

(a) **Note** that five submissions were received on the MLI issues paper and this report summarises the submissions received and officials' advice with respect to those submissions.

Noted Noted

(b) **Refer** this report and its attachments to the Minister of Foreign Affairs for consultation.

Referred/Not referred

(c) **Agree** to the recommended position for New Zealand on each substantive provision of the MLI set out in Appendix B.

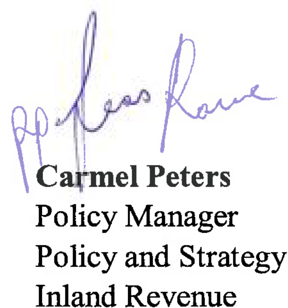
Agreed/Not Agreed Agreed/Not Agreed

(d) **Sign and refer** the Cabinet paper, the text of the MLI, New Zealand's draft reservations and notifications, and the extended NIA to Cabinet Office before 10am on Thursday 27 April 2017.

Signed/Not signed

Signed and referred/Not signed and Referred

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



Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

1. Addressing tax treaty abuse has been a major part of the BEPS project and a number of the Action items in the OECD/G20 BEPS Action Plan make recommendations that can only be implemented through changes to DTAs, including:

- preventing the granting of treaty benefits in inappropriate circumstances;
- preventing the artificial avoidance of permanent establishment status;
- neutralising the effects of hybrid mismatch arrangements that have a treaty aspect and modifying the approach to a company that is resident in both contracting states; and
- providing improved mechanisms for effective dispute resolution.

2. Some of these recommendations are BEPS "minimum standards" that countries that commit to solving BEPS are expected to adopt. All other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following adoption of the OECD/G20 BEPS Action Plan.

3. Countries were presented with the difficulty of how to quickly and efficiently implement these measures without requiring the bilateral renegotiation of several thousand existing DTAs. To this end, the OECD brought approximately 100 jurisdictions together to develop a multilateral treaty that would swiftly modify the DTAs of participating jurisdictions, thus avoiding the need for protracted bilateral negotiations.

4. New Zealand officials were involved in the negotiation of the MLI text, which was formally adopted by the OECD in November 2016.

5. The New Zealand Government has committed to signing the MLI on 7 June 2017 at the OECD signing ceremony in Paris and the Minister of Finance has delegated this duty to the Minister of Revenue. An Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI. The Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature.

6. New Zealand and other participating jurisdictions have submitted a preliminary list of notifications and reservations to the OECD, which includes the DTAs New Zealand has nominated to be modified by the MLI. These lists will determine which of New Zealand's DTAs are modified and how they are modified, but will not be considered final until New Zealand ratifies the MLI.

7. Where both parties to a DTA include that DTA in their respective lists of notifications and reservations, that DTA is a "covered tax agreement". A list of New Zealand's current covered tax agreements based on preliminary notifications and reservations as at 11 April 2017 is included at Appendix C. Based on current draft notifications, New Zealand is expected to have 29 covered tax agreements. While this list is not final, it provides a fairly

good indication of the likely coverage of the MLI. New Zealand's approach is to nominate most of its 40 DTAs. This gives New Zealand the best chance of strengthening our DTAs with as many jurisdictions as possible. The only DTAs not nominated are those with counterparties who are not expected to sign the MLI.

8. A list of the provisions New Zealand has indicated it will adopt is included as Appendix B. New Zealand's approach has been to adopt all applicable minimum standard and optional provisions. This is because the OECD Model Tax Convention plays an important role in informing New Zealand's treaty policy and New Zealand has committed to resolving BEPS more generally. New Zealand also believes the changes to be made by the MLI are correct in principle and should be as widely adopted as possible.

Public consultation

9. An officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. The issues paper sought feedback on possible implementation issues associated with New Zealand's signature and ratification of the MLI.

10. While we do not generally consult on tax treaties, because of the novel nature of the MLI we recommended seeking submissions from the private sector on how it will work in practice. This issues paper focused on implementation issues, however submitters also commented on the substantive provisions as well.

11. Submissions closed on 7 April 2017 and five were received from Chartered Accountants Australia and New Zealand (CA ANZ), Corporate Taxpayers Group (CTG), EY, PwC and KPMG.

12. Two stakeholder workshops with representatives from CA ANZ and CTG were held on 27 and 28 March 2017 to enable officials to better understand practitioners' concerns prior to formal submissions being made.

Overall comments

13. CA ANZ and EY supported the adoption of the MLI as the most effective way to implement the treaty-related BEPS recommendations. EY agreed that the MLI should be implemented as widely as possible, taking up minimum standards and virtually all optional articles, with few reservations.

14. PwC acknowledged that participating in OECD and G20 initiatives to target BEPS is a key focus for the New Zealand Government, while not explicitly supporting the adoption.

15. CTG did not express an overall view on adoption, but submitted that New Zealand should not adopt all of the optional provisions.

16. KPMG acknowledged that the New Zealand Government has the constitutional ability to decide New Zealand's tax treaty position and that it therefore makes sense to achieve this in the shortest time at the least cost through the MLI, but KPMG noted that despite this constitutional position, it is also clear that in the current environment there is a demand for transparency and actual consultation for New Zealand's treaties. KPMG submit that this has not occurred with New Zealand's decision to sign the MLI, even with the release of the issues paper and views the implementation of the MLI as a "fait accompli". KPMG references in their submission as a point of comparison, the detailed consultation undertaken by the Australian Government.

17. Officials note that, consistent with international treaty practice, the negotiation of the MLI was on a strictly confidential basis and that public consultation by Australia and the UK (like New Zealand), was undertaken after the MLI had been negotiated and formally adopted. Unlike New Zealand, however, Australia consulted on what position the Australian Government should take in relation to specific provisions. The New Zealand Government did not choose to take that approach – instead focussing on implementation.

Specific submissions

18. The main issues raised in submissions relate to:

- substantive positions taken by New Zealand;
- requests for additional guidance and administrative resources to help taxpayers apply DTAs as modified by the MLI; and
- technical domestic law changes.

Substantive positions taken by New Zealand

19. Consistent with New Zealand's approach to DTAs more generally, submissions were not requested on New Zealand's position on the substantive provisions of the MLI.

20. We note the MLI has been negotiated and adopted at an international level, and is not able to be changed. The text was formally adopted by the OECD in November 2016. New Zealand supported the outcomes of the OECD/G20 BEPS Action Plan which are reflected in the MLI. The strengthened provisions contained in the MLI will be incorporated into the OECD Model Tax Convention and New Zealand's negotiating model going forward.

21. The issues paper did include a summary of the provisions New Zealand is intending to sign up to, in order to provide additional context for submitters. Submitters did comment on New Zealand position on the substantive provisions. We have highlighted the most controversial aspects in Appendix D. Generally speaking, the issues raised in relation to the substantive provisions are able to be managed administratively, are necessary to ensure New Zealand's DTA network is strengthened against common BEPS techniques or are consistent with New Zealand's overall position as a supporter of the OECD/G20 BEPS Action Plan. The

positions are also broadly consistent with the direction of New Zealand's treaty policy over time.

22. The substantive points raised by submitters and officials' responses are summarised in the table in Appendix D.

Additional guidance and administrative resources

23. A strong theme in submissions was the need for administrative guidance and access to competent authority resource to resolve uncertainty associated with the implementation of the MLI.

24. Submitters requested:

- guidance on how Article 3 (the fiscally transparent entity provision) affects collective investment vehicles with non-resident beneficiaries;
- specific guidance on the competent authority process for the application of dual resident entity provision (Article 4) and in the case of Australia (at least) the existence of a streamlined process or a self-assessment system;
- guidance on the application of the 365 day rule in the dividend transfer provision (Article 8) where the 365 day rule has not yet been met;
- administrative guidance on a simplified measurement rule for assessing whether a company is a land rich company rule (Article 9), for example a rule based on quarterly measurements;
- guidance on the interaction between section BG 1 and the treaty principal purpose test (PPT) (for example, a standard practice statement);
- guidance on New Zealand's position on profit attribution to permanent establishments;
- that Inland Revenue should maintain a list on its website of covered tax agreements, dates of "entry into effect for specific taxes" for each of New Zealand's covered tax agreements and any changes/additions by DTA partners so that taxpayers can easily determine when a DTA has been modified and the effective date of amendments to particular provisions;
- that Inland Revenue should produce consolidated versions of New Zealand's DTAs as modified by the MLI; and
- more competent authority resource to address cases of double taxation and assist taxpayers with disputes.

Withheld under section 6(a) of the Official Information Act 1982

26. In relation to the request for specific guidance on the interaction between section BG 1 and the PPT, officials note that the Commissioner of Inland Revenue has previously issued a

substantial Interpretation Statement on the interpretation and application of the GAAR (IS 13/01 "Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007"). It is not considered that further guidance on how the PPT and the GAAR will apply would be helpful, and specific cases will depend on particular facts and circumstances. We also note that the OECD/G20 final report on Action 6 gave guidance on the interaction of domestic law general anti-avoidance rules and tax treaties, including the PPT.

27. In terms of providing guidance on New Zealand's approach to profit attribution to permanent establishments, this topic is not directly covered by the MLI and is still subject to work at the OECD level. Once that work is complete, consideration could be given to producing guidance on New Zealand's position on this issue.

28. In response to the request for Inland Revenue to produce consolidated versions of the DTAs modified by the MLI, we note that publishers may produce consolidated texts as they currently do with amending protocols and original DTAs. However, based on requests for Inland Revenue to produce these and the fact that many of our counterparties are already considering producing them, we are looking into whether it would be feasible for Inland Revenue to produce informal consolidated versions (or endorse those produced by our treaty partners), in respect of New Zealand's most significant DTAs. These informal versions would not be legally binding.

29. In addition to this, New Zealand Inland Revenue officials are continuing discussions with overseas counterparts to determine what additional certainty the competent authorities may be able to provide to taxpayers (for example, through a memorandum of understanding which sets out in further detail how each MLI provision applies to the DTA).

Technical domestic law changes

30. Submitters suggested a number of technical changes to domestic law.

31. In particular, they were concerned about ensuring that the arbitration process under the MLI would function seamlessly with New Zealand's domestic dispute resolution procedures. Officials will report separately to you on domestic law changes needed in this respect.

32. Submitters also suggested that domestic time limits for refunds should be extended (from the current 4 years) where a refund is the result of MAP or arbitration, given the length of time these processes can take.

33. Submitters also raised the need for clarity around the interaction between the strengthened permanent establishment provisions in the MLI and the proposed permanent establishment anti-avoidance provision currently being considered by the Government. Officials will advise Ministers on this issue when reporting on the outcomes of consultation on the Government Discussion Document *BEPS – Transfer pricing and permanent establishment avoidance*.

34. One submitter suggested there should be a domestic law change to prevent section BG 1 of the Income Tax Act 2007 applying in cases where the PPT in a DTA has been invoked.

Officials do not support this suggestion. It runs counter to the recent reform to ensure section BG 1 overrides DTAs in avoidance cases. The application of either or both provisions to a particular transaction will depend on the facts and circumstances of the case.

35. Officials will report to you separately with recommendations on these domestic law issues.

Next steps

36. This report recommends that you sign and refer the attached Cabinet paper to Cabinet Office. It is intended that the Cabinet paper be considered by the Cabinet External Relations and Defence Committee at its meeting of 2 May 2017. The Cabinet Office deadline for receiving papers for that meeting is 10am, Thursday 27 April 2017.

37. The Cabinet paper seeks agreement for New Zealand to sign the MLI. The Cabinet paper also seeks approval for the steps necessary to give effect to the provisions of the MLI under New Zealand law. As one of the steps involves Parliamentary treaty examination, the Cabinet paper seeks approval of an extended NIA.

38. After the MLI is signed, it will need to be given effect under New Zealand domestic law. This will be achieved by an Order in Council made under section BH 1 of the Income Tax Act 2007. We will report to you on the Order in Council once the MLI has been signed and other relevant steps have been taken, including the completion of Parliamentary treaty examination.

39. The Cabinet Manual requires that Cabinet approval for any treaty action be sought either jointly or in consultation with the Minister of Foreign Affairs. The Cabinet paper and accompanying documents therefore need to be referred to the Minister of Foreign Affairs for consultation.

40. The Cabinet paper and extended NIA, along with the full text of the MLI and New Zealand's proposed reservations and notifications are attached. The accompanying documents are to be appended as annexes to the Cabinet paper when it is submitted to Cabinet Office.

41. The reasons for signing the MLI are set out in the Cabinet paper and extended NIA, along with an analysis of the advantages and disadvantages of the MLI for New Zealand.

42. The Cabinet paper recommends, in particular, that Cabinet:

- approve the text of the MLI and New Zealand's reservations and notifications, and authorise the signing of the MLI;
- approve the extended NIA;

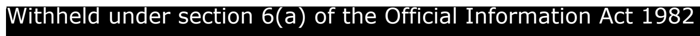
- agree that, following signature, the MLI and NIA be submitted for Parliamentary treaty examination;

- invite the Minister of Revenue to issue drafting instructions for an Order in Council to give effect to the MLI; and

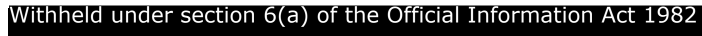
- authorise officials (once all necessary steps have been completed) to deposit New Zealand's instrument of ratification with the MLI Depositary and confirm New Zealand's notifications and reservations.

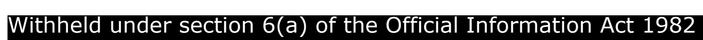
43. There is an opportunity for the Minister of Revenue to sign the MLI at a signing ceremony arranged by the OECD, to be held in Paris on 7 June 2017. If the Minister of Revenue is not able to attend, then it is possible that another Minister or the New Zealand Ambassador to the OECD may be able to attend the signing ceremony.

Withheld under section 6(a) of the Official Information Act 1982



Withheld under section 6(a) of the Official Information Act 1982


Withheld under section 6(a) of the Official Information Act 1982


Withheld under section 6(a) of the Official Information Act 1982

Appendix B

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
1. Neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2 report)	**Fiscally transparent entities** The MLI introduces or amends a fiscally transparent entity (FTE) provision. FTEs (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The MLI provision clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident. New Zealand already includes this provision (or an equivalent provision) in its DTAs with Australia, United States, Chile and Japan. *Article 3 of the MLI*	No	Yes	Similar substantive position to NZ. Adopt for DTAs that do not contain a detailed provision addressing FTEs.
	Dual resident entities The MLI introduces or amends a dual resident entity (DRE) tie breaker provision. Like FTEs, DREs can be used to take advantage of arbitrage opportunities. The proposed provision will require CAs to agree the residence status of a DRE. Where there is no agreement, either treaty benefits will be denied or only allowed to the extent the CAs agree. *Article 4 of the MLI*	No	Yes	Similar substantive position to NZ. Adopt, but exclude the last sentence (for constitutional issues).
	Relief of double taxation The MLI allows countries to strengthen their application of the exemption method to relieve double taxation. New Zealand already applies the (more robust) credit method in all of its DTAs, and therefore proposes not to adopt any of the options. *Article 5 of the MLI*	No	Not applicable	Same as NZ Not applicable

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
2. Preventing the granting of treaty benefits in inappropriate circumstances (Action 6 report)	**Preamble language – minimum standard** The MLI will amend the preamble to DTAs to emphasise that as well as aiming to relieve double taxation, the treaty also aims to prevent opportunities for non-taxation, reduced taxation or tax avoidance. *Article 6(1) and (2) of the MLI*	Yes	Yes	Same as New Zealand
	Preamble language – optional amendment The MLI allows countries to adopt the following optional amendment to the preamble to DTAs: "Desiring to further develop their economic relationship and to enhance their co-operation in tax matters," *Article 6(3) and (6) of the MLI*	No	No	Different to New Zealand. Adopt

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Treaty anti-abuse rules The MLI requires jurisdictions to introduce an anti-abuse rule into DTAs. Jurisdictions can meet this minimum requirement in one of three ways: 1. a principal purpose test (PPT) alone; 2. a PPT plus a "simplified limitation on benefits" (LOB) clause. The LOB is a mechanical provision that seeks to identify, through a series of black-letter tests, whether a person is genuinely entitled to the benefits of a DTA; or 3. enter into bilateral negotiations to include a detailed LOB provision plus a PPT or anti-conduit rules. New Zealand has indicated it wishes to adopt a PPT alone. The PPT is similar to New Zealand's domestic law GAAR and will deny treaty benefits if the principal purpose of an arrangement was to secure those benefits. Also, in officials' view, it generally covers the same treaty shopping issues as the alternative approaches. *Article 7 of the MLI*	Yes	Yes	Same as New Zealand
	Dividend transfer transactions The MLI introduces a provision that requires shares to be held for a minimum of 365 days for the shareholder to be entitled to the reduced withholding tax (WHT) rates on dividends. This is to stop shareholders buying shares temporarily to access the reduced WHT rates and then immediately selling them. *Article 8 of the MLI*	No	Yes	Same as New Zealand

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Land rich company rules The MLI introduces a treaty provision that strengthens the anti-abuse "land-rich company" test (land rich companies are companies whose assets are mainly land). Some treaties do not contain this provision at all, so the MLI also allows it to be inserted into those treaties. The new rule reinforces the position that the source jurisdiction can tax land held by non-resident owners in the other jurisdiction through corporate vehicles. To prevent artificial and temporary dilution of the amount of land held by a company just before sale, the MLI provision requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares. The MLI provision also ensures the same rule applies to other investment vehicles such as partnerships and trusts. *Article 9 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt generally, but do not adopt para. (b) for DTAs that already contain an equivalent provision.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Third-state PE rule The MLI introduces a treaty provision that denies treaty benefits in the case of income derived by a PE of a resident of one of the parties to the DTA, where that PE is situated in a low tax third-state. *Article 10 of the MLI*	No	Yes	Different to New Zealand Do not adopt.
	Right to tax own residents The MLI introduces a provision that preserves a jurisdiction's right to tax its own residents. For example, this rule prevents New Zealand residents engaged in a tax avoidance arrangement claiming a DTA prevents New Zealand from using the domestic law GAAR to impose tax. *Article 11 of the MLI*	No	Yes	Same as New Zealand.
3. Preventing the artificial avoidance of PE status	**Commissionaire arrangements and similar strategies** Currently, a number of artificial structures, including the civil law concept of a "commissionaire", arrangements whereby contracts which are substantially negotiated in a State are not concluded in that State because they are finalised or authorised abroad and arrangements whereby a related party who habitually concludes contracts on behalf of an enterprise is characterised as "independent agents", can be used to avoid having a PE in a jurisdiction. A new provision will deem non-residents using these structures to have a PE in the jurisdiction. *Articles 12 and 15 of the MLI*	No	Withheld under section 6(a) of the Official Information Act 1982	

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Specific activity exemptions – preparatory and auxiliary qualification Certain specific activities carried on in a jurisdiction are deemed **not** to constitute a PE (for example, premises used for simply storing goods or stock maintained for display or delivery). These specific carve-outs from the PE definition allowed quite substantial economic activities to fall within them. The MLI proposes clarifying that the specific carve-outs listed in the DTA must be subject to an additional requirement that they be "preparatory and auxiliary" in nature. There are two options for dealing with this issues – Option A (which New Zealand favours) which subjects all of the existing specific activities to an explicit "preparatory and auxiliary" test, and Option B, which does not subject the specific activities to the "preparatory and auxiliary" test (because these activities are considered to be inherently preparatory and auxiliary in nature), but subjects any other activity or combination of activities to the "preparatory and auxiliary" test. *Articles 13 and 15 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt Option A for DTAs that do not already contain an equivalent provision.
	Specific activity exemptions – Anti-fragmentation rule The MLI introduces an "anti-fragmentation" rule that will prevent an enterprise from dividing up all of its activities so that related parties each carry on a separate part of the business (that fall within the PE exceptions), but taken together they constitute a PE. *Articles 13 and 15 of the MLI*	No	Yes	Same as New Zealand.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Anti-contract splitting rule Currently a construction, installation or building project does not constitute a PE unless it last for more than 12 months (or six months in the case of many of New Zealand's treaties). Entities were abusing this time limit by having back-to-back contracts so they never exceeded the time threshold. Generally the contracts were undertaken by different companies within the same group of companies. The new an "anti-contract splitting" rule will aggregate related projects to prevent PE avoidance. *Articles 14 and 15 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt except for provisions of DTAs that cover exploration for or exploitation of natural resources.
4. Providing improved mechanisms for effective dispute resolution	**MAP – access to the CAs of either jurisdiction** In covered tax agreements that do not already have it, the MLI will introduce a provision allowing taxpayers to request mutual agreement procedure (MAP) in cases where they believe taxation is not in accordance with the treaty. If a MAP provision is already contained in a DTA, the MLI will amend it to allow taxpayers to approach the CA of *either* jurisdiction to resolve uncertainty as to how the DTA applies (New Zealand's DTAs currently contain MAP provisions, but taxpayers are only entitled to approach the CA of the jurisdiction of which they are a resident). *Article 16 of the MLI*	Yes	Yes	Same as New Zealand.
	MAP – corresponding adjustment Requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. *Article 17 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt, except for DTAs that already contain an equivalent provision.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Arbitration If, under the MAP process, the CAs do not agree on the correct interpretation of the DTA, the CAs can submit the matter to an independent arbitrator (or a panel of three arbitrators) for decision. The arbitrators will decide which of the CAs is correct. The CAs are generally bound by the decision of the arbitrators, but the taxpayer is not. Therefore, the taxpayer could pursue a court case if it disagrees with the arbitrators' decision. New Zealand's approach is to adopt what is referred to as "final offer" or "last best offer" arbitration (in Article 23(1)), but to accept "independent opinion" arbitration if the other party to the Covered Tax Agreement chooses this (by entering a reservation under Article 23(2)). In the case of "independent opinion" arbitration, New Zealand will adopt Article 24(2) and (3) which means that the arbitrators' decision will not be binding on the CAs if they come to an alternative resolution of all unresolved issues within 3 calendar months of the delivery of the arbitrators' decision. New Zealand also proposes to require undertakings of confidentiality by all parties involved in arbitration (Article 23(5)) and reserves the right not to include arbitration provisions in Covered Tax Agreements with jurisdictions that do not require the same (Article 23(6) and (7)). New Zealand intends to enter a free form reservation in respect to arbitration to carve out cases that involve the application of New Zealand's general anti-avoidance rule contained in section BG 1 of the Income Tax Act 2007. *Articles 18 – 26 of the MLI*	No	Yes	Very similar substantive position to New Zealand (including reserving on GAAR). But has not reserved the right to not adopt arbitration with jurisdictions which do not require confidentiality of proceedings.

Appendix C

New Zealand has 40 DTAs currently in force. The table below shows the coverage of the MLI across New Zealand's treaty network.

		DTA	Status
Covered tax agreements	1.	Australia	Covered tax agreement under the MLI
	2.	Belgium	Covered tax agreement under the MLI
	3.	Canada	Covered tax agreement under the MLI
	4.	Chile	Covered tax agreement under the MLI
	5.	China	Covered tax agreement under the MLI
	6.	Czech Republic	Covered tax agreement under the MLI
	7.	Denmark	Covered tax agreement under the MLI
	8.	Finland	Covered tax agreement under the MLI
	9.	France	Covered tax agreement under the MLI
	10.	Germany	Covered tax agreement under the MLI
	11.	Hong Kong (China)	Covered tax agreement under the MLI
	12.	India	Covered tax agreement under the MLI
	13.	Indonesia	Covered tax agreement under the MLI
	14.	Ireland	Covered tax agreement under the MLI
	15.	Italy	Covered tax agreement under the MLI
	16.	Japan	Covered tax agreement under the MLI
	17.	Malaysia	Covered tax agreement under the MLI
	18.	Mexico	Covered tax agreement under the MLI
	19.	Netherlands	Covered tax agreement under the MLI
	20.	Poland	Covered tax agreement under the MLI
	21.	Russia	Covered tax agreement under the MLI
	22.	Singapore	Covered tax agreement under the MLI
	23.	South Africa	Covered tax agreement under the MLI
	24.	Spain	Covered tax agreement under the MLI
	25.	Sweden	Covered tax agreement under the MLI
	26.	Switzerland	Covered tax agreement under the MLI
	27.	Turkey	Covered tax agreement under the MLI
	28.	United Kingdom	Covered tax agreement under the MLI
	29.	Korea	Covered tax agreement under the MLI
Not modified by the MLI	30.	Viet Nam	Withheld under section 6(a) of the Official Information Act 1982
	31.	Thailand	
	32.	Philippines	
	33.	Norway	
	34.	Austria	
	35.	United Arab Emirates	
	36.	Papua New Guinea	
	37.	Samoa	
	38.	Taiwan	
	39.	Fiji	
	40.	United States	

Appendix D

Submission	Officials' response
The dual resident entity provision in Article 4 should not be adopted. There are compliance costs associated with adopting this provision. Submitters felt many cases of dual resident entities were innocent. There are existing domestic law rules that address the mischief this rule aims to address.	• For some time OECD countries have been dissatisfied with the existing rule. This is partly because there is no consensus on how it should be interpreted and applied, and partly because there is concern about abuse. • Eight of New Zealand's DTAs (including the New Zealand-US DTA) already contain this provision and it has not, to our knowledge, been problematic. • This provision is the new OECD best practice and will be the international standard going forward in terms of the OECD Model Tax Convention. Australia is opting for it as well. • While there are some domestic law measures that prevent certain types of abuse by dual resident entities, they do not cover all situations. • New Zealand officials will manage the compliance costs and certainty issues by providing administrative guidance, in particular through a potential agreement with Australia on how the provision will be applied in practice between our two countries.
It is not necessary to adopt specific anti-avoidance measures (such as the contract splitting rule in Article 14, the dividend transfer rule in Article 8, and the land-rich company rule in Article 9), given there will be an overall general anti-abuse rule. These provisions will increase compliance costs.	• Specific provisions that address known abusive arrangements are desirable. • These provisions will become part of the OECD Model Tax Convention (sometimes as alternative provisions in the commentaries) and will be the starting point for future bilateral negotiations going forward. • Some of these provisions are already included in some of New Zealand's DTAs with no apparent issues. • Officials are looking at administrative measures to reduce compliance costs (e.g. administrative guidance on accepting quarterly valuations for the land-rich company provisions).
New Zealand should exclude from its list of covered tax agreements DTAs with countries who do not agree to adopt arbitration. This leaves open the possibility that "bad faith" adjustments will be made by a country under the	• This approach would reduce the efficacy of the MLI in enabling New Zealand to meet the OECD minimum standard as New Zealand would have to endeavour to undertake bilateral negotiations with these excluded jurisdictions, which could represent about half of New Zealand's DTAs, based on current draft notifications.

strengthened MLI provisions, with no ability for taxpayers to request binding arbitration of this decision.	• This would mean that – until bilateral negotiations can take place – the DTAs excluded on this basis would remain vulnerable to the BEPS techniques the MLI is designed to address. • On balance it is in New Zealand's interest to obtain the stronger DTA provisions, even if it is without the optional arbitration provisions. • We also note that many of New Zealand's DTAs already include a principal purpose test and wide permanent establishment rules, but no ability to pursue arbitration. Therefore this combination is already a feature of some of our existing DTAs and, from New Zealand's perspective, is not problematic. • We also have to expect that our treaty partners will apply DTA provisions in good faith. New Zealand's DTAs contain MAP processes to address any issues with this. • Finally, there is hope that, over time, more countries will adopt arbitration through the MLI or bilateral negotiations.
The rationale for New Zealand's reservation on section BG 1 of the Income Tax Act (the domestic law general anti-avoidance provision (GAAR)) in respect of arbitration is not clear. New Zealand should not reserve on section BG 1.	• New Zealand's domestic GAAR overrides DTAs under section BH 1 of the Income Tax Act 2007. • This means that, to the extent to which an arbitration decision was contrary to the GAAR, New Zealand would be unable to implement it. As arbitration is required to binding, New Zealand's inability to implement a decision that is contrary to the GAAR is problematic. • Therefore, New Zealand has taken the position (as have a number of other countries[3]), that a case will be excluded from arbitration to the extent that any unresolved issues relate to the application of a domestic law GAAR. • We do not agree that New Zealand should remove this reservation as it would give rise to potential conflicts with our domestic law.
New Zealand's section BG 1 reservation with respect to arbitration should also extend to MAP.	• This is not an option under the MLI. • Additionally, subjecting section BG 1 cases to MAP does not present the same domestic law conflict as binding arbitration.

[3] Australia, Austria, Canada, Germany, Finland, Ireland, Italy, Norway, Slovenia and Spain.

New Zealand should consider expanding the section BG 1 reservation to include the proposed PE avoidance rule (contained in the Government Discussion Document *BEPS – Transfer pricing and permanent establishment avoidance*)	• This is not yet in domestic law (or even approved by Cabinet), so it would not be appropriate to include this in a reservation at this time. This is something that could be added before New Zealand deposits its instrument of ratification after further consideration.
Listed companies may not be able to access arbitration as their continuous disclosure obligations (to the stock exchange) would not allow arbitration to be kept confidential	• Confidentiality of arbitration is core to its acceptance by a large number of jurisdictions (including New Zealand). • If New Zealand did not agree to confidentiality, other countries would not agree to arbitration with New Zealand. This would mean all taxpayers – not just listed companies – would be denied arbitration. • This is not in taxpayers' interests. • We expect that the level of disclosure could be managed to prevent the loss of arbitration.
DTAs under negotiation should be included at covered tax agreements.	• We have included DTAs currently under negotiation where the other party has agreed to this approach.
New Zealand would be justified in making the application of the MLI to a particular DTA conditional on acceptance that New Zealand taxpayers include PIEs and KiwiSaver schemes and confirmation that a look through entity is also entitled to DTA relief.	• This is not an option under the MLI. • Additionally, look through entities are also the subject of the fiscally transparent provision of the MLI which makes entitlement to treaty benefits conditional on an item of income being taxed in the state in which the entity is resident. A blanket approach to fiscally transparent entities is therefore inconsistent with the provision itself, New Zealand treaty policy and international best practice.
Why has New Zealand taken a different position from Australia on the third state PE rule (in Article 10)	• Australia has not yet made a decision on whether to adopt Article 10, so it is not yet clear whether we differ from Australia. • We have considered this provision – in particular how it applies to outbound investors – and believe it is principled, appropriate and balanced. • If the provision applies too widely or applies to innocent cases, there is competent authority discretion to grant treaty benefits.

Cabinet

Summary

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting: Approval for Signature and Ratification

Portfolio **Revenue**

Purpose

This paper seeks approval of the text and agreement to sign the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the MLI).

Previous Consideration

In February 2017, EGI noted that there is significant global media and political concern about base erosion and profit shifting (BEPS), and agreed to the release of an officials' issues paper on *New Zealand's Implementation of the Multilateral Convention to Prevent BEPS* [EGI-17-MIN-0005].

Summary

Double tax agreements (DTAs) are bilateral international treaties which are designed to reduce tax impediments to cross-border services, trade, and investment without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. DTAs also enable tax administrations to support each other in the detection and prevention of tax evasion and avoidance.

The MLI (attached as **Annex 1**) proposes to quickly and efficiently amend a significant number of DTAs to take into account new treaty standards relating to treaty abuse and dispute resolution resulting from the OECD and G20's 15 point Action Plan on base erosion and profit shifting. New Zealand's MLI will cover 34 DTAs (i.e. those New Zealand holds with jurisdictions who are also signing the MLI). New Zealand's MLI position is discussed in **paragraphs 18-24**.

Submissions on the officials' issues paper concerning BEPS identified issues relating to the need for a New Zealand-specific approach (as the MLI is broadly drafted), the need for additional guidance and administrative resources to help taxpayers apply DTAs as modified by the MLI, and domestic law updates to support a smooth implementation of the MLI (discussed in **paragraph 29**).

Regulatory Impact Analysis

The Regulatory Impact Analysis and tax strategy teams at the Treasury consider that the National Impact Statement meets quality assurance criteria.

Baseline Implications

Data limitations prevent an accurate estimation of the impact on net tax revenue, though it is expected that the overall impact will be positive. There will be some administrative costs to IRD, which are expected to be small.

Legislative Implications The Income Tax Act 2007 provides for the regulation and giving of effect to DTAs. An Order in Council will give effect to the MLI.

Timing Issues The MLI signing ceremony is 7 June 2017. An Instrument of Full Powers will need be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI.

Announcement National communications relating to this matter will be managed by the office of the Minister of Revenue.

The text of the MLI, New Zealand's notifications and reservations, and the NIA will be tabled in the House of Representatives for Parliamentary treaty examination, as the MLI it is subject to ratification.

Proactive Release None proposed.

Consultation Paper prepared by Inland Revenue. MBIE and MFAT were consulted.

The Minister of Revenue indicates that discussion is not required with the government caucus, or with other parties represented in Parliament.

The Minister of Revenue recommends that Cabinet:

1 note that the Income Tax Act 2007 authorises the negotiation of, and giving effect to double tax agreements (DTAs) with other jurisdictions;

2 note that officials participated in the negotiation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the MLI), the text of which was formally adopted in November 2016;

3 note that the MLI will quickly and efficiently amend the majority of New Zealand's DTAs to include the recommended changes to tax treaties arising out of the OECD/G20 15 point Action Plan on base erosion and profit shifting;

4 approve the text of the MLI attached to the paper under CAB-17-SUB-0241 as Annex A, subject to any minor technical changes resulting from the process of translation or legal verification;

5 note that officials have finalised New Zealand's expected notifications and reservations in relation to the choices available in the MLI;

6 approve New Zealand's expected notifications and reservations attached to the paper under CAB-17-SUB-0241 as Annex B;

7 authorise the Minister of Finance and Minister of Revenue to approve any changes to the notifications and reservations as a result of developments in other jurisdictions' positions and any other minor technical changes;

8 agree that New Zealand sign the MLI;

9 note that an Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI, and that the Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature;

10 approve the extended National Interest Analysis (NIA) attached to the paper under CAB-17-SUB-0241 as Annex D;

11 note that the content of the NIA may change as a result of developments in other jurisdictions' positions between now and Parliamentary treaty examination;

12 note that the government will present any international treaty that is the subject of ratification to the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

13 agree that, following signature, the text of the MLI, New Zealand's notifications and reservations, and the NIA be tabled in the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

14 note that the MLI will be incorporated into New Zealand domestic law through an Order in Council with overriding effect made pursuant to section BH 1 of the Income Tax Act 2007;

15 invite the Minister of Revenue to instruct the Parliamentary Counsel Office to draft the Order in Council to give effect to the MLI, following signature and completion of the Parliamentary treaty examination process;

16 authorise officials, following signature, completion of the Parliamentary treaty examination process, and promulgation of the Order in Council, to bring the MLI into force by depositing New Zealand's instrument of ratification and list of confirmed notifications and reservations with the OECD Depositary.

Jenny Vickers
for Secretary of the Cabinet

Hard-copy distribution:
The Cabinet

Restricted

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

Cabinet

Signature and ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Proposal

1. This paper proposes that Cabinet authorises New Zealand's signature of, and the steps necessary to ratify and bring into force, the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("the Multilateral Instrument" or "MLI"). The full text of the MLI is attached as Annex A and a full list of New Zealand's proposed notifications and reservations to be submitted at the time of signature and confirmed upon ratification is attached as Annex B. A table showing the MLI's coverage of New Zealand's double tax agreement ("DTA") network is attached as Annex C.

Executive summary

2. DTAs are bilateral international treaties designed to reduce tax impediments to cross-border services, trade and investment without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. DTAs also enable tax administrations to assist each other in the detection and prevention of tax evasion and avoidance. Section BH 1 of the Income Tax Act 2007 provides for the negotiation of and giving of effect to DTAs with other countries. New Zealand currently has 40 DTAs in force, primarily with major trading and investment partners.

3. The MLI is a multilateral international treaty that proposes to quickly and efficiently amend a significant number of DTAs around the world to take into account new treaty standards relating to treaty abuse and dispute resolution that have arisen out of the Organisation for Economic Co-operation and Development (OECD) and G20's 15-point Action Plan on base erosion and profit shifting ("BEPS"). It allows New Zealand to update the majority of its 40 DTAs without entering into bilateral negotiations with each of its treaty partners.

4. In May 2016, Cabinet considered the MLI as part of the New Zealand Government's response to BEPS (CAB-16-MIN-0218 refers). In February 2017, Cabinet approved the release of an officials' issues paper seeking submissions on New Zealand's implementation of the MLI (EGI-17-MIN-0005, CAB-17-MIN-0041 refers).

5. This paper seeks Cabinet approval for New Zealand to sign the MLI at a signing ceremony arranged by the OECD to be held in Paris on 7 June 2017. As the MLI is subject to ratification it must be presented to the House of Representatives for Parliamentary treaty examination in accordance with Standing Order 397, this paper also proposes that Cabinet approves the text of an extended National Interest Analysis ("NIA") for submission to Parliament. The extended NIA is attached as Annex D. This paper also proposes that Cabinet authorises the steps necessary to give effect to the provisions of the MLI under New Zealand

law and, after those steps have been successfully completed, authorise officials to ratify the MLI by depositing an instrument of ratification, along with New Zealand's list of confirmed notifications and reservations, with the MLI Depositary (the OECD).

Background

6. DTAs are bilateral international treaties designed to reduce tax impediments to cross-border services, trade and investment without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. DTAs also enable tax administrations to assist each other in the detection and prevention of tax evasion and avoidance. Section BH 1 of the Income Tax Act 2007 provides for the negotiation of and giving of effect to DTAs with other countries. New Zealand currently has 40 DTAs in force, primarily with major trading and investment partners.

7. While DTAs are beneficial for taxpayers, investors and governments themselves, there is the potential for these bilateral agreements to be misused to reduce or eliminate a multinational's worldwide tax. Misuse of DTAs in this way has been a feature of a number of cross-border tax avoidance arrangements.

8. The misuse of DTAs forms part of a wider problem referred to as BEPS, which has been the focus of significant global media and political attention since late 2012, following evidence suggesting that some multinationals pay little or no tax anywhere in the world.

9. BEPS is a global problem as many BEPS strategies exploit technical differences between different countries' tax rules, so New Zealand has been working with the OECD and G20 to develop a co-ordinated global solution to address BEPS through the 15-point OECD/G20 BEPS Action Plan.

10. A number of the items on the OECD/G20 BEPS Action Plan address the misuse of DTAs and can only be implemented through changes to DTAs themselves. These are:

- preventing the granting of treaty benefits in inappropriate circumstances (Action 6);
- preventing the artificial avoidance of permanent establishment status (Action 7);
- neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2); and
- providing improved mechanisms for effective dispute resolution (Action 14).

11. Some of these solutions are "minimum standards" that countries that commit to solving BEPS are expected to adopt. Other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following adoption of the OECD/G20 BEPS Action Plan.

12. Countries, including New Zealand, were presented with the difficulty of how to quickly and efficiently implement these measures without requiring the bilateral renegotiation of several thousand existing DTAs, which could take several years (or even potentially decades). For this reason, the Multilateral Instrument was developed under Action 15 of the OECD/G20 BEPS Action Plan to swiftly amend the DTAs of all participating jurisdictions.

The Multilateral Instrument

13. The MLI is a multilateral international treaty that proposes to quickly and efficiently amend a significant number of DTAs around the world to take into account new treaty standards relating to treaty abuse and dispute resolution that have arisen out of the OECD/G20 BEPS Action Plan, as outlined in paragraph 10. It allows New Zealand to update the majority of its 40 DTAs without entering into bilateral negotiations with each of its treaty partners.

14. New Zealand's treaty negotiation resources are limited and to update New Zealand's entire DTA network would take several years, if not decades, particularly as many of New Zealand's treaty partners would likely place greater importance on updating more significant treaties. This would limit New Zealand's likelihood of being able to meet the OECD minimum standard in a timely fashion.

15. The text of the MLI was developed by the OECD Ad Hoc Group consisting of officials from more than 100 participating jurisdictions, including New Zealand, and was formally adopted by the OECD in November 2016. Experts in both international tax and public international law participated in the OECD Ad Hoc Group that developed the MLI to ensure that it works as intended.

16. The MLI is flexible and allows jurisdictions to choose:

- which of their existing DTAs they wish to modify through the MLI;
- alternative ways of meeting BEPS minimum standards on treaty abuse and dispute resolution; and
- whether they want to adopt the OECD-recommended provisions for non-minimum standards.

17. Within some of these provisions, there are alternative ways of addressing BEPS concerns and the ability for countries to enter a variety of reservations.

New Zealand's proposed MLI positions

18. To make the best use of the MLI, New Zealand's proposed strategy is to include the majority of its DTAs within the scope of the MLI and to adopt as many of the MLI provisions as possible, where they are in line with New Zealand's overall treaty policy. This will give New Zealand the best chance of strengthening its DTAs with as many jurisdictions as possible and will introduce consistency across New Zealand's treaty network.

19. Of New Zealand's 40 in-force DTAs, New Zealand has nominated 34 to be covered by the MLI. Many of these DTAs were concluded in the 1970s and 1980s and do not reflect modern treaty standards, even before the work on BEPS was completed. The six DTAs that have not been listed are with jurisdictions who will not be signing the MLI. To be modified by the MLI, both New Zealand and the other jurisdiction must elect for the MLI to apply to the DTA (if there is a match, then the DTA is a "covered tax agreement"). Based on current draft notifications, New Zealand is expected to have 28 covered tax agreements. See Annex C. While this list is not final, it provides a fairly good indication of the likely coverage of the MLI. Final coverage will not be confirmed until each jurisdiction deposits its instrument of ratification with the OECD Depositary.

20. As noted in paragraph 18, New Zealand's proposed strategy is to adopt as many of the MLI provisions as possible. This is because they are base protection measures that are in line with New Zealand's existing treaty policy (which has a greater source state emphasis than the OECD Model Tax Convention on which the New Zealand negotiating model is based). For example, New Zealand generally takes a broader approach in its DTAs than the current OECD Model Tax Convention in determining whether a permanent establishment exists. This means that the recommendations under Action 7 (preventing the artificial avoidance of permanent establishment status) of the OECD/G20 BEPS Action Plan which are contained in Articles 12 to 15 of the MLI are not contrary to New Zealand's general treaty policy and, in New Zealand's view, represent an improvement to the OECD Model Tax Convention.

Withheld under section 6(a) of the Official Information Act 1982

22. In addition to the proposed changes to the concept of a permanent establishment, it is proposed that New Zealand signs up to the provisions that relate to the following common problems identified with the OECD Model Tax Convention:

- Fiscally transparent entities (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The provision in Article 3 clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident.
- Dual resident entities can be used to take advantage of arbitrage opportunities by manipulating the current "place of effective management" test. The proposed provision in Article 4 will require competent authorities to agree the residence status of a dual resident entity. If there is no agreement, then treaty benefits will be denied, or only granted to the extent to which the competent authorities can agree.
- In the OECD Model Tax Convention and in many of New Zealand's modern treaties, a lower withholding tax rate is available where the shareholder owns more than a certain proportion of the company's shares. The MLI provision in Article 8 requires shares to be held for a minimum of 365 days for the shareholder to be entitled to reduced withholding tax rates on dividends. This prevents shareholders buying shares and holding them temporarily in order to access lower withholding rates.
- Investors can hold land through companies and dispose of the shares in the company to avoid paying tax on the disposal of that land. Many treaties contain a "land-rich company rule" which allows the source jurisdiction to tax income derived from land when the majority of a company's assets consist of land. To prevent artificial and temporary dilution of the amount of land held by a company just before sale, the provision in Article 9 requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares and extends the rule to interests in other entities such as partnerships and trusts.
- Permanent establishments can be established in third states to exploit low tax rates and branch exemptions. Article 10 of the MLI introduces a provision that denies treaty benefits in the case of income derived by a permanent establishment of one of the parties to the DTA, where that permanent establishment is situated in a low tax third state.

- Article 11 introduces a provision that preserves a jurisdiction's right to tax its own residents. For example, this provision would prevent a New Zealand resident who is engaged in a tax avoidance arrangement from claiming that a DTA prevents New Zealand from using its domestic general anti-avoidance rule to impose tax.

23. In addition to addressing these specific BEPS concerns, Article 6 of the MLI proposes to amend the preamble to DTAs to confirm that they are not intended to be used to generate double non-taxation, and under Article 7, New Zealand has selected the option of adding a principal purpose test to its DTAs. The principal purpose test is a general anti-abuse rule that applies to the whole DTA. Both Articles 6 and 7 form part of the OECD minimum standard.

24. In addition to these base protection measures, New Zealand is signing up to taxpayer friendly measures relating to the mutual agreement procedure ("MAP") and the availability of arbitration as a form of dispute resolution. These measures are a result of the work on Action 14 of the G20/OECD BEPS Action Plan relating to the improvement of mechanisms for effective dispute resolution. The key provisions are as follows:

- Article 16 of the MLI introduces a provision allowing taxpayers to request MAP where they believe taxation is not in accordance with the treaty. This is a new OECD minimum standard. While the majority of New Zealand's DTAs contain MAP provisions, the MLI will amend these provisions to allow taxpayers to approach the competent authority of either jurisdiction (currently they only permit a case to be presented to the competent authority of the taxpayer's country of residence).
- Article 16 also creates a new minimum standard regarding time limits for bringing a case to MAP and time limits for implementing a solution.
- Article 17 requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. This provision is already found in most of New Zealand's DTAs except for New Zealand's oldest treaties.
- New Zealand has also opted to apply Part VI of the MLI, which will introduce arbitration as a means of dispute resolution. If a solution cannot be reach under MAP, taxpayers have the ability to request that unresolved issues can be taken to arbitration. New Zealand has already agreed to arbitration in its treaties with Australia and Japan. New Zealand's experience is that the arbitration facility is very rarely used, but it acts as an incentive for the competent authorities of two jurisdictions to come to an agreement within the required time period for MAP.

Implementation issues and consultation

25. The main difficulty in implementing the provisions of MLI compared with amending protocols stems from the fact that the provisions in the MLI have been drafted more broadly than they otherwise would for an amending protocol to take account of the fact that the MLI must be able to apply to not one DTA, but several thousand.

26. This means that there can be some ambiguity in how the MLI applies to a particular DTA. This ambiguity is mitigated in many cases as a MLI provision will only replace the corresponding existing provision if both treaty partners notify the same provision. However, compliance costs may still be incurred as taxpayers will need to consider the DTA and MLI alongside both jurisdictions' notifications and reservations.

27. While officials generally do not consult on the content of tax treaties, due to the unusual nature of the MLI, public feedback was sought on potential implementation issues related to the Multilateral Instrument. An officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. Submissions closed on 7 April 2017 and 5 were received (from EY, KPMG, PwC, Corporate Taxpayers Group ("CTG") and Chartered Accountants Australia and New Zealand ("CA ANZ")). Two stakeholder workshops were held on 27 and 28 March 2017 with CTG and CA ANZ to enable officials to better understand practitioners' concerns.

28. Two of the submissions supported the adoption of the MLI as the most effective way to implement the treaty related BEPS recommendations. One submission acknowledged that the New Zealand Government has the constitutional ability to decide New Zealand's tax treaty position and it therefore makes sense to achieve this in the shortest time at the least cost through the MLI. One submission acknowledged that participating in OECD and G20 initiatives to target BEPS is a key focus for the government, while not explicitly supporting the adoption. The final submission did not express an overall view on adoption, but submitted that New Zealand should not adopt all of the optional provisions.

29. The main issues raised in submissions relate to:

a. **substantive positions taken by New Zealand**. Although consultation was intended to focus on implementation issues, submitters did comment on the substance of the new provisions in the MLI. Most submitters were generally supportive of New Zealand's adoption of the MLI and a number supported the proposals to take up most of the MLI provisions as an efficient way to amend our treaty network, but some submitters raised concerns about specific provisions. One point of contention among submitters was the proposal to adopt Article 4 of the MLI, relating to dual-resident entities (refer paragraph 22 above). However, this new rule is being adopted by many countries as a means of curbing certain forms of treaty abuse. It is also consistent with the position New Zealand has taken in a number of bilateral treaties. Officials are exploring ways to reduce compliance costs associated with this provision. Another concern related to one aspect of the new permanent establishment provisions which might lead to more taxation of New Zealanders operating offshore. However, New Zealand's adoption of this provision would be consistent with both the proposals contained in the recent Government discussion document titled *BEPS – Transfer pricing and permanent establishment avoidance* and the long-term direction of New Zealand's tax treaty policy.

b. **requests for additional guidance and administrative resources** to help taxpayers apply DTAs as modified by the MLI (including requests for Inland Revenue to produce consolidated versions of New Zealand's DTAs as modified by the MLI). New Zealand officials have already been working with their Australian counterparts to scope what administrative guidance could be jointly developed to assist taxpayers. Publishers may produce consolidated texts as they currently do with amending protocols and original DTAs. In addition to this, New Zealand Inland Revenue officials are continuing discussions with overseas counterparts to determine what additional certainty the competent authorities may be able to provide (for example, through a memorandum of understanding which sets out in more detail how each MLI provision applies to the DTA).

c. **technical domestic law changes** needed to implement the MLI smoothly. Officials are considering these suggestions and will report separately to Ministers on what domestic law changes may be required before the MLI comes into effect.

Next steps

30. Subject to Cabinet's approval for New Zealand to sign the MLI, we propose that the Minister of Revenue signs the MLI at a signing ceremony arranged by the OECD to be held in Paris on 7 June 2017. At the signing ceremony, New Zealand will also need to present its expected notifications and reservations.

31. An Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI. The Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature.

32. Standing Order 397 provides that the Government will present any international treaty that is the subject of ratification by New Zealand to the House of Representatives for treaty examination by Select Committee. Accordingly, after signature, it is proposed that the MLI be submitted to the House of Representatives for Parliamentary treaty examination. For this purpose, an extended NIA has been drafted and is attached at Annex D. This paper seeks Cabinet approval of the extended NIA so that it can be submitted to Parliament as part of the Parliamentary treaty examination process.

33. The MLI will be implemented by an Order in Council made pursuant to section BH 1 of the Income Tax Act 2007 which has overriding effect in relation to other legislation relating to tax and the exchange of information that relates to tax. Subject to satisfactory completion of Parliamentary treaty examination, this paper also seeks Cabinet approval for me to issue drafting instructions for an Order in Council to implement the MLI into New Zealand domestic law.

34. Article 34 provides that the MLI will enter into force for New Zealand once New Zealand has deposited its instrument of ratification. New Zealand will be in a position to deposit its instrument of ratification following the completion of all domestic procedures for entry into force. Subject to the successful promulgation of an Order in Council, this paper seeks Cabinet approval for officials to ratify the MLI by depositing New Zealand's instrument of ratification with the MLI Depositary. New Zealand will also need to confirm its final notifications and reservations at this point in time.

Consultation

35. Tax policy officials and the Ministry of Foreign Affairs and Trade were consulted in the preparation of this Cabinet paper.

36. In addition, an officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. Submissions closed on 7 April 2017 and 5 were received. Officials met with interested stakeholders. These submissions and views are summarised in paragraphs 26 to 29 above.

Financial implications

37. Normally, new DTAs or amending protocols constrain New Zealand from taxing certain income and limit the rate at which tax on passive income (dividends, interest, and royalties) can be imposed and therefore result in the reduction of New Zealand tax. This upfront revenue cost is then typically offset by other factors (for example, through reduced need to allow foreign tax credits).

38. The MLI differs in that its provisions are typically base protection measures which increase New Zealand's ability to tax inbound investment and equips New Zealand with a whole-of-treaty anti-abuse rule to prevent tax avoidance through the use of DTAs. This may result in more tax paid by non-residents in New Zealand. However, as the provisions are reciprocal, the MLI may increase the amount of foreign income tax paid by New Zealand residents with investments and business operations overseas. This could decrease the amount of New Zealand income tax paid on that foreign income as a foreign tax credit is provided for foreign income tax paid.

39. Data limitations prevent officials from accurately estimating the actual impact on net tax revenue. However, as New Zealand is a capital importer and the MLI covers the majority of New Zealand's DTA network, it is expected that overall impact on tax revenue will be positive.

40. In terms of costs borne by Inland Revenue, there will be costs associated in administering the arbitration provisions of the MLI and some of the provisions that require competent authority agreement. However, these are expected to be relatively small. The existence of arbitration provides a strong incentive for tax authorities to resolve issues under the mutual agreement procedure before arbitration can be triggered. New Zealand's DTAs with Australia and Japan already provide for arbitration and New Zealand's experience is that very few cases have been brought by taxpayers under the mutual agreement procedure and almost all of these have been settled within the required time period, regardless of whether the DTA provides for arbitration.

Human rights

41. No inconsistencies with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993 have been identified.

Legislative implications

42. The MLI must be given effect by Order in Council, pursuant to section BH 1 of the Income Tax Act 2007.

43. Accordingly this paper seeks approval for an Order in Council to be drafted and submitted to Cabinet following the signing of the MLI and the completion of the Parliamentary treaty examination process.

Regulatory impact analysis

44. As this proposal has regulatory implications (it requires an Order in Council), the Regulatory Impact Analysis (RIA) requirements apply. However, as this paper relates to an international treaty, an extended NIA has been prepared (see Annex D) rather than a separate Regulatory Impact Statement.

45. The extended NIA was prepared by Inland Revenue. The extended NIA was circulated with this paper to the Treasury and the Ministry of Foreign Affairs and Trade for departmental consultation.

46. As this proposal has regulatory implications (it requires an Order in Council), the Regulatory Impact Analysis (RIA) requirements apply. However, as this paper relates to an international treaty, an extended NIA has been prepared (see Annex D) in accordance with the RIA requirements.

47. The extended NIA was prepared by Inland Revenue. The extended NIA was circulated with this paper to the Treasury and the Ministry of Foreign Affairs and Trade for departmental consultation.

48. The Regulatory Impact Analysis Team (RIAT) and the tax strategy team in the Treasury have jointly reviewed the extended NIA prepared by Inland Revenue and associated supporting material, and considers that the information and analysis summarised in the extended NIA meets the quality assurance criteria.

49. The extended NIA compares the benefits and costs of signing the treaty relative to taking no action or other potential approaches to amending DTAs, and provides sufficient analysis to support the proposals.

50. In part because provisions in the MLI are drafted broadly it has been difficult to project the revenue and compliance impacts from the treaty. RIAT recommends ongoing monitoring and evaluation of the impacts of the MLI as part of the Government's response to BEPS to ensure that any unintended consequences are known.

Publicity

51. It is proposed that New Zealand participates in the signing ceremony arranged by the OECD to be held in Paris on 7 June 2017. Appropriate media statements and announcements will be arranged once details have been finalised. The text of the MLI and New Zealand's notifications and reservations will be publicly available on Inland Revenue's Tax Policy website. The extended NIA will be publicly available on the Parliamentary website following Parliamentary treaty examination.

52. It is expected that the OECD will also arrange its own publicity for the signing ceremony and will make all signatories' reservations and notifications publicly available following the signing ceremony.

Recommendations

53. We recommend that the Cabinet:

1. **note** that the Income Tax Act 2007 authorises the negotiation of, and giving effect to double tax agreements ("DTAs") with other jurisdictions;

2. **note** that officials participated in the negotiation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "MLI"), the text of which was formally adopted in November 2016;

3. **note** that the MLI will quickly and efficiently amend the majority of New Zealand's DTAs to include the recommended changes to tax treaties arising out of the OECD/G20 15 point Action Plan on base erosion and profit shifting;

4. **approve** the text of the MLI attached to the Cabinet paper as Annex A (subject to any minor technical changes resulting from the process of translation or legal verification);

5. **note** that officials have finalised New Zealand's expected notifications and reservations in relation to the choices available in the MLI;

6. **approve** New Zealand's expected notifications and reservations attached to the Cabinet paper as Annex B;

7. **delegate** to the Minister of Finance and Minister of Revenue the authority to approve any changes to the notifications and reservations as a result of developments in other jurisdictions' positions and any other minor technical changes;

8. **agree** that New Zealand sign the MLI;

9. **note** that an Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI. The Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature;

10. **approve** the extended National Interest Analysis ("NIA") attached to the Cabinet paper as Annex D;

11. **note** the content of the NIA may change as a result of developments in other jurisdictions' positions between now and Parliamentary treaty examination;

12. **note** that the Government will present any international treaty that is the subject of ratification to the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

13. **agree** that, following signature, the text of the MLI, New Zealand's notifications and reservations, and the NIA be tabled in the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

14. **note** that the MLI will be incorporated into New Zealand domestic law through an Order in Council with overriding effect made pursuant to section BH 1 of the Income Tax Act 2007;

15. **invite** the Minister of Revenue to instruct the Parliamentary Counsel Office to draft the Order in Council to give effect to the MLI, following signature and completion of the Parliamentary treaty examination process;

16. **authorise** officials, following signature, completion of the Parliamentary treaty examination process, and promulgation of the Order in Council to bring the MLI into force by depositing New Zealand's instrument of ratification and list of confirmed notifications and reservations with the OECD Depositary.

Hon Steven Joyce Minister of Finance ____/_____/__________ Date	**Hon Judith Collins** Minister of Revenue ____/_____/__________ Date

Annex A

Text of the MLI

Annex B

New Zealand's notifications and reservations

Annex C

New Zealand has 40 DTAs currently in force. The table below shows the coverage of the MLI across New Zealand's treaty network (as at 9 May 2017).

	DTA	
Covered tax agreements	1.	Australia
	2.	Belgium
	3.	Canada
	4.	Chile
	5.	China
	6.	Czech Republic
	7.	Denmark
	8.	Finland
	9.	France
	10.	Germany
	11.	Hong Kong (China)
	12.	India
	13.	Indonesia
	14.	Ireland
	15.	Italy
	16.	Japan
	17.	Malaysia
	18.	Mexico
	19.	Netherlands
	20.	Poland
	21.	Russia
	22.	Singapore
	23.	South Africa
	24.	Spain
	25.	Sweden
	26.	Turkey
	27.	United Kingdom
	28.	Korea
Not modified by the MLI	29.	Switzerland
	30.	Viet Nam
	31.	Thailand
	32.	Philippines
	33.	Norway
	34.	Austria
	35.	United Arab Emirates
	36.	Papua New Guinea
	37.	Samoa
	38.	Taiwan
	39.	Fiji
	40.	United States

Annex D

Extended NIA

Annex A – Text of the Multilateral Instrument

The text of Multilateral Instrument is available on OECD's website at
http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

New Zealand

Status of List of Reservations and Notifications at the Time of Signature

This document contains a provisional list of expected reservations and notifications to be made by New Zealand pursuant to Articles 28(7) and 29(4) of the Convention.

Article 2 – Interpretation of Terms

Notification - Agreements Covered by the Convention

Pursuant to Article 2(1)(a)(ii) of the Convention, New Zealand wishes the following agreements to be covered by the Convention:

No	Title	Other Contracting Jurisdiction	Original/ Amending Instrument	Date of Signature	Date of Entry into Force
1	Convention between Australia and New Zealand for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion	Australia	Original	26-6-2009	19-03-2010
2	Agreement between New Zealand and the Republic of Austria with respect to taxes on income and on capital	Austria	Original	21-09-2006	01-12-2007
3	Convention Between the Government of New Zealand and the Government of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income	Belgium	Original	15-09-1981	08-12-1983
			Amending Instrument (a)	07-12-2009	N/A
4	Convention between New Zealand and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Canada	Original	03-05-2012	26-06-2015
			Amending Instrument (a)	12-09-2014	26-06-2015
5	Convention between New Zealand and the Republic of Chile for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Chile	Original	10-12-2003	21-06-2006
6	Agreement between the Czech Republic and New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Czech Republic	Original	26-10-2007	29-08-2008
7	Convention between the Government of New Zealand and the Government of the Kingdom of Denmark for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Denmark	Original	10-10-1980	22-06-1981
			Amending Instrument (a)	12-03-1985	22-07-1985
8	Convention between the Government of New Zealand and the Government of Finland for the	Finland	Original	12-03-1982	22-09-1984
			Amending Instrument	05-12-1986	08-05-1988

	avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income		(a)		
9	Convention between the Government of New Zealand and the Government of the French Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	France	Original	30-11-1979	19-03-1981
10	Agreement between New Zealand and the Federal Republic of Germany for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and certain other taxes	Germany	Original	20-10-1978	21-12-1980
11	Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Hong Kong	Original	01-12-2010	09-11-2011
12	Convention between the Government of New Zealand and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	India	Original	17-10-1986	03-12-1986
			Amending Instrument (a)	29-08-1996	09-01-1997
			Amending Instrument (b)	21-06-1999	17-12-1999
			Amending Instrument (c)	26-10-2016	N/A
13	Agreement between the Government of New Zealand and the Government of the Republic of Indonesia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Indonesia	Original	25-03-1987	24-06-1988
14	Convention between the Government of New Zealand and the Government of Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains	Ireland	Original	19-09-1986	26-09-1988
15	Convention between the Government of New Zealand and the Government of the Republic of Italy for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion	Italy	Original	06-12-1979	23-03-1983

16	Convention between New Zealand and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Japan	Original	10-12-2012	25-10-2013
17	Agreement between the Government of New Zealand and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Malaysia	Original	19-03-1976	02-09-1976
			Amending Instrument (a)	14-07-1994	01-07-1996
			Amending Instrument (b)	06-11-2012	12-01-2016
18	Agreement between the Government of New Zealand and the Government of the United Mexican States for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Mexico	Original	16-11-2006	16-06-2007
19	Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Netherlands	Original	15-10-1980	18-03-1981
			Amending Instrument (a)	20-12-2001	22-08-2004
20	Convention between New Zealand and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Certain other Taxes	Norway	Original	20-04-1982	31-03-1983
			Amending Instrument (a)	16-06-1998	16-07-1998
21	Convention between the Government of New Zealand and the Government of the Republic of the Philippines for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Philippines	Original	29-04-1980	14-05-1981
			Amending Instrument (a)	21-02-2002	02-10-2008
22	Agreement between New Zealand and the Republic of Poland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Poland	Original	21-04-2005	16-08-2006
23	Agreement between the Government of New Zealand and the Government of the Russian Federation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Russian Federation	Original	05-09-2000	04-07-2003
24	Agreement Between The Government Of New Zealand And	Singapore	Original	21-08-2009	12-08-2010

	The Government Of The Republic Of Singapore For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income				
25	Agreement between the Government of New Zealand and the Government of the Republic of South Africa for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	South Africa	Original	06-02-2002	23-07-2004
26	Agreement between the Government of New Zealand and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Spain	Original	28-07-2005	31-07-2006
27	Convention between the Government of New Zealand and the Government of Sweden for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Sweden	Original	21-02-1979	14-11-1980
28	Convention between New Zealand and the Swiss Confederation for the avoidance of double taxation with respect to taxes on income	Switzerland	Original	06-06-1980	21-11-1981
29	Agreement between the Government of New Zealand and the Government of the Kingdom of Thailand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Thailand	Original	22-10-1998	14-12-1998
30	Agreement between the Government of New Zealand and the Government of the Republic of Turkey for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Turkey	Original	22-04-2010	28-07-2011
31	Convention between the Government of New Zealand and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains	United Kingdom	Original	04-08-1983	16-03-1984
			Amending Instrument (a)	22-12-1983	22-12-1983
			Amending Instrument (b)	04-11-2003	23-07-2004
			Amending Instrument (c)	07-11-2007	28-08-2008
32	Agreement between the	Viet Nam	Original	05-08-2013	05-05-2014

	Government of New Zealand and the Government of the Socialist Republic of Viet Nam for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income				
33	Agreement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	China	Original	16-09-1986	17-12-1986
			Amending Instrument (a)	7-10-1997	22-03-2000
34	Convention between the Government of New Zealand and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Republic of Korea	Original	6-10-1981	22-04-1983
			Amending Instrument (a)	14-07-1997	10-10-1997

Article 3 – Transparent Entities

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 3(6) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 3(4)

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 1(2)
5	Chile	Article 4(4)
16	Japan	Article 4(5)

Article 4 – Dual Resident Entities

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 4(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 4(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 4(3)
2	Austria	Article 4(3)
3	Belgium	Article 4(3)
4	Canada	Article 4(5)
5	Chile	Article 4(3)
6	Czech Republic	Article 4(3)
7	Denmark	Article 4(3)
8	Finland	Article 4(3)
9	French Republic	Article 4(3)
10	Germany	Article 4(3)
11	Hong Kong (China)	Article 4(3)
12	India	Article 4(3)
13	Indonesia	Article 4(3)
14	Ireland	Article 4(3)
15	Italy	Article 4(3)
16	Japan	Article 4(3); Protocol (3)
17	Malaysia	Article 3(3)
18	Mexico	Article 4(4)
19	Netherlands	Article 4(3)
20	Norway	Article 4(3)
21	Philippines	Article 4(3)
22	Poland	Article 4(4)
23	Russian Federation	Article 4(4)
24	Singapore	Article 4(3)
25	South Africa	Article 4(3)
26	Spain	Article 4(3)
27	Sweden	Article 3(3)
28	Switzerland	Article 4(3)
29	Thailand	Article 4(4)
30	Turkey	Article 4(3)
31	United Kingdom	Article 4(3)
32	Viet Nam	Article 4(3)
33	China	Article 4(3)
34	Republic of Korea	Article 4(3)

Article 6 – Purpose of a Covered Tax Agreement

Notification of Existing Preamble Language in Listed Agreements

Pursuant to Article 6(5) of the Convention, New Zealand considers that the following agreements are not within the scope of a reservation under Article 6(4) and contain preamble language described in Article 6(2). The text of the relevant preambular paragraph is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Preamble Text
1	Australia	Desiring to conclude a Convention for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion,
2	Austria	desiring to conclude an Agreement with respect to taxes on income and on capital,
3	Belgium	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
4	Canada	DESIRING to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
5	Chile	desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income;
6	Czech Republic	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
7	Denmark	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
8	Finland	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
9	French Republic	desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
10	Germany	Desiring to conclude an Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Certain Other Taxes,
11	Hong Kong (China)	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
12	India	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
13	Indonesia	Desiring to conclude an Agreement for the avoidance of

		double taxation and the prevention of fiscal evasion with respect to taxes on income,
14	Ireland	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains;
15	Italy	desiring to conclude a convention for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion.
16	Japan	Desiring to conclude a new Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
17	Malaysia	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
18	Mexico	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
19	Netherlands	Desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
20	Norway	Desiring to conclude a Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income and certain other taxes,
21	Philippines	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
22	Poland	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
23	Russian Federation	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
24	Singapore	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
25	South Africa	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
26	Spain	desiring to conclude an Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income,
27	Sweden	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
28	Switzerland	Desiring to conclude a Convention for the avoidance of double taxation with respect to taxes on income
29	Thailand	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
30	Turkey	desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with

		respect to taxes on income,
31	United Kingdom	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains;
32	Viet Nam	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
33	China	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income;
34	Republic of Korea	Desiring to conclude a Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income,

Article 7 – Prevention of Treaty Abuse

Notification of Choice of Optional Provisions

Pursuant to Article 7(17)(b) of the Convention, New Zealand hereby chooses to apply Article 7(4).

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 7(17)(a) of the Convention, New Zealand considers that the following agreements are not subject to a reservation under Article 7(15)(b) and contain a provision described in Article 7(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 10(9); Article 11(9); Article 12(7); Article 14(5), second sentence
4	Canada	Article 10(9); Article 11(10); Article 12(7)
5	Chile	Article 22(2)
11	Hong Kong	Article 10(8); Article 11(10); Article 12(7)
14	Ireland	Article 13(7); Article 14(7)
16	Japan	Article 23
24	Singapore	Article 10(6); Article 12(7)
31	United Kingdom	Article 11(6); Article 12(9); Article 13(7); Article 21A(5); Article 22(5)
32	Viet Nam	Article 10(6); Article 11(7); Article 12(7)
33	China	Article 4(1)(a) of (a)

Article 8 – Dividend Transfer Transactions

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 8(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 8(1) that is not subject to a reservation described in Article 8(3)(b). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 10(2)(a) and (3)
4	Canada	Article 10(2)(a)
11	Hong Kong	Article 10(2)(a) and (3)
16	Japan	Article 10(3)
18	Mexico	Protocol (9)
24	Singapore	Article 10(2)(a)
30	Turkey	Article 10(2)(a)
32	Viet Nam	Article 10(2)(a)

Article 9 – Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property

Notification of Choice of Optional Provisions

Pursuant to Article 9(8) of the Convention, New Zealand hereby chooses to apply Article 9(4).

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 9(7) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 9(1). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 13(4)
2	Austria	Article 13(4)
4	Canada	Article 13(4)
6	Czech Republic	Article 13(4)
9	French Republic	Article 13(4)
10	Germany	Protocol (5)(a), first sentence
11	Hong Kong (China)	Article 13(4)
12	India	Article 13(4)
14	Ireland	Article 15(2)
15	Italy	Article 13(3)
16	Japan	Article 13(2)
18	Mexico	Article 13(4)
20	Norway	Article 13(5)
21	Philippines	Protocol (7)
22	Poland	Article 13(4)
24	Singapore	Article 13(4)
25	South Africa	Article 13(4)
26	Spain	Article 13(4)
27	Sweden	Article 12(a)(ii) and (b)(ii)
30	Turkey	Article 13(4)
31	United Kingdom	Part of Article 14(1), but only the following words "or from the alienation of shares in a company deriving their value or the greater part of their value directly or indirectly from such property"
32	Viet Nam	Article 13(4)

Article 10 – Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions

Notification of Existing Provisions in Listed Agreements

Not applicable

Article 11 – Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 11(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 11(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
4	Canada	Article 27(1) and (2)
21	Philippines	Article 1(2); Protocol (9)
16	Japan	Protocol (1)

Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 12(5) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 12(3)(a). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(8)(a)
2	Austria	Article 5(6)
3	Belgium	Article 5(6)
4	Canada	Article 5(8)(a)
5	Chile	Article 5(8)
6	Czech Republic	Article 5(6)
7	Denmark	Article 5(6)
8	Finland	Article 5(6)
9	French Republic	Article 5(6)
10	Germany	Article 5(5)
11	Hong Kong (China)	Article 5(8)(a)
12	India	Article 5(4)(a)
13	Indonesia	Article 5(5)(a)
14	Ireland	Article 5(6)
15	Italy	Article 5(5)
16	Japan	Article 5(8)(a)
17	Malaysia	Article 4(5)(a)
18	Mexico	Article 5(7)
19	Netherlands	Article 5(6)
20	Norway	Article 5(6)
21	Philippines	Article 5(4)
22	Poland	Article 5(7)
23	Russian Federation	Article 5(6)(a)
24	Singapore	Article 5(7)(a)
25	South Africa	Article 5(8)
26	Spain	Article 5(6)
27	Sweden	Article 4(5)(a)
28	Switzerland	Article 5(6)
29	Thailand	Article 5(8)(a)
30	Turkey	Article 5(7)
31	United Kingdom	Article 5(5)
32	Viet Nam	Article 5(8)(a)
33	China	Article 5(5)
34	Republic of Korea	Article 5(6)

Pursuant to Article 12(6) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 12(3)(b). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(9)
2	Austria	Article 5(7)
3	Belgium	Article 5(7)
4	Canada	Article 5(9)
5	Chile	Article 5(9)
6	Czech Republic	Article 5(7)
7	Denmark	Article 5(7)
8	Finland	Article 5(7)
9	French Republic	Article 5(7)
10	Germany	Article 5(6)
11	Hong Kong (China)	Article 5(9)
12	India	Article 5(5)
13	Indonesia	Article 5(6)
14	Ireland	Article 5(7)
15	Italy	Article 5(6)
16	Japan	Article 5(9)
17	Malaysia	Article 4(6)
18	Mexico	Article 5(8)
19	Netherlands	Article 5(7)
20	Norway	Article 5(7)
21	Philippines	Article 5(5)
22	Poland	Article 5(8)
23	Russian Federation	Article 5(7)
24	Singapore	Article 5(8)
25	South Africa	Article 5(9)
26	Spain	Article 5(7)
27	Sweden	Article 4(6)
28	Switzerland	Article 5(7)
29	Thailand	Article 5(9)
30	Turkey	Article 5(8)
31	United Kingdom	Article 5(6)
32	Viet Nam	Article 5(9)
33	China	Article 5(6)
34	Republic of Korea	Article 5(7)

Article 13 – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions

Notification of Choice of Optional Provisions

Pursuant to Article 13(7) of the Convention, New Zealand hereby chooses to apply Option A under Article 13(1).

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 13(7) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 13(5)(a). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(7)
2	Austria	Article 5(5)
3	Belgium	Article 5(4)
4	Canada	Article 5(7)
5	Chile	Article 5(7)
6	Czech Republic	Article 5(5)
7	Denmark	Article 5(4)
8	Finland	Article 5(4)
9	French Republic	Article 5(4)
10	Germany	Article 5(4)
11	Hong Kong (China)	Article 5(7)
12	India	Article 5(3)
13	Indonesia	Article 5(4)
14	Ireland	Article 5(5)
15	Italy	Article 5(3)
16	Japan	Article 5(7)
17	Malaysia	Article 4(3)
18	Mexico	Article 5(6)
19	Netherlands	Article 5(4)
20	Norway	Article 5(4)
21	Philippines	Article 5(3)
22	Poland	Article 5(6)
23	Russian Federation	Article 5(5)
24	Singapore	Article 5(6)
25	South Africa	Article 5(7)
26	Spain	Article 5(3)
27	Sweden	Article 4(3)
28	Switzerland	Article 5(4)
29	Thailand	Article 5(7)
30	Turkey	Article 5(6)
31	United Kingdom	Article 5(4)
32	Viet Nam	Article 5(7)
33	China	Article 5(4)
34	Republic of Korea	Article 5(4)

Article 14 – Splitting-up of Contracts

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 14(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 14(2) that is not subject to a reservation under Article 14(3)(b). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(6)
2	Austria	Protocol (2)
4	Canada	Article 5(6)
5	Chile	Article 5(6)
11	Hong Kong (China)	Article 5(6)
13	Indonesia	Protocol (With reference to Article 5)(b), second sentence and third sentence
16	Japan	Article 5(6)
18	Mexico	Article 5(5)
20	Norway	Article 22(2)
22	Poland	Article 5(5)
23	Russian Federation	Protocol (2)
24	Singapore	Article 5(5)
25	South Africa	Article 5(6)
26	Spain	Article 5(5)
29	Thailand	Article 5(6)
30	Turkey	Protocol (2)
32	Viet Nam	Article 5(6)
33	China	Article 5(3)(c)(ii)

Article 16 – Mutual Agreement Procedure

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 16(6)(a) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 16(4)(a)(i). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 25(1), first sentence
2	Austria	Article 24(1), first sentence
3	Belgium	Article 24(1), first sentence
4	Canada	Article 23(1), first sentence
5	Chile	Article 24(1), first sentence
6	Czech Republic	Article 22(1), first sentence
7	Denmark	Article 23(1), first sentence
8	Finland	Article 24(1), first sentence
9	French Republic	Article 24(1), first sentence
10	Germany	Article 24(1), first sentence
11	Hong Kong (China)	Article 23(1), first sentence
12	India	Article 25(1), first sentence
13	Indonesia	Article 24(1), first sentence
14	Ireland	Article 26(1), first sentence
15	Italy	Article 24(1), first sentence
16	Japan	Article 26(1), first sentence
17	Malaysia	Article 21(1), first sentence
18	Mexico	Article 23(1), first sentence
19	Netherlands	Article 23(1), first sentence
20	Norway	Article 25(1), first sentence
21	Philippines	Article 24(1), first sentence
22	Poland	Article 23(1), first sentence
23	Russian Federation	Article 24(1), first sentence
24	Singapore	Article 22(1), first sentence
25	South Africa	Article 23(1), first sentence
26	Spain	Article 23(1), first sentence
27	Sweden	Article 25(1), first sentence
28	Switzerland	Article 23(1), first sentence
29	Thailand	Article 25(1), first sentence
30	Turkey	Article 24(1), first sentence
31	United Kingdom	Article 24(1)
32	Viet Nam	Article 24(1), first sentence
33	China	Article 25(1), first sentence
34	Republic of Korea	Article 24(1), first sentence

Pursuant to Article 16(6)(b)(i) of the Convention, New Zealand considers that the following agreements contain a provision that provides that a case referred to in the first sentence of Article 16(1) must be presented within a specific time period that is shorter than three years from the first

notification of the action resulting in taxation not in accordance with the provisions of the Covered Tax Agreement. The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
13	Indonesia	Article 24(1), second sentence
15	Italy	Article 24(1), second sentence
21	Philippines	Article 24(1), second sentence

Pursuant to Article 16(6)(b)(ii) of the Convention, New Zealand considers that the following agreements contain a provision that provides that a case referred to in the first sentence of Article 16(1) must be presented within a specific time period that is at least three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Covered Tax Agreement. The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 25(1), second sentence
2	Austria	Article 24(1), second sentence
3	Belgium	Article 24(1), second sentence
4	Canada	Article 23(1), second sentence
5	Chile	Article 24(1), second sentence
6	Czech Republic	Article 22(1), second sentence
7	Denmark	Article 23(1), second sentence
8	Finland	Article 24(1), second sentence
9	French Republic	Article 24(1), second sentence
11	Hong Kong (China)	Article 23(1), second sentence
12	India	Article 25(1), second sentence
14	Ireland	Article 26(1), second sentence
16	Japan	Article 26(1), second sentence
18	Mexico	Article 23(1), second sentence
19	Netherlands	Article 23(1), second sentence
20	Norway	Article 25(1), second sentence
22	Poland	Article 23(1), second sentence
23	Russian Federation	Article 24(1), second sentence
24	Singapore	Article 22(1), second sentence
25	South Africa	Article 23(1), second sentence
26	Spain	Article 23(1), second sentence
28	Switzerland	Article 23(1), second sentence
29	Thailand	Article 25(1), second sentence
30	Turkey	Article 24(1), second sentence
32	Viet Nam	Article 24(1), second sentence
33	China	Article 25(1), second sentence
34	Republic of Korea	Article 24(1), second sentence

Notification of Listed Agreements Not Containing Existing Provisions

Pursuant to Article 16(6)(c)(i) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(b)(i).

Listed Agreement Number	Other Contracting Jurisdiction
18	Mexico
27	Sweden

Pursuant to Article 16(6)(c)(ii) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(b)(ii).

Listed Agreement Number	Other Contracting Jurisdiction
5	Chile
7	Denmark
10	Germany
13	Indonesia
14	Ireland
17	Malaysia
18	Mexico
21	Philippines
27	Sweden
28	Switzerland
31	United Kingdom

Pursuant to Article 16(6)(d)(i) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(c)(i).

Listed Agreement Number	Other Contracting Jurisdiction
9	French Republic
27	Sweden

Pursuant to Article 16(6)(d)(ii) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(c)(ii).

Listed Agreement Number	Other Contracting Jurisdiction
3	Belgium
5	Chile
6	Czech Republic
10	Germany
11	Hong Kong
15	Italy
22	Poland
23	Russian Federation
24	Singapore
25	South Africa
27	Sweden
29	Thailand
31	United Kingdom

Article 17 – Corresponding Adjustments

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 17(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 17(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 9(3)
2	Austria	Article 9(2)
3	Belgium	Article 9(2) (after amendment by Article 4 of (a))
4	Canada	Article 9(2)
5	Chile	Article 9(2)
6	Czech Republic	Article 9(2)
7	Denmark	Article 9(2)
11	Hong Kong (China)	Article 9(2)
12	India	Article 9(2) and (3)
14	Ireland	Article 11(2)
16	Japan	Article 9(2)
18	Mexico	Article 9(2)
19	Netherlands	Article 9(2)
21	Philippines	Article 9(2)
22	Poland	Article 9(2)
23	Russian Federation	Article 9(2)
24	Singapore	Article 9(2)
26	Spain	Article 9(2)
29	Thailand	Article 9(3)
30	Turkey	Article 9(2)
31	United Kingdom	Article 22(4)
32	Viet Nam	Article 9(2)
33	China	Article 9(2)

Article 18 – Choice to Apply Part VI

Notification of Choice of Optional Provisions

Pursuant to Article 18 of the Convention, New Zealand hereby chooses to apply Part VI.

Article 19 – Mandatory Binding Arbitration

Reservation

Pursuant to Article 19(12) of the Convention, New Zealand reserves the right for the following rules to apply with respect to its Covered Tax Agreements notwithstanding the other provisions of Article 19:

a) any unresolved issue arising from a mutual agreement procedure case otherwise within the scope of the arbitration process provided for by the Convention shall not be submitted to arbitration, if a decision on this issue has already been rendered by a court or administrative tribunal of either Contracting Jurisdiction;

b) if, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities of the Contracting Jurisdictions, a decision concerning the issue is rendered by a court or administrative tribunal of one of the Contracting Jurisdictions, the arbitration process shall terminate.

Article 23 – Type of Arbitration Process

Reservation

Pursuant to Article 23(7) of the Convention, New Zealand reserves the right for Part VI not to apply with respect to all Covered Tax Agreements for which the other Contracting Jurisdiction makes a reservation pursuant to Article 23(6).

Notification of Choice of Optional Provisions

Pursuant to Article 23(4) of the Convention, New Zealand hereby chooses to apply Article 23(5).

Article 24 – Agreement on a Different Resolution

Notification of Choice of Optional Provisions

Pursuant to Article 24(1) of the Convention, New Zealand hereby chooses to apply Article 24(2).

Reservation

Pursuant to Article 24(3) of the Convention, New Zealand reserves the right for Article 24(2) to apply only with respect to its Covered Tax Agreements for which Article 23(2) applies.

Article 26 – Compatibility

Reservation

Not applicable

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 26(1) of the Convention, New Zealand considers that the following agreements are not within the scope of a reservation under Article 26(4) and contain a provision that provide for arbitration of unresolved issues arising from a mutual agreement procedure case. The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 25(6) and (7)
16	Japan	Article 26(5);Protocol (16)

Article 28 – Reservations

Reservation Formulated for Scope of Arbitration

Pursuant to Article 28(2)(a) of the Convention, New Zealand formulates the following reservation with respect to the scope of cases that shall be eligible for arbitration under the provisions of Part VI.

1. New Zealand reserves the right to exclude a case presented under the mutual agreement procedure article of its Covered Tax Agreements from the scope of Part VI (Arbitration) to the extent that any unresolved issue involves the application of New Zealand's general anti-avoidance rule contained in section BG 1 of the Income Tax Act 2007.

NATIONAL INTEREST ANALYSIS:
Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Executive summary

1. On [__________] in [_________], New Zealand signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI).

2. The MLI is a multilateral international treaty that proposes to quickly and efficiently amend a significant number of double tax agreements (DTAs) around the world to take into account new treaty standards relating to treaty abuse and dispute resolution. The MLI cannot in and of itself allocate taxing rights between two jurisdictions; it is effective by modifying pre-existing DTAs. For it to modify a particular DTA, both jurisdictions must be parties to the MLI and must have included the DTA in their lists of notifications and reservations provided at the same time their instruments of ratification are deposited.

3. The negotiation of, and giving of effect to, DTAs (and the MLI) is provided for by section BH 1 of the Income Tax Act 2007.

4. DTAs are bilateral international treaties that are principally designed to encourage growth in economic ties between countries. They do this by reducing tax impediments to cross-border services, trade and investment. New Zealand has 40 DTAs in force, primarily with New Zealand's major trading and investment partners.

5. While DTAs are beneficial for taxpayers, investors and governments themselves, there is the potential for these bilateral agreements to be misused to reduce or eliminate a multinational's worldwide tax. Misuse of DTAs in this way has been a feature of a number of cross-border tax avoidance arrangements.

6. The misuse of DTAs forms part of a wider problem referred to as base erosion and profit shifting (BEPS), which has been the focus of significant global media and political attention since late 2012, following evidence suggesting that some multinationals pay little or no tax anywhere in the world.

7. BEPS is a global problem as many BEPS strategies exploit technical differences between different countries' tax rules, so New Zealand has been working with the Organisation for Economic Co-operation and Development (OECD) and G20 to develop a co-ordinated global solution to address BEPS through the 15-point OECD/G20 BEPS Action Plan.

8. A number of the items on the BEPS Action Plan address the misuse of DTAs and can only be implemented through changes to DTAs themselves. Some of these solutions are "minimum standards" that countries that commit to solving BEPS are expected to adopt.

Other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following adoption of the OECD/G20 BEPS Action Plan.

9. Countries, including New Zealand, were presented with the difficulty of how to quickly and efficiently implement these measures without requiring the bilateral renegotiation of several thousand existing DTAs, which could take several years (or even potentially decades). For this reason, the Multilateral Instrument was developed under Action 15 of the OECD/G20 BEPS Action Plan to swiftly amend the DTAs of all participating jurisdictions.

10. To make the best use of the MLI, New Zealand's strategy has been to include the majority of its DTAs within the scope of the MLI and has chosen to adopt as many of the MLI provisions as possible, as they are in line with New Zealand's overall treaty policy. This gives New Zealand the best chance of strengthening its DTAs with as many jurisdictions as possible.

Nature and timing of the proposed treaty action

11. New Zealand signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI) on [____] in [____]. The text of the Multilateral Instrument is attached as Annex A.

12. The proposed treaty action is to ratify the Multilateral Instrument into force by depositing New Zealand's instrument of ratification with the Depositary of the Multilateral Instrument, the Secretary-General of the OECD, in accordance with Articles 27 and 34 of the Multilateral Instrument, after the necessary domestic procedures for entry into force have been completed. At the same time New Zealand's instrument of ratification is deposited, New Zealand must also provide its list of confirmed notifications and reservations. This is attached as Annex B.

13. Before ratification can occur, the MLI must undergo Parliamentary treaty examination, in accordance with Parliament's Standing Order 397, and must successfully be given the force of law in New Zealand by an Order in Council made pursuant to section BH 1 of the Income Tax Act 2007.

14. In general, the MLI will enter into force for New Zealand on the first day of the month following the expiration of a period of three calendar months after the date New Zealand's instrument of ratification is deposited. However, the MLI itself will only enter into force once five jurisdictions have deposited their instruments of ratification. The procedure for entry into force of the MLI is set out in Article 34 of the MLI.

15. The MLI cannot in and of itself allocate taxing rights between two jurisdictions; it is effective by modifying pre-existing DTAs. As DTAs are bilateral agreements negotiated by two jurisdictions, Article 35 of the MLI provides that the provisions of the MLI will only have effect in relation to a particular DTA once the MLI has entered into force for both parties to that DTA where both jurisdictions have nominated the DTA to be covered by the MLI by

including the DTA in their list of confirmed notifications and reservations submitted at the time the instrument of ratification is deposited (i.e. it is a covered tax agreement).

16. As with New Zealand's DTAs more generally, Zealand's signature of the Multilateral Instrument does not extend to Tokelau.

Reasons for New Zealand becoming party to the treaty

General reasons for New Zealand concluding double tax agreements

17. New Zealand began entering into DTAs in 1947, and currently has a network of 40 DTAs in force, predominantly with New Zealand's main trading and investment partners.

18. DTAs are bilateral international treaties that are principally designed to encourage growth in economic ties between countries. DTAs do this by reducing tax impediments to cross-border services, trade and investment. Some impediments to cross-border economic activity can be addressed unilaterally. For example, New Zealand generally relieves double taxation by unilaterally allowing tax residents who derive foreign-sourced income to credit foreign tax paid against their New Zealand tax liability. New Zealand also unilaterally reduces withholding taxes on certain forms of inbound investment. However, unilateral solutions cannot address all of the issues that arise from cross-border activity. Moreover, the country applying unilateral measures must then bear the full cost of the relief. DTAs address these problems by facilitating bilateral solutions. DTAs enable a wider range of issues to be addressed than is possible unilaterally, and also enable the parties to a DTA to share the cost of providing relief.

19. DTA networks make an important contribution to the expansion of world trade and to the development of the world economy, which are key objectives of the OECD. Internationally, the OECD has therefore assumed a leading role in promoting the use of DTAs. In particular, the OECD has produced a Model Tax Convention, and a comprehensive commentary, for member and non-member countries to use as a basis for concluding DTAs. As a member of the OECD, New Zealand is subject to an express recommendation issued by the OECD Council in 1997[1] for all member countries:

1. to pursue their efforts to conclude bilateral tax conventions … with those member countries, and where appropriate with non-member countries, with which they have not yet entered into such conventions …

2. when concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention, as interpreted by the Commentaries thereon.

20. New Zealand's negotiating model is based on the OECD Model Tax Convention, with some differences that take into account New Zealand's status as a small capital importing

[1] The recommendation follows similar OECD Council recommendations that have been in place since before New Zealand joined the OECD.

nation and other unique features of New Zealand's economy, for example, the importance of primary industries. Therefore, the OECD Model Tax Convention and its associated commentary play an important role in New Zealand's overall treaty policy and New Zealand's DTA network.

Reasons for New Zealand becoming party to the Multilateral Instrument

21. While DTAs are beneficial for taxpayers, investors and governments, there is the potential for these bilateral agreements to be misused to reduce or eliminate a multinational's worldwide tax. Misuse of DTAs in this way has been a feature of a number of cross-border tax avoidance arrangements.

22. The misuse of DTAs forms part of a wider problem referred to as base erosion and profit shifting (BEPS), which has been the focus of significant global media and political attention since late 2012, following evidence suggesting that some multinationals pay little or no tax anywhere in the world.

23. BEPS is a global problem as many BEPS strategies exploit technical differences between different countries' tax rules, and New Zealand has been working with the OECD and G20 to develop a co-ordinated global solution to address BEPS through the 15-point OECD/G20 BEPS Action Plan. The New Zealand Government has confirmed its commitment to resolving BEPS on a number of occasions.[2]

24. A number of the items on the OECD/G20 BEPS Action Plan address the misuse of DTAs and can only be implemented through changes to DTAs themselves. These are:

- preventing the granting of treaty benefits in inappropriate circumstances (Action 6);
- preventing the artificial avoidance of permanent establishment status (Action 7);
- neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2); and
- providing improved mechanisms for effective dispute resolution (Action 14).

25. Some of the solutions under these Action items are "minimum standards" that countries that commit to solving BEPS are expected to adopt. Other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following the adoption of the OECD/G20 BEPS Action Plan.

26. Given the important role the OECD Model Tax Convention plays in informing New Zealand's treaty policy, as well as New Zealand's commitment to resolving BEPS more generally, New Zealand is committed to including these minimum standards as well as the

[2] See for example, the BEPS Cabinet Paper released in June 2016 http://taxpolicy.ird.govt.nz/sites/default/files/2016-other-cabinet-paper-beps-update.pdf and the Government press release welcoming the release of the Multilateral Instrument on 28 November 2016 https://www.beehive.govt.nz/release/oecd-multilateral-instrument-counter-beps.

optional best practice provisions in its DTAs, where they are in line with overall New Zealand treaty policy.

27. New Zealand's treaty negotiation resources are limited and to update New Zealand's entire DTA network would take several years, if not decades, particularly as many of New Zealand's treaty partners would likely place greater importance on updating more significant treaties. This would limit New Zealand's ability to meet the OECD minimum standard in a timely fashion.

28. Finding resources to update DTAs is a common problem faced by many countries, not just New Zealand. The development of the Multilateral Instrument under Action 15 of the OECD/G20 BEPS Action Plan takes into account the existence of several thousand DTAs around the world and allows participating jurisdictions to quickly and efficiently amend their DTAs to counter BEPS. The text of the MLI was developed by the OECD Ad Hoc Group consisting of officials from more than 100 participating jurisdictions including New Zealand and was formally adopted by the OECD in November 2016.

29. The MLI is flexible and allows countries to choose:

- which of their existing DTAs they wish to modify through the MLI;
- alternative ways of meeting BEPS minimum standards on treaty abuse and dispute resolution; and
- whether they want to adopt the OECD-recommended provisions for non-minimum standards. Within some of these provisions, there are alternative ways of addressing BEPS concerns and the ability for countries to enter a variety of reservations.

30. To make the best use of the MLI, New Zealand's strategy has been to include the majority of its DTAs within the scope of the Multilateral Instrument and has chosen to adopt as many of the MLI provisions as possible. This gives New Zealand the best chance of strengthening its DTAs with as many jurisdictions as possible.

31. New Zealand's list of notifications and reservations can be found in Annex B. This document lists the DTAs New Zealand wishes to be covered by the MLI and the provisions New Zealand has indicated it will adopt. This document must be submitted at the time instrument of ratification is deposited and will be considered "confirmed" at that point in time. There is limited ability to amend New Zealand's notifications and reservations following entry into force, which is discussed in further detail the section titled *Subsequent protocols and/or amendments to the treaty and their likely effects.*

32. Of New Zealand's 40 in-force DTAs, New Zealand has nominated 34 to be covered by the MLI. Many of these DTAs were concluded in the 1970s and 1980s and do not reflect modern treaty standards, even before the work on BEPS was completed. The six DTAs that have not been listed are with jurisdictions who will not be signing the MLI. To be modified by the MLI, both New Zealand and the other jurisdiction must elect for the MLI to apply to the DTA (if there is a match, then the DTA is a "covered tax agreement"). Based on current

draft notifications, New Zealand is expected to have 28 covered tax agreements. See Annex C. While this list is not final, it provides a fairly good indication of the likely coverage of the MLI. Final coverage will not be confirmed until each jurisdiction deposits its instrument of ratification with the OECD Depositary.

33. As noted above, New Zealand's strategy in formulating its notifications and reservations has been to adopt as many of the MLI provisions as possible. This is because they are base protection measures that are in line with New Zealand's existing treaty policy (which has a greater source state emphasis than the OECD Model Tax Convention) or are taxpayer friendly measures that provide improved access to dispute resolution. For example, New Zealand generally takes a broader approach in its DTAs than the current OECD Model Tax Convention in determining whether a permanent establishment exists. This means that the recommendations under Action 7 (preventing the artificial avoidance of permanent establishment status) of the OECD/G20 BEPS Action Plan which are contained in Articles 12 to 15 of the MLI are not contrary to New Zealand's general treaty policy and, in New Zealand's view, represent an improvement to the OECD Model Tax Convention.

34. The optional provisions New Zealand has chosen cover the following issues:

- Fiscally transparent entities (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The provision in Article 3 clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident.
- Dual resident entities can be used to take advantage of arbitrage opportunities by manipulating the current "place of effective management" test. The proposed provision in Article 4 will require competent authorities to agree the residence status of a dual resident entity. If there is no agreement, then treaty benefits will be denied, or only granted to the extent to which the competent authorities can agree.
- In the OECD Model Tax Convention – and in many of New Zealand's modern treaties – a lower withholding tax rate is available where the shareholder owns more than a certain proportion of the company's shares. The MLI provision in Article 8 requires shares to be held for a minimum of 365 days for the shareholder to be entitled to reduced withholding tax rates on dividends. This prevents shareholders buying shares and holding them temporarily in order to access lower withholding rates.
- Investors can hold land through companies and dispose of the shares in the company to avoid paying tax on the disposal of that land. Many treaties contain a "land-rich company rule" which allows the source jurisdiction to tax income derived from land when the majority of a company's assets consist of land. To prevent the artificial and temporary dilution of the amount of land held by a company just before sale, the provision in Article 9 requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares and extends the rule to interests in other entities such as partnerships and trusts.

- Permanent establishments can be established in third states to exploit low tax rates and branch exemptions. Article 10 of the MLI introduces a provision that denies treaty benefits in the case of income derived by a permanent establishment of an enterprise resident in one of the parties to the DTA, where that permanent establishment is situated in a low tax third state and the residence state exempts the permanent establishment's income.
- Article 11 introduces a provision that preserves a jurisdiction's right to tax its own residents. For example, this provision would prevent a New Zealand resident who is engaged in a tax avoidance arrangement from claiming that a DTA prevents New Zealand from using its domestic general anti-avoidance rule to impose tax.
- A source jurisdiction generally cannot tax the business profits of a resident of the other contracting state unless there is a permanent establishment in the source state. The provisions in Articles 12 to 15 of the MLI introduce changes to counter common strategies used to avoid permanent establishment status.

35. In addition to addressing these specific BEPS concerns, Article 6 of the MLI proposes to amend the preamble to DTAs to confirm that they are not intended to be used to generate double non-taxation. Under Article 7, New Zealand has selected the option of adding a principal purpose test to its DTAs. The principal purpose test is a general anti-abuse rule that applies to the whole DTA. Both Articles 6 and 7 form part of the OECD minimum standard.

36. In addition to these base protection measures, New Zealand is signing up to taxpayer friendly measures relating to the mutual agreement procedure (MAP) and the availability of arbitration as a form of dispute resolution. These measures are a result of the work on Action 14 of the OECD/G20 BEPS Action Plan relating to improving mechanisms for effective dispute resolution. They recognise the fact that measures to counter BEPS should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues.

37. Article 16 of the MLI introduces a provision allowing taxpayers to approach the competent authorities of either party to the DTA to request MAP where they believe taxation is not in accordance with the treaty. This is a new OECD minimum standard. While the majority of New Zealand's DTAs contain MAP provisions, the MLI will amend these provisions to allow taxpayers to approach the competent authority of either jurisdiction (currently they only permit a case to be presented to the competent authority of the taxpayer's country of residence). In addition, Article 16 creates a new minimum standard regarding time limits for bringing a case to MAP and for implementing a solution.

38. Article 17 requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. This provision is already found in most of New Zealand's DTAs except for New Zealand's oldest treaties, which were concluded before the OECD Model Tax Convention included such a provision.

39. New Zealand has also opted to apply Part VI of the MLI, which will introduce arbitration as a means of dispute resolution. If a solution cannot be reached under MAP, taxpayers have the ability to request that unresolved issues can be taken to arbitration. New Zealand has already agreed to arbitration in two of its treaties (with Australia and Japan). New Zealand's experience is that the arbitration facility is very rarely used, but it acts as an incentive for the competent authorities of two jurisdictions to come to an agreement within the required time period for MAP.

40. Note that while New Zealand has indicated that it will sign up to many of the optional provisions, these will only apply to a DTA if New Zealand's treaty partner also signs the MLI, includes their DTA with New Zealand in their list of notifications and reservations and chooses to apply the same option as New Zealand.

Advantages and disadvantages to New Zealand of the Multilateral Instrument entering into force and not entering into force for New Zealand

41. The standard process for making amendments to DTAs is to renegotiate a new agreement or to negotiate a protocol that amends specific parts of the existing DTA (an amending protocol). In absence of the MLI, New Zealand would be expected to enter into bilateral negotiations with each of its treaty partners in order to meet the new OECD minimum standard. The advantages and disadvantages of bringing the MLI into force are therefore considered in relation to the status quo and also in relation to this bilateral negotiation approach.

42. The MLI is a novel approach to modifying DTAs, but it is not unprecedented in international law. Experts in both international tax and public international law participated in the OECD Ad Hoc Group that developed the MLI to ensure that it works as intended.

43. The provisions in the MLI have been drafted more broadly than they otherwise would for an amending protocol to take account of the fact that the MLI must be able to apply to not one DTA, but several thousand. This, combined with a limited ability to customise the MLI's provisions, means that the interaction between the MLI and DTAs is not as straightforward as an amending protocol.

44. This complication is one of the most significant trade-offs, but despite this, ratifying the MLI is expected to be in New Zealand's overall interests.

Advantages of the Multilateral Instrument entering into force for New Zealand

45. The main advantage in the MLI entering into force for New Zealand is that it would reduce the ability of multinationals and other investors to misuse DTAs to reduce both their New Zealand tax and their worldwide tax, or in other words, it resolves BEPS issues that relate to tax treaties. This is achieved through changes to specific provisions found in DTAs,

as well as through more general changes, such as a new preamble and the introduction of a general treaty anti-abuse rule.

46. Many of New Zealand's treaties already contain pre-cursors to some of the MLI provisions, which will also feature in the updated OECD Model Tax Convention (for example, a principal purpose test, or a land-rich company rule that extends to interests in other entities). However, the drafting of these provisions often differs from treaty to treaty with no or little OECD commentary to rely on. By signing up to the relevant MLI provisions and replacing existing provisions, New Zealand will have consistency across its treaty network and will also be able to rely on the new OECD commentary relating to those provisions.

47. While the resolution of treaty-related BEPS issues and the introduction of improved mechanisms for dispute resolution could also occur in absence of the MLI, in order to do this New Zealand would be required to enter into bilateral negotiations with each of its treaty partners.

48. The main advantage of the MLI compared with the bilateral negotiation approach is that the MLI process is much faster and more efficient. Based on current projections it is possible that the MLI could enter into effect for New Zealand in 2019. Bilateral negotiations, on the other hand, could take several years or potentially decades to complete. No additional negotiations or discussions with treaty partners are required for the MLI to apply to a DTA. This is because jurisdictions have been required to provide draft notifications and reservations at various stages of the MLI project, which has provided clarity as to jurisdictions' positions. In addition, "speed matching" sessions were arranged by the OECD in late February – early March 2017 so that bilateral treaty partners could meet to discuss any issues with the application or implementation of the MLI, either in general or with regard to specific provisions.

49. In addition to the time it would take to complete bilateral negotiations, each individual amending protocol would need to be ratified according to each jurisdiction's domestic law requirements, as opposed to ratifying the single MLI. This could add further time to the process and create bottlenecks in parliamentary processes, as other jurisdictions may place greater importance on ratifying amending protocols with more significant economies than New Zealand.

50. In this respect, the main advantages of the MLI compared with entering into individual bilateral negotiations are that the BEPS solutions will be incorporated into New Zealand's DTAs as soon as possible and resources (from both a policy perspective and a Parliamentary perspective) will be freed up to work on other priorities.

51. New Zealand's tax system operates on the principle of voluntary compliance, which relies on taxpayers understanding their tax obligations and how the wider tax system works. An important part of this is that, overall, the tax system is seen to be fair. If the view persists that multinationals do not pay their fair share of tax, this could undermine the integrity of the

tax system. Therefore, New Zealand's ratification of the MLI and the resolution of treaty-related BEPS issues in a timely manner support the overall integrity of the New Zealand tax system. This is discussed in further detail in the section titled *Economic, social, cultural and environmental costs and effects of the treaty action.*

52. The advantages to New Zealand in becoming a party to the MLI (as compared to the bilateral negotiation approach) can therefore be summarised as follows:

- it significantly reduces the possibility of New Zealand's DTAs being misused to reduce or eliminate tax liabilities;
- it introduces taxpayer friendly measures relating to disputes resolution;
- it allows New Zealand to update the majority of its DTAs quickly and efficiently;
- the timely resolution of treaty related BEPS issues supports the overall integrity of the New Zealand tax system.

Disadvantages of the Multilateral Instrument entering into force for New Zealand

53. The main disadvantage of the MLI entering into force for New Zealand stems from the fact that the provisions in the MLI have been drafted more broadly than they otherwise would for an amending protocol to take account of the fact that the MLI must be able to apply to not one DTA, but several thousand.

54. This means that there can be some ambiguity in how the MLI applies to a particular DTA. This ambiguity is mitigated in many cases as a given MLI provision will only replace the corresponding DTA provision if both treaty partners notify the same provision.

55. Any residual ambiguity may give rise to compliance costs as taxpayers will need to consider the DTA alongside the text of the MLI and the confirmed notifications and reservations of both parties to the DTA. This would not occur if instead of ratifying the MLI, New Zealand into individual bilateral amending protocols with each of its DTA partners.

56. There are ways in which these upfront compliance costs may be mitigated. Publishers may produce consolidated texts as they currently do with amending protocols and original DTAs. In addition to this, New Zealand Inland Revenue officials are continuing discussions with overseas counterparts to determine what additional certainty the competent authorities may be able to provide (for example, through the mutual agreement procedure in DTAs, competent authorities can produce a memorandum of understanding to resolve any difficulties or doubts arising as to the interpretation or application of the MLI with respect to a specific DTA). New Zealand officials may also consider producing informal consolidated versions of New Zealand's DTAs in response to submissions requesting this.

57. This complication is one of the most significant trade-offs, but despite this, bringing the MLI into force is expected to be in New Zealand's overall interests. Any upfront compliance costs associated with determining how the MLI modifies a particular DTA and

the administrative costs associated with producing guidance on the application of the MLI would be offset by the savings made from not having to enter into bilateral negotiations with each DTA partner and then having to bring each amending protocol into force.

58. There are also compliance and administrative costs that would still arise if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTAs partners, for example in the context of competent authority agreements to determine the residence of dual resident entities or in challenge the application of specific anti-avoidance provisions.

59. The issue of compliance and administrative costs is discussed in further detail in the section titled *The costs to New Zealand of compliance with the treaty*. While we are unable to quantify these compliance and administrative costs, we expect them to be modest and through consultation officials are working on ways to minimise these further.

60. Another disadvantage is the uncertainty of outcomes for each individual DTA. Note that while New Zealand has indicated that it will sign up to many of the optional provisions, these will only apply to a DTA if New Zealand's treaty partner also signs the MLI, includes their DTA with New Zealand in their list of notifications and reservations and chooses to apply the same option as New Zealand. As stated, notifications and reservations are considered to be in draft form until the instrument of ratification is deposited. Therefore, the modifications to a specific DTA will not be completely certain until both parties have completed their domestic procedures for entry into force and deposited their instruments of ratification. Notwithstanding this uncertainty, New Zealand can control its own position and only choose provisions that it believes are principled and will enhance New Zealand's DTA network. If countries choose to sign up to fewer MLI provisions than New Zealand, then the DTA will still be strengthened to the extent there is a match. New Zealand believes the provisions in the MLI are principled improvements on the current OECD Model Tax Convention and therefore supports the inclusion of the provisions in its treaties so far as it is possible.

61. Some stakeholders have raised issues about the inability to consider a set and certain package of measures on a treaty-by-treaty basis (as DTAs are usually a negotiated package, tailored to the specific circumstances of the jurisdictions involved and their bilateral relationship). For example, they have suggested it may be ideal to combine the new strengthened permanent establishment rules or the principal purpose test with the counterbalancing taxpayer-friendly measure of binding arbitration.

62. Some countries may choose only to adopt the former provisions and not the latter, particularly as the inclusion of a principal purpose test is one way of meeting the minimum standard on treaty abuse under Article 7, while arbitration is optional. Theoretically it would be possible to exclude from the scope of the MLI DTAs with jurisdictions who have indicated in their draft notifications that they will not be signing up to arbitration. However, this would reduce the efficacy of the MLI in enabling New Zealand to meet the OECD minimum standard as New Zealand would have to endeavour to undertake bilateral negotiations with

these excluded jurisdictions, which could represent about half of New Zealand's DTAs, based on current draft notifications. This is undesirable for the reasons outlined above. It would also mean that – until bilateral negotiations can take place – the DTAs excluded on this basis would remain vulnerable to the BEPS techniques the MLI is designed to address. On balance it is in New Zealand's interest to obtain the stronger DTA provisions, even if it is without the optional arbitration provisions. We also note that many of New Zealand's DTAs already include a principal purpose test and broader permanent establishment rules, but no ability to pursue arbitration. Therefore this combination is already a feature of some of our existing DTAs and, from New Zealand's perspective, is not problematic.

63. Some of the provisions in the MLI (for example, the dual resident entity provision) require taxpayer engagement with competent authorities to determine their tax position. This will increase compliance and administrative costs in these cases. These provisions are used sparingly and are generally confined to areas where tax avoidance arrangements have been prevalent. However, there will be a need to put in place administrative measures to increase taxpayer certainty and minimise compliance costs as much as possible, particularly in bona fide cases where there is no mischief. Eight of New Zealand's DTAs already contain this provision and it has not, to our knowledge, been problematic. In addition, if instead of ratifying the MLI, New Zealand entered into individual bilateral amending protocols, these costs would still arise. This is discussed in the section titled *The costs to New Zealand of compliance with the treaty*.

64. As New Zealand is signing up to the optional arbitration provisions contained in Part VI of the MLI, costs will be incurred if a case is submitted for arbitration. However, as noted below in the section titled *The costs to New Zealand of compliance with the treaty*, the actual costs associated with administering the arbitration provisions are likely to be negligible as New Zealand's experience is that arbitration is very rarely used and would still arise if New Zealand agreed to include arbitration in its DTAs in individual bilateral amending protocols.

Advantages of the Multilateral Instrument not entering into force for New Zealand

65. It is an option not to ratify the MLI. In that case, the disadvantages identified above relating to implementation would not arise.

66. In the fullness of time, New Zealand would be able to negotiate amending protocols with each of its DTA partners and tailor the drafting of these protocols to suit the preferences and needs of the treaty partners. This would make it clearer to taxpayers, practitioners and tax authorities what the exact change to each DTA is.

67. In addition, the amending protocols would also be able to cover issues not included in the MLI.

Disadvantages of the Multilateral Instrument not entering into force for New Zealand

68. If New Zealand does not become a party to the MLI, there are two possible options.

69. The first is to leave New Zealand's DTAs as they are. This would mean that there would still be opportunities for New Zealand's DTAs to be misused to eliminate tax and New Zealand would not meet the new OECD minimum standard. As an OECD member country and a member of BEPS Inclusive Framework,[3] this position is undesirable.

70. The second and more realistic option, given that New Zealand has indicated its commitment to the BEPS project is for New Zealand to begin bilateral negotiations with each of its DTA partners to incorporate the BEPS recommendations into its existing DTAs.

71. Bilateral negotiations, however, could take several years or decades to complete. In comparison, no additional negotiations or discussions with treaty partners would be required for the MLI to apply to a DTA. This is because jurisdictions have been required to provide draft notifications and reservations at various stages of the MLI project, which has provided clarity as to jurisdictions' positions. In addition, "speed matching" sessions were arranged by the OECD in late February and early March 2017 so that bilateral treaty partners could meet to discuss any issues with the application or implementation of the MLI, either in general or with regard to specific provisions.

72. In addition to the time it would take to complete bilateral negotiations, each individual amending protocol would need to be brought into force according to each jurisdiction's domestic law requirements, as opposed to bringing into force the single MLI. This could add further time to the process and create bottlenecks in parliamentary processes, as other jurisdictions may place greater importance on ratifying amending protocols with more significant economies than New Zealand.

73. This is problematic for several reasons. It leaves New Zealand's DTAs open to misuse for a much longer period of time, but it also has the potential to undermine the integrity of the tax system if there is a continued perception that multinationals do not pay their fair of tax in New Zealand. This is discussed in further detail in the sections titled *Advantages of ratifying the Multilateral Instrument* and *Economic, social, cultural and environmental costs and effects of the treaty action.* It would also mean that resources that could otherwise be used to progress other projects and government priorities would be tied up in negotiating and ratifying individual bilateral protocols.

74. Therefore, not becoming party to the MLI, and entering into bilateral negotiations with all of New Zealand's treaty partners would not be in New Zealand's overall interests. Of the options available, the proposed treaty action is the best policy option and will achieve the Government's policy objectives.

[3] The Inclusive Framework is a group of over 90 jurisdictions that have committed to combatting BEPS. Members of the inclusive framework will develop a monitoring process for the four minimum standards as well as put in place the review mechanisms for other elements of the BEPS Package. One of the functions of the Inclusive Framework is to support the development of the toolkits for low-capacity developing countries.

Legal obligations which would be imposed on New Zealand by the treaty action, the position in respect of reservations to the treaty, and an outline of any dispute settlement mechanisms

75. DTAs cannot impose additional tax obligations beyond what is provided for under domestic law. This means that although the MLI consists largely of base protection measures that would allow the source country to impose tax where the existing DTA does not, these measures cannot go beyond what would otherwise be imposed in absence of a DTA.

76. The text of the MLI itself cannot be amended to suit each jurisdiction's preferences, but the MLI provides flexibility by allowing jurisdictions to opt into or reserve against certain provisions. The possible reservations are described in each Article and Article 28 provides that these are the only reservations that are able to be made. In the case of arbitration, free form reservations are permitted, but these must be accepted by the jurisdiction's treaty partner in order for the reservation to apply to a DTA.

77. To ensure the operation of the MLI is clear and transparent, signatories must notify the OECD Depositary of which DTAs they wish to cover, which reservations they wish to enter, optional provisions they wish to choose and which provisions in their nominated DTAs will be modified by the MLI. The OECD will publish this information online and it will be readily accessible to the public.

78. These reservations must either be made at the time of signature of the MLI and confirmed at the time the instrument of ratification is deposited, or a provisional list of expected reservations must be provided at the time of signature and subsequently confirmed at the time the instrument of ratification is deposited. At the time of signature, New Zealand provided a provisional list of expected reservations and so New Zealand's confirmed notifications and reservations must be submitted at the time the instrument of ratification is deposited.

79. After a jurisdiction's choices and reservations are confirmed at the time the instrument of ratification is deposited, that jurisdiction is still able to add new DTAs to their list of treaties covered by the MLI and withdraw their reservations (or reduce the scope of their reservations), but are unable to enter new or broader reservations. The effect of this is that, following ratification, New Zealand (and other) jurisdictions can expand, but not narrow, the application of the MLI to their DTA network. This is provided for in Articles 28 and 29 of the Multilateral Instrument.

80. New Zealand's provisional notifications and reservations can be found in Annex B and the overall effect of New Zealand's options and reservations is discussed in the section titled *Reasons for New Zealand becoming party to the treaty*. As noted in that section, the MLI provisions will only apply to a DTA if the other treaty partner also chooses the same option. This means that the effect of the MLI could vary from treaty to treaty.

81. There is no dispute settlement mechanism for the MLI itself, but Article 32 provides that any questions arising as to the interpretation or implementation of the MLI may be addressed by a "Conference of the Parties". Under Article 31 a Conference of the Parties can be convened to consider a proposed amendment at the request of one of the parties to the MLI, but only if one third of the parties to the MLI support the request within six calendar months of the request being communicated.

82. Note, however, that New Zealand is signing up to improved MAP provisions and arbitration, which will improve the dispute resolution mechanisms available in New Zealand's existing DTAs that are being amended by the MLI.

Measures which the Government could or should adopt to implement the treaty action, including specific reference to implementing legislation

83. Subject to the successful completion of the Parliamentary treaty examination process, the MLI will be incorporated into domestic legislation by Order in Council pursuant to section BH 1 of the Income Tax Act 2007. Section BH 1 provides for the giving of overriding effect to DTAs by Order in Council. However, the override relates only to tax matters, and applies only in respect of the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993.

84. The override of the Inland Revenue Acts is necessary to give effect to the core provisions of the MLI and New Zealand's DTAs, which may provide relief from tax that would otherwise be imposed under domestic law. The override of the Official Information Act 1982 is necessary to ensure that confidential communications with the other jurisdiction do not have to be disclosed. The override of the Privacy Act 1993 is necessary to ensure that information regarding natural persons can be exchanged according to the terms of the treaty.

85. Article 34 of the MLI provides that the agreement itself will only enter into force once five jurisdictions have completed their domestic law requirements and have deposited their instruments of ratification. In particular, it will enter into force on the first day of the month following the expiration of a period of three calendar months beginning on the date of deposit of the fifth instrument of ratification. If New Zealand is one of the first five jurisdictions to ratify the MLI, it will enter into force for New Zealand on that date. If not, the MLI will enter into force for New Zealand on the first day of the month following the expiration of a period of three calendar months after the date New Zealand's instrument of ratification is deposited.

86. New Zealand will be in a position to deposit its instrument of ratification with the Depositary of the MLI, the Secretary-General of the OECD, once the Order in Council has entered into force, which will be 28 days after its publication in the *New Zealand Gazette.*

87. As the MLI affects pre-existing DTAs that have been negotiated by two jurisdictions, Article 35 provides that the provisions of the MLI will only have effect in relation to a particular DTA once the MLI has entered into force for both parties to that DTA. For withholding tax, it will apply where the event giving rise to the tax occurs on or after 1

January of the next calendar year beginning on or after the latest date on which the MLI enters into force for each of the parties to the covered tax agreement. For income tax, it will apply to taxable periods (in New Zealand's case, income years) beginning on or after a 6 month period from the latest date on which the MLI enters into force for each of the parties to the covered tax agreement.

88. Some domestic law changes may be needed to facilitate the modifications to New Zealand's DTAs by the MLI. For example, officials anticipate there may need to be some amendments to the dispute procedures in Part 4A of the Tax Administration Act 1994 to enable cases to be submitted to arbitration without prejudicing taxpayer rights under the domestic law. There may also be changes needed to the time bar rules to allow arbitration decisions to be implemented notwithstanding domestic law time limits for amending assessments and providing taxpayer refunds.

89. As an alternative to the above Order in Council mechanism, the MLI could be given legislative effect by means of the enactment of a dedicated statute. However, this option would unnecessarily increase the amount of primary tax legislation and could be difficult to achieve in reality given the system for depositing notification and reservations, so it is not preferred or practical.

Economic, social, cultural and environmental costs and effects of the treaty action

90. With the political and media focus on BEPS in recent years, there has been a sentiment among the general public that multinationals are not paying their fair share of tax.

91. New Zealand's tax system operates on the principle of voluntary compliance, which relies on taxpayers understanding their tax obligations and how the wider tax system works. An important part of this is that, overall, the tax system is seen to be fair. If the view persists that multinationals do not pay their fair share of tax, this could undermine the integrity of the tax system and the ability to New Zealand to operate a tax system based on voluntary compliance and self-assessment.

92. The provisions that New Zealand is signing up to in the MLI are base protection measures which will strengthen New Zealand's ability to tax a multinational's income where there is a New Zealand source and will reduce the ability of multinationals to misuse those DTAs to eliminate tax in New Zealand.

93. Therefore, New Zealand's ratification of the MLI and the resolution of treaty-related BEPS issues in a timely manner will assist in supporting the overall integrity of the New Zealand tax system.

94. In addition, ratifying the MLI may enhance or reinforce New Zealand's reputation in the international community as a supporter of the OECD/G20 BEPS project.

95. From an economic impact perspective, the MLI, as a tool to resolve BEPS concerns that arise as a result of the misuse of DTAs, increases worldwide economic efficiency. This is because the use of BEPS techniques results in cross-border investments being subsidised relative to domestic investment. This leads to an inefficient allocation of investment internationally. Eliminating this misallocation would increase worldwide efficiency, leading to higher worldwide incomes.

96. One source of such inefficiency arises from the use of complex arrangements to benefit from certain provisions found in DTAs. The introduction of a whole-of-treaty anti-abuse rule (the principal purpose test in Article 7) through the MLI should have a dampening effect on taxpayers' appetites to use such complex arrangements.

97. However, there is a potential trade-off that should be noted - increasing the tax that New Zealand is able to impose under a DTA could have a negative impact on the level of foreign investment into New Zealand and on the cost of capital. This concern is not unique to the MLI and is a potential concern with any tax measure that increases the effective rate of tax on inbound investment. In June 2016, officials released a draft paper titled *New Zealand's taxation framework for inbound investment* which explores the issue in greater detail and can be found at www.taxpolicy.ird.govt.nz. In line with the analysis in this paper, our assessment is that any impact would likely be low and is acceptable in the overall context of the BEPS project. New Zealand is adopting the MLI alongside a number of likeminded countries who are implementing the BEPS measures broadly at the same time. Furthermore, the base protection measures included in the MLI are important to protect the New Zealand tax base and ensure that New Zealand is able to collect its fair share of revenues.

98. As stated in *New Zealand's taxation framework for inbound investment:*

"Taxes are necessary to fund government spending. New Zealand faces growing fiscal pressures with an ageing population. Maintaining robust tax bases is important to reduce upward pressures on tax rates and help maintain our coherent tax structure.

New Zealand levies tax on the profits of non-resident-owned firms that are sourced in New Zealand. These taxes should not be voluntary. Tax rules should not allow foreign-owned firms to sidestep paying taxes on their profits in New Zealand.

Almost all taxes are likely to have some negative effects on economic activity. In setting taxes on inbound investment there is a balance to be struck. Taxes should not unduly discourage inbound investment but we want the tax system to be robust. It is important that taxes are fair and seen to be fair.

…Deviations from normal tax rules, intended or otherwise, can lead to substitution of low-taxed investors for tax-paying investors, reducing national income without necessarily lowering the overall pre-tax cost of capital to New Zealand or increasing investment. Accordingly, base-maintenance provisions that ensure the intended level of tax is collected will often be in New Zealand's best interest."

99. Note that this is a secondary effect that arises from behavioural changes which officials are unable to quantify.

100. When resolving BEPS issues it is important that New Zealand remains an attractive place to base a business and invest. Taking a unilateral approach could harm New Zealand's reputation as a good place to do business, because New Zealand's tax treaty network could look less favourable relative to other countries' networks. However, a co-ordinated approach through the MLI minimises this risk by broadly simultaneously amending potentially several thousand treaties at the same time.

101. Regardless, the overall benefits of ratifying the MLI are expected to outweigh the costs.

The costs to New Zealand of compliance with the treaty

102. Normally, new DTAs or amending protocols constrain New Zealand from taxing certain income and limit the rate at which tax on passive income (dividends, interest, and royalties) can be imposed and therefore result in the reduction of New Zealand tax. However, this upfront revenue cost is typically offset by other factors (for example, through a reduced need for New Zealand to allow foreign tax credits for foreign income tax paid by New Zealand residents on foreign-sourced income).

103. The MLI differs in that its provisions are typically base protection measures which increase New Zealand's ability to tax inbound investment and equips New Zealand with a whole-of-treaty anti-abuse rule to prevent tax avoidance through the use of DTAs. This may result in more tax paid by non-residents in New Zealand.

104. However, as the provisions are reciprocal, the MLI may also increase the amount of foreign income tax paid by New Zealand residents with overseas investments and business operations. This could decrease the amount of net New Zealand income tax paid on that foreign income as a foreign tax credit is provided for foreign income tax paid.

105. Data limitations prevent officials from estimating the actual impact on net tax revenue. However, as New Zealand is a capital importer and the MLI covers the majority of New Zealand's DTA network, it is expected that the overall impact on tax revenue will be positive. A similar effect would be expected if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTA partners.

106. In terms of costs borne by Inland Revenue, there will be costs associated in administering the arbitration and other competent authority agreement provisions contained in the MLI. However, these are expected to be small and would be the same if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTA partners.

107. The existence of arbitration provides a strong incentive for revenue authorities to resolve issues under the MAP before arbitration can be triggered. New Zealand's DTAs with Australia and Japan already provide for arbitration and New Zealand's experience is that very few cases have been brought by taxpayers under the MAP and almost all of these have been settled within the required time period, regardless of whether the DTA provides for arbitration.

108. As mentioned above, there will be additional compliance and/or administrative costs associated with determining how the MLI modifies particular DTAs, producing guidance on the application of the MLI and using competent authority agreements to determine the treaty residence of dual-resident entities or challenging the application of specific anti-avoidance provisions such as the third state permanent establishment rule. While we are unable to quantify these compliance and administrative costs, we expect them to be modest and through consultation officials are working on ways to minimise these further.

109. Some of these compliance and administrative costs would still arise if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTAs partners, for example in the context of competent authority agreements to determine the treaty residence of dual-resident entities or in challenging the application of specific anti-avoidance provisions.

110. Other costs are unique to the ratification of the MLI but would be offset by the benefits of the MLI. For example, the upfront compliance costs associated with determining how the MLI modifies particular DTA and the administrative costs associated with producing guidance on the application of the MLI would be offset by the savings made from not having to enter into bilateral negotiations with each DTA partner and then having to bring each amending protocol into force.

Completed or proposed consultation with the community and parties interested in the treaty action

111. The Treasury and the Ministry of Foreign Affairs and Trade were consulted about the content of this extended National Interest Analysis.

112. In addition, an officials' issues paper titled *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* was published in March 2017 and is available at www.taxpolicy.ird.govt.nz. While officials generally do not consult on the content of tax treaties, due to the complicated nature of the MLI, public feedback was sought on potential implementation issues related to the MLI. Two stakeholder workshops were held on 27 and 28 March 2017 with interested practitioners to enable officials to better understand practitioners' concerns. Submissions closed on 7 April 2017. Submissions received by that date were taken into account in the drafting of this extended National Interest Analysis, particularly in relation to the potential mitigation of identified disadvantages associated with New Zealand's ratification of the MLI.

Subsequent protocols and/or amendments to the treaty and their likely effects

113. After a jurisdiction's choices and reservations are confirmed at the time the instrument of ratification is deposited, that jurisdiction is still able to add new DTAs as DTAs covered by the MLI and withdraw their reservations (or reduce the scope of their reservations), but are unable to enter new reservations. The effect of this is that, following ratification, New Zealand (and other) jurisdictions can expand, but not narrow, the application of the MLI to their DTA network. This is provided for in Articles 28 and 29 of the MLI.

114. Article 33 provides that any party may propose an amendment to the MLI by submitting the proposed amendment to the Depository. Under Article 31 a "Conference of the Parties" could be convened to consider the proposed amendment at the request of the proposer, but only if one third of the parties to the MLI support the request within six calendar months of the request being communicated.

115. Article 38 provides that the MLI could be supplemented by one or more protocols. To become a party to such a protocol, one must be a party to the MLI, but parties to the MLI are not bound by such protocols unless they also become a party to that protocol.

116. New Zealand may enter into subsequent bilateral protocols which could supersede and replace the MLI provisions in a DTA.

117. Going forward, the MLI provisions are likely to form part of New Zealand's negotiating model and so will be generally incorporated into new DTAs.

Withdrawal or denunciation provision in the treaty

118. Article 37 provides that any party to the MLI may withdraw from the Multilateral Instrument at any time by notifying the Depositary. The withdrawal is effective from the date of receipt of the notification by the Depositary.

119. However, if the MLI has already entered into force for both parties to a DTA, then that DTA will remain modified by the Multilateral Instrument.

Agency Disclosure Statement

Inland Revenue has prepared this extended National Interest Analysis (NIA). Inland Revenue has analysed the issue of implementing the Multilateral Instrument, and the legislative and regulatory proposals arising from that implementation.

As part of that process, Inland Revenue considered the option of not entering into the MLI and instead retaining the status quo or entering into bilateral negotiations with each of New Zealand's DTA partners.

Inland Revenue is of the view that there are no significant constraints, caveats or uncertainties concerning the regulatory analysis. The policy aligns with the Government Statement on Regulation.

The provisional notifications and reservations lodged by New Zealand at the time of signature reflect the new OECD minimum and best practice standards relating to tax treaties. The position taken by New Zealand in the provisional notifications and reservations are consistent with the New Zealand negotiating model and will likely be incorporated into the New Zealand negotiating model going forward.

The revenue effect for New Zealand as a result of the changes under the MLI is expected to be negligible but potentially revenue positive due to New Zealand's status as a net capital importer.

An Order in Council will be required to give the MLI effect in New Zealand law. The Order in Council will override the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993; this is provided for under section BH 1 of the Income Tax Act 2007 and is necessary to give effect to the terms of the MLI.

The Treasury and the Ministry of Foreign Affairs and Trade have been consulted about the content of this extended NIA. An officials' issues paper on implementation issues associated with the MLI was released in March 2017 and the submissions received informed the analysis in this extended NIA.

Inland Revenue's view is that the policy options considered will not impose material additional costs on business interests; nor impair private property rights, market competition, or the incentives for business to innovate and invest; nor override fundamental common law principles.

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

9 May 2017

Annex A

Text of the MLI

Annex B

Notifications/reservations

Annex C

New Zealand has 40 DTAs currently in force. The table below shows the coverage of the MLI across New Zealand's treaty network (as at 9 May 2017).

	DTA	
Covered tax agreements	1.	Australia
	2.	Belgium
	3.	Canada
	4.	Chile
	5.	China
	6.	Czech Republic
	7.	Denmark
	8.	Finland
	9.	France
	10.	Germany
	11.	Hong Kong (China)
	12.	India
	13.	Indonesia
	14.	Ireland
	15.	Italy
	16.	Japan
	17.	Malaysia
	18.	Mexico
	19.	Netherlands
	20.	Poland
	21.	Russia
	22.	Singapore
	23.	South Africa
	24.	Spain
	25.	Sweden
	26.	Turkey
	27.	United Kingdom
	28.	Korea
Not modified by the MLI	29.	Switzerland
	30.	Viet Nam
	31.	Thailand
	32.	Philippines
	33.	Norway
	34.	Austria
	35.	United Arab Emirates
	36.	Papua New Guinea
	37.	Samoa
	38.	Taiwan
	39.	Fiji
	40.	United States

POLICY AND STRATEGY

Tax policy report: Update on Multilateral Instrument

Date:	18 May 2017	Priority:	**High**
Security level:	Restricted	Report no:	T2017/1363 IR2017/320

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendation in this report	25 May 2016
Minister of Revenue	**Agree** to the recommendation in this report	25 May 2016

Contact for telephone discussion (if required)

Name	Position	Telephone
Carmel Peters	Policy Manager, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Jess Rowe	Senior Policy Advisor, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	

18 May 2017

Minister of Finance
Minister of Revenue

Update on Multilateral Instrument

1. On Monday 15 May 2017, Cabinet approved New Zealand's signature of the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI). CAB-17-MIN-0241 refers.

2. Cabinet also approved New Zealand's expected notifications and reservations, which included a list of 34 double tax agreements (DTAs) that New Zealand nominated to be covered by the MLI. T2017/1004; IR2017/260 explains why these 34 DTAs were chosen.

3. Jurisdictions' positions on the MLI are still subject to change. To allow New Zealand to respond to treaty partner's changing positions, Cabinet authorised the Minister of Finance and Minister of Revenue to approve any changes to the notifications and reservations as a result of developments in other jurisdictions' positions.

4. Yesterday the OECD advised that Papua New Guinea and the United Arab Emirates have joined the Ad Hoc Group on the MLI.

5. Accordingly, we recommend that you approve adding New Zealand's DTAs with these two countries to our list of nominated DTAs in New Zealand's expected notifications and reservations.

6. We do not yet know if these countries will list their DTAs with New Zealand. But by adding them to New Zealand's list, it means that if they sign the MLI and nominate their DTA with New Zealand, our DTAs with these countries will be modified to contain the improved BEPS provisions.

7. The final expected notifications and reservations must be provided to the OECD no later than 26 May to allow processing before signature of the MLI on 7 June 2017. Changes can be made after signature, but this would be procedurally unusual. Therefore, we recommend that addition of the Papua New Guinea and United Arab Emirates DTAs is made in the final version submitted to the OECD by 26 May 2017.

Recommended action

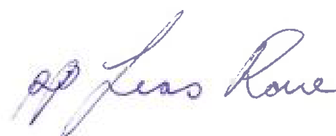
We recommend that you agree that New Zealand adds our double tax agreements (DTAs) with Papua New Guinea and the United Arab Emirates to the list of nominated DTAs in New Zealand's expected notifications and reservations provided to the OECD by 26 May 2017.

Agreed/Not agreed

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

Steve Mack
Principal Advisor
The Treasury

Agreed/Not agreed



Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

POLICY AND STRATEGY

RECEIVED

24 JUL 2017

MINISTERIAL SERVICES UNIT

Tax policy report: BEPS – summary of submissions on March 2017 discussion documents

Date:	15 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1630 IR2017/361

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations	19 June 2017
Minister of Revenue	**Agree** to the recommendations	19 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Gordon Witte	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Carmel Peters	Policy Manager, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	

15 June 2017

Minister of Finance
Minister of Revenue

BEPS – summary of submissions on March 2017 discussion documents

Executive summary

1. This report summarises the main points made by submitters on the two BEPS discussion documents released in March 2017:

- *BEPS – transfer pricing and permanent establishment avoidance* ("transfer pricing and PE avoidance"); and
- *BEPS – strengthening our interest limitation rules* ("interest limitation").

2. We received 43 submissions on these discussion documents in total – 16 submissions on the transfer pricing and PE avoidance discussion document, and 27 submissions on the interest limitation discussion document. A full list of all the submitters, together with a brief description, is included in the appendix to this report.

3. We have considered all the submissions in detail and we will report back to you with advice on these submissions next week. We will include recommendations that endeavour to meet the concerns raised by submitters to the greatest extent possible, while still achieving the desired policy objectives.

General reaction

4. Some general comments provided by submitters were similar for both discussion documents.

- Submitters acknowledged that it was important to address BEPS risks facing New Zealand and agreed in principle that change is needed to strengthen interest limitation, transfer pricing and PE rules.

- Submitters argued that the proposals will have a negative impact on New Zealand's attractiveness as an investment destination.

- Submitters indicated that the application date for all new law changes should be sufficiently prospective to allow taxpayers to restructure their affairs.

- A number of submitters also argued that existing advance pricing agreements (APAs)[1] should be grandparented and allowed to run their course.

Main issues raised by submitters

5. The main issues raised by submitters in relation to the specific proposals were:

- **The interest rate cap proposal should not proceed.** Many submitters on the interest limitation discussion document argued that no specific rule for limiting interest rates on related-party debt was necessary given the proposed strengthening of the transfer pricing rules (in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*). The allowable interest rate on related-party loans is currently set using transfer pricing, and submitters argued that strengthening the transfer pricing rules would be sufficient to address any concerns about interest rates on related-party loans.

- **Deferred tax should be carved out from the proposed non-debt liability adjustment.** The interest limitation discussion document proposed a change to how allowable debt levels are calculated under our thin capitalisation rules. A near-universal comment from submitters was that deferred tax liabilities should be carved out from the proposed adjustment. Deferred tax is an accounting concept – accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make; however, submitters argued that this is often not the case.

- **The PE avoidance rule should be more narrowly targeted.** Many submitters considered that the proposed rule could widen the PE definition in substance rather than just prevent avoidance. They were also concerned that it could capture ordinary commercial arrangements and discourage foreign investment.

- **The "time bar" for transfer pricing should remain at 4 years**. There was strong opposition to the proposal to extend the transfer pricing time bar to 7 years (in line with Australia's 7 year time bar). The time bar limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position.

Next steps

6. Officials are happy to discuss this report with you at your joint Ministers' meeting on 19 June. We will report back next week with advice and recommendations on these submissions and the other issues raised by submitters.

---

[1] An APA is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years.

Recommended action

We recommend that you:

(a) **Note** the main issues raised by submitters.

Noted   Noted ✓

(b) **Note** we will report back next week (beginning 19 June) with advice and recommendations on these submissions and other issues raised by submitters.

Noted   Noted ✓

(c) **Discuss** this report with officials at your joint Ministers' meeting on 19 June.

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

Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

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

8. New Zealand's tax system is already quite robust by international standards. However, there is room for improvement. As New Zealand is a strong supporter of the OECD's BEPS work, many of our BEPS measures are based on the recommendations from the G20/OECD Action Plan Report which seek to counter large multinationals engaged in aggressive BEPS tax practices. In response to the OECD's BEPS work, the New Zealand Government released a series of public consultation documents, including two discussion documents in March 2017:

- *BEPS – transfer pricing and permanent establishment avoidance* ("transfer pricing and PE avoidance"); and
- *BEPS – strengthening our interest limitation rules* ("interest limitation").

9. The Government received 43 submissions on these discussion documents in total – 16 submissions on the transfer pricing and PE avoidance discussion document, and 27 submissions on the interest limitation discussion document. A full list of all the submitters, together with a brief description, is included in the appendix to this report.

10. Most of the submitters are tax advisors or represent businesses that could be negatively affected by the proposals. Therefore, the submissions are understandably critical of some of the measures. However, submitters have also provided constructive suggestions on how the proposals could be redesigned or better targeted in order to reduce unintended impacts such as uncertainty for investors or double taxation. We are confident we can refine the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

11. This report summarises the main issues raised by submitters. We will report back with advice and recommendations on these submissions and other issues next week.

General issues raised by submitters

Submission: general support for addressing BEPS

12. Submitters acknowledged that it was important to address BEPS risks facing New Zealand and agreed in principle that change is needed to strengthen interest limitation, transfer pricing and PE rules. However, submitters did not agree with many of the proposed changes put forward in the discussion documents. Only two submitters supported all of the proposed changes in both documents (Oxfam and NZ Council of Trade Unions).

Submission: wider economic concerns

13. Many submitters argued that the proposals have the potential to significantly impact the flow of capital to New Zealand and the willingness of non-residents to establish business in New Zealand. Submitters argued that many of the proposals contained in the discussion documents could make New Zealand a less-attractive investment destination and, on this basis, should not be implemented (CTG, CA ANZ, Olivershaw, NFTC).

14. Some submitters on the PE avoidance proposals argued that the proposals introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand (CTG, CA ANZ, NFTC).

Submission: application date

15. The planned commencement date for these measures is income years starting on or after 1 July 2018. At the time the discussion documents were released, this commencement date was not publicly known.[2] However, many submitters anticipated the Government would seek an early commencement date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary (PwC, CTG, EY, CA ANZ).

16. Several submitters (including PwC and Powerco) submitted that the application date for these proposals should be no earlier than 1 April 2019.

17. A number of submissions on the interest limitation discussion document also argued that transitional rules should be provided for existing investments for up to five years post enactment.

Submission: grandparenting APAs

18. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. A large number of submitters expressed concern that APAs would be invalidated when the new legislation comes into effect. These submitters suggested that all existing APAs affected by

[2] The discussion document proposed that the measures would apply from income years beginning on or after the date that the new legislation was enacted.

the proposals in these discussion documents should be preserved under transitional rules for the term of the APA.

Comment

19. The majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that deliberately attempt to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

20. Furthermore, it is highly unlikely that foreign companies would remove their existing personnel from New Zealand as a result of the PE avoidance proposals, as most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. It is also very unlikely that they would cease to operate in New Zealand.

21. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

Interest rate cap

Summary of proposed rule

22. The interest limitation discussion document proposed moving away from a transfer pricing approach for pricing cross-border related-party loans, and instead proposed two new pricing rules (one for when a company has a foreign parent and one when it does not):

- An *interest rate cap,* which would apply when a New Zealand company has a foreign parent (e.g. it is a subsidiary of a multinational company). Under the interest rate cap, the allowable interest rate on related-party debt would be set with reference to the interest rate the parent company could borrow at.

- A *modified transfer pricing rule* when a New Zealand company has no foreign parent (e.g. it is owned by a group of non-residents acting together). Under the modified transfer pricing approach, the allowable interest rate on related-party debt would be determined using transfer pricing, but with a presumed set of conditions (including that the debt is senior unsecured debt issued on standard terms).

General reaction

23. This proposal – in particular the *interest rate cap* – was the focus of most submissions. Several submitters agreed that the rules for limiting the interest rate on related-party loans need strengthening, but only two submitters agreed with the proposed approach (Oxfam and NZCTU).

24. The general view of submitters was that the proposed interest rate cap should not be adopted at all, or if it is adopted, that it should only be a safe harbour, meaning that an interest rate higher than that provided for under the cap would be allowed if it can be justified under transfer pricing.

25. The proposal has also attracted positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.[3]

26. Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".[4]

Submission: interest rate cap proposal should not proceed

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

Submission: concerns with design and impact of interest rate cap proposal

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

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

Comment

29. We agree that transfer pricing, with the modifications proposed in the discussion document *BEPS – Transfer pricing and permanent establishment avoidance* will limit the ability for taxpayers to use artificial or commercially irrational funding structures. However, we remain concerned that these rules would not be adequate to prevent taxpayers from choosing to borrow from related-parties using higher-priced forms of debt than they would typically choose when borrowing from third parties.

30. We will report back with our advice and recommendations in relation to these submissions.

---

[3] *Government plan to target tax avoidance cops criticism*, National Business Review, May 12 2017.
[4] Hoke, William, *Australian Court Rejects Chevron's Transfer Pricing Appeal*, Tax Notes International, May 1 2017.

Non-debt liability adjustment

Summary of proposed rule

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

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

General reaction

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

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

Submission: deferred tax should be carved out

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

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

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

- often deferred tax does not represent a real cash liability the company has to pay in the future;

- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

Comment

38. We have considered these submissions carefully, including discussing them with the agency in charge of setting accounting standards in New Zealand (the External Reporting Board or XRB) and the Australian Treasury. Our report next week will provide you with advice and recommendations on this issue.

PE avoidance

Summary of proposed rule

39. Where a DTA applies, New Zealand is only able to tax a non-resident on its income from sales to New Zealand customers if the non-resident has a PE in New Zealand. The discussion document proposed a rule to prevent non-residents from structuring their affairs to avoid having such a permanent establishment in New Zealand where one exists in substance.

General reaction

40. Submitters were not strongly opposed to a new PE rule in principle, with two submitters supporting the proposal (Oxfam, NZCTU) and the remainder mostly accepting the need (or inevitability) for some form of PE avoidance rule. However, seven submitters considered that we should not adopt any PE avoidance rule at this stage. These submitters argued that:

- The OECD's Multilateral Instrument (MLI)[5] includes a widened definition of a PE. Any PE avoidance issues should be addressed under this. Alternately we should defer consideration of a PE avoidance rule until the impact of the OECD's BEPS measures has been determined (EY, AmCham, DEG, CA ANZ).

- The rule is unnecessary, as any current issues with PE avoidance can be addressed through our transfer pricing rules (NZLS, DEG, CA ANZ).

- The rule will apply to non-abusive transactions, is outside the OECD's BEPS initiatives and will erode taxpayer certainty (CTG, NFTC, Deloitte).

Threshold for the application of the new measures

41. A majority of submitters (EY, NFTC, DEG, Deloitte, CTG CA ANZ, PwC, KPMG,

[5] The *Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting*. The MLI is a multilateral convention which is intended to prevent DTAs from being used to facilitate cross-border tax avoidance. The MLI amends a large number of each signatory's DTAs at once, and so implements the OECD's recommended DTA changes much faster than a succession of bilateral negotiations could. New Zealand signed the MLI on 7 June 2017.

Russell McVeagh) considered that the proposed PE avoidance test was too broad. They argued that it would widen the PE definition in substance rather than just prevent avoidance. They were also concerned that it could capture ordinary commercial arrangements and discourage foreign investment. Submitters suggested two options for narrowing the scope of the rule:

- the PE avoidance rule could be targeted at abusive or artificial arrangements; or
- New Zealand could adopt the wording of the OECD's widened PE avoidance definition in the MLI.

Overriding DTAs

42. A majority of submitters considered that our PE rule should not override our DTAs (CTG, KPMG, CA ANZ, NFTC, NZLS, EY, Russell McVeagh, DEG). This is because DTAs are important to international trade, and New Zealand exporters also need to rely on them. Submitters also considered that we should not depart from the OECD's agreed BEPS measures, particularly where the country of the non-resident has declined to adopt the widened PE definition in the MLI.

Comment

43. Our proposed PE avoidance rule is broadly consistent with the OECD's BEPS initiatives and measures adopted by the UK and Australia.

44. The OECD's Commentary to the Model Tax Convention (the 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). Accordingly, the proposed PE avoidance rule should not conflict with New Zealand's DTAs. We also note that both the UK and Australian PE avoidance rules over-ride their DTAs.

45. We will report back with advice and recommendations on these submissions.

Transfer pricing

Summary of proposed rules

46. Transfer pricing rules guard against multinationals using related-party payments to shift profits offshore by requiring these payments to be consistent with an arm's length or market price that unrelated parties would agree to. Chapter 5 of the discussion document outlined a package of proposals to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules.

General reaction

47. Three submitters (CTG, EY, KPMG) considered the transfer pricing proposals were unnecessary and argued that the existing transfer pricing rules are sufficient.

48. Other submitters generally accepted that there was a need to update New Zealand's transfer pricing legislation so it aligned with the OECD's new transfer pricing guidelines (which were developed to combat BEPS).

49. However, as expected, there was strong opposition to the proposal to extend the time bar for transfer pricing adjustments to 7 years.

Extending the time bar to 7 years

50. Inland Revenue currently has 4 years from the day that a taxpayer has filed an income tax return in which it can investigate and adjust the tax position taken by the taxpayer in their income tax return. This 4 year period is known as the time bar. The discussion document proposed that transfer pricing issues should have a longer time bar of 7 years (consistent with fact that Australia and Canada have 7-year time bars for transfer pricing).

51. Most submissions on the discussion document opposed this proposal. The main arguments raised by submitters were:

- A longer time bar increases uncertainty for taxpayers and does not promote efficiency in transfer pricing disputes (will delay timely resolution).
- The discussion document argued that a longer time bar is needed because transfer pricing issues are complex and fact-specific, but submitters noted that this is also true of other areas of tax such as tax avoidance, the capital / revenue boundary and complex financial arrangements.
- Most countries have the same time bar for transfer pricing and other tax issues, and in most cases this was less than 7 years.
- If a transfer pricing dispute is resolved in favour of Inland Revenue, the taxpayer will be at risk of double tax in jurisdictions where the time bar has already passed.
- Imposing a longer time bar is inconsistent with Inland Revenue's Business Transformation goals of real-time review and helping taxpayers get it right from the start.
- Inland Revenue should invest more resource into its transfer pricing team if the investigations are taking longer than 4 years.

Comment

52. We will report back with further advice and recommendations on this and the other transfer pricing submissions.

Next steps

53. Officials are happy to discuss this report with you at your joint Ministers' meeting on 19 June. We will report back with advice and recommendations on these submissions and other issues next week.

54. Subject to your decisions, we anticipate the following timeline:

Date	Milestone/action
Monday 19 June	Joint Ministers' meeting to discuss these reports and policy recommendations
Week commencing 19 June	• Report with advice and policy recommendations on transfer pricing and PE avoidance • Report with advice and policy recommendations on interest limitation
Week commencing 26 June	• Report on hybrids entities and instruments proposals sent to Ministers • Draft cover Cabinet paper with overview of the BEPS package to Ministers
Wednesday 5 July	Joint Ministers' meeting to discuss hybrids recommendations and draft cover Cabinet paper
Week commencing 10 July	Provide the following Cabinet Papers and RISs to Ministers: • Cover paper with overview of BEPS package • Transfer pricing and permanent establishment avoidance • Interest limitation • Hybrid mismatches
Thursday 20 July	Deadline for lodging Cabinet Papers in CabNet
Wednesday 26 July	EGI
Monday 31 July	Cabinet

55. Consultation on draft legislation and technical design details will take place following Cabinet decisions, with a planned BEPS bill to be introduced after the general election. To stay on track with the planned commencement date of income years starting on or after 1 July 2018, the BEPS bill will need to be introduced and have its first reading by 14 December 2017.

Appendix: List of submitters

Abbreviation	Full name	Description	IL[6]	TP[7]
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓	✓
AMP (Aus)	AMP Capital Investors Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓	
AMP (NZ)	AMP Capital Investors (New Zealand) Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓	✓
ANZ	ANZ Bank New Zealand Limited	ANZ is a major bank in New Zealand and Australia.	✓	
BNZ	Bank of New Zealand	BNZ is a major bank in New Zealand and Australia (NAB).	✓	
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓	✓
DEG	Digital Economy Group	DEG is an informal coalition of leading US and non-US software, information/content, social networking, and e-commerce companies that provide goods or services through digital and non-digital means.		✓
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓	✓✓[8]
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓	✓
First Gas	First Gas Limited	First Gas is one of NZ's largest gas networks.	✓	

[6] Submission received on *BEPS – strengthening our interest limitation rules*

[7] Submission received on *BEPS – transfer pricing and permanent establishment avoidance*

[8] Deloitte made two separate submissions on the *BEPS – transfer pricing and permanent establishment avoidance* discussion document.

Abbreviation	Full name	Description	IL	TP
First State	First State Investments	First State Investments (FSI) is the investment management business of the Commonwealth Bank of Australia.	✓	
InfraRed	InfraRed Capital Partners Limited	InfraRed is an active equity investor in the New Zealand PPP sector, currently holding interests in the Auckland South Correctional Facility and Transmission Gully Motorway projects.	✓	
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓	✓
Methanex	Methanex New Zealand Limited	Methanex produces and sells methanol globally. Methanex NZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China	✓	
NFTC	National Foreign Trade Council	NFTC is an association of approximately 250 United States business enterprises engaged in all aspects of international trade and investment.		✓
NZBA	New Zealand Bankers Association	NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks.	✓	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCTU is made up of 30 unions and has 320,000 members.	✓	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓	✓
Olivershaw	Olivershaw Limited	Olivershaw provides tax advisory services for corporate clients, corporate boards, high net worth individuals and accounting firms.	✓	
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty. Oxfam NZ is the New Zealand arm of the global organisation.	✓	✓
Plenary	Plenary Origination Pty Ltd	Plenary Group is an independent long-term investor, developer and manager of public infrastructure in Australia.	✓	

Abbreviation	Full name	Description	IL	TP
Powerco	Powerco Limited	Powerco is New Zealand's largest electricity distributer. It also has the second largest gas distribution network.	✓	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓	✓
QIC	QIC Private Capital Pty Limited	QIC is an investor in global infrastructure markets and manages a 58% interest in Powerco NZ Holdings Limited.	✓	
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓	✓
SKYCITY	SKYCITY Entertainment Group Limited	SKYCITY is an entertainment and gaming business owning and operating casinos in New Zealand (Auckland, Hamilton and Queenstown) and Australia (Adelaide and Darwin).	✓	
TPEQ	TP Equilibrium | AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓	✓
Westpac	Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch	Westpac is a major bank in New Zealand and Australia.	✓	

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

RECEIVED
6 JUL 2017
MINISTERIAL SERVICES UNIT

Tax policy report: Base erosion and profit shifting – overview of current reports

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1578 IR2017/329

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to the recommendations	29 June 2017
Minister of Revenue	**Agree** to the recommendations	29 June 2017

Contact for telephone discussion (if required)

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

22 June 2017

Minister of Finance
Minister of Revenue

Base erosion and profit shifting – overview of current reports

1. This report accompanies three papers providing further updates on the development of policy proposals introduced in three Government discussion documents on base erosion and profit shifting (BEPS):

- *Addressing hybrid mismatch arrangements* (released in September 2016);
- *BEPS – Strengthening our interest limitation rules* (released in March 2017); and
- *BEPS – Transfer pricing and permanent establishment avoidance* (released in March 2017).

2. We reported to you on 9 March 2017 with a summary of submissions received on the discussion document *Addressing hybrid mismatch arrangements* (T2017/460, IR2017/133 refers). We also reported to you last week with a summary of submissions on the two March 2017 discussion documents (T2017/1630, IR2017/361 refers).

3. This package of reports seeks policy decisions on a range of proposals relating to all three discussion documents, including a number of suggested refinements to address issues raised by submitters. The attached reports are:

- BEPS – interest limitation submissions and policy decisions (T2017/1576, IR2017/325);
- BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions (T2017/1577, IR2017/330); and
- BEPS – recommendations on addressing hybrid mismatch arrangements (T2017/1604, IR2017/353).

4. These reports also seek your approval for officials to prepare a set of four papers seeking Cabinet's agreement to policy decisions and to include the BEPS proposals in a tax bill later this year. Subject to your decisions and assuming you are comfortable with all the proposals, we anticipate the following timeline:

Date	Milestone/action
Thursday 29 June	Joint Ministers' meeting to discuss these reports and policy recommendations
Week commencing 10 July	Provide the following Cabinet papers and RISs to Ministers: • Cover paper with overview of BEPS package • Transfer pricing and permanent establishment avoidance • Interest limitation • Hybrid mismatches
Thursday 20 July	Deadline for lodging Cabinet Papers in CabNet
Wednesday 26 July	EGI
Monday 31 July	Cabinet

Further consultation

5. We recommend that, following Cabinet decisions in July, further consultation is undertaken on outstanding policy issues and technical design details relating to the BEPS package. We will report back to you on that consultation and any further feedback we receive on the proposals.

6. A number of submitters have also expressed interest in consultation on an exposure draft of the planned BEPS bill. We have signalled to submitters that an exposure draft could be provided on specific aspects of the proposals that are likely to be of most interest – for example, the permanent establishment anti-avoidance rule proposed in the discussion document *BEPS – Transfer pricing and permanent establishment avoidance.*

7. To stay on track with the planned commencement date of income years starting on or after 1 July 2018, the BEPS bill will need to be introduced and have its first reading by 14 December 2017. Due to this timing constraint, we are not proposing that submitters be consulted on an exposure draft of the entire bill. However, targeted drafting of specific sections where consultation will provide the most value is possible within this timeframe.

8. In the attached reports on interest limitation, and transfer pricing and permanent establishment avoidance, we have focused on the major issues relevant to the policy decisions to be made by Cabinet in July. We have not addressed all submissions on the March 2017 discussion documents that relate to technical or operational detail. We will advise you on such submissions following detailed design and further consultation with submitters. The hybrids report seeks more detailed final policy decisions because it has already been subject to a second round of consultation.

Fiscal implications

9. Some of the revenue for these proposals has already been included in Budget 2017 forecasts:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

10. If our recommendations in these four reports are agreed to and adopted by the Government, then the forecasts could be adjusted further by these amounts:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
BEPS measures – transfer pricing, permanent establishments, and interest limitation	0	0	45	90	90	90	90
BEPS measures – hybrid instruments	0	0	19	19	19	14	0
Total additional revenue effect	0	0	64	109	109	104	90

11. The additional revenue from certain hybrid instruments is a result of agreeing to the OECD hybrids recommendation 1 proposal with the grandparenting approach for these instruments recommended in the attached paper on hybrids. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

12. The total would come to the maximum revenue forecast for new BEPS measures that we have previously advised ($190 million per year for out years) and exceed this revenue forecast for the first four years in which the BEPS measures will apply. We are recommending in the report BEPS – interest limitation submissions and policy decisions (T2017/1576, IR2017/325 refers) that we continue to consult on details of the thin capitalisation proposal. Depending on the outcome of this consultation, the revenue forecast could be $10 million per year lower.

Economic implications

13. It is inevitable that the higher tax payments resulting from these measures will make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. At the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, random reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. Given this, we believe implementing these measures remains in New Zealand's best economic

interests.

Administrative implications

14. The changes proposed in the BEPS discussion documents and recommended in these reports are not expected to increase administrative costs or require any significant systems changes for Inland Revenue. This is because the reforms change the way some taxpayers self-assess their tax liabilities that they report to Inland Revenue.

15. We note, however, that a common theme in submissions on all three discussion documents was that administration of the proposals would place a higher demand on Inland Revenue's audit and investigation functions. Our view is that any required increase in Inland Revenue's resourcing as a result of the BEPS package will be accommodated within existing baselines. We will report back if these administrative implications are expected to change.

Application date

16. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

17. At the time the March 2017 discussion documents were released, this application date was not publicly known. However, many submitters anticipated the Government would seek an early application date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary. We expect to receive more feedback on the planned application date and other transitional issues in the next round of consultation.

Proactive release

18. We recommend that the Government consider proactively releasing submissions on the BEPS discussion documents and the MLI officials' issues paper, the BEPS Cabinet papers, and policy reports (including the pre-Budget 2017 Cabinet paper and policy report (T2017/949, IR2017/237)). This could be done at the time of announcements Ministers may want to make in relation to the package.

Recommended action

We recommend that you:

(a) **Note** the three reports attached.

Noted | Noted

(b) **Agree** that work progresses along the indicative timeline.

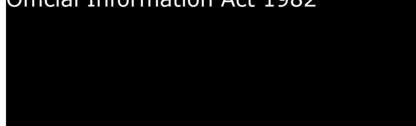
Agreed / Not Agreed | Agreed / Not Agreed

(c) **Agree** that the BEPS Cabinet paper should recommend that officials undertake further consultation on outstanding policy issues, technical design details and an exposure draft of selected items for the planned BEPS bill, with a view to introducing the bill after the General Election.

Agreed / Not Agreed | Agreed / Not Agreed

(d) **Agree** to proactively release the BEPS Cabinet papers, policy reports and submissions on consultation documents.

Agreed / Not Agreed | Agreed / Not Agreed



Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

POLICY AND STRATEGY

RECEIVED

6 JUL 2017

MINISTERIAL SERVICES UNIT

Tax policy report: BEPS – interest limitation submissions and policy decisions

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1576 IR2017/325

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to the recommendations	29 June 2017
Minister of Revenue	**Agree** to the recommendations	29 June 2017

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Hamish Slack	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Steve Mack	Principal Advisor, The Treasury	
Carmel Peters	Policy Manager, Inland Revenue	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS – interest limitation submissions and policy decisions

Executive summary

1. In March this year the Government released the discussion document *BEPS – strengthening our interest limitation rules*. This report advises on the main issues relevant to the policy decisions to be made by Cabinet in July. Following this decision, we will design the detail of the proposals, on which we propose further consultation.

2. The use of debt is one of the simplest ways of shifting profits out of New Zealand. Robust rules limiting the use of debt (and limiting interest payments on that debt) are therefore important base protection measures. Accordingly, the discussion document proposed two key changes to these rules:

- a new method for limiting the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower (referred to as the interest rate cap), which we estimated would increase tax revenues by $40 million per year; and
- a change to how allowable debt levels are calculated under our thin capitalisation rules (referred to as an adjustment for non-debt liabilities), which we estimated would increase tax revenues by $50 million per year.

3. We received 27 submissions on the proposals. A full list of submitters is included in the appendix to this report. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals. In general, submitters acknowledged the need to respond to BEPS concerns. However, many submitters did not support the specific proposals put forward.

4. In summary, we are recommending several modifications to the original proposals put forward. We estimate these modifications will not affect the revenue estimate for the proposals (which was $90 million per annum from the 2018/19 year). However, as discussed below, we are proposing to consult further on the details of one of the proposals (to exclude deferred tax from the non-debt liability adjustment), the outcome of which could have a fiscal consequence. If deferred tax were to be entirely omitted from the proposal, the revenue forecast would reduce by $10 million per year.

Interest rate cap

5. The discussion document proposed replacing transfer pricing rules with a rule to cap the interest rate deduction allowed on related-party loans from a non-resident to a New Zealand borrower ("inbound related-party loans") based on the credit rating of the parent company - with a one-notch reduction for the New Zealand subsidiary. We viewed this interest rate cap proposal as a straight-forward, simple and non-manipulable way of pricing related-party debt. We considered that the cap was largely consistent with an arm's length approach under transfer pricing principles – albeit we accept that this would not be true in every case.

6. As a starting point, many submitters argued that no specific rule for limiting interest rates on related-party debt was necessary. Submitters noted that the Government has proposed to strengthen those rules generally (in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*). They thought that these strengthened rules should be sufficient to address any concerns about interest rates on related-party loans.

7. Submitters were concerned that the rule was novel and untested. They were concerned that New Zealand would stand out on its own and that this would deter FDI.

8. Another concern raised by submitters is that the cap would frequently result in double taxation because the foreign revenue authority would require a higher return on the debt and impose tax on that basis. (As explained in the body of our report, our view is that it is unlikely that our treaty partners will challenge this approach under our treaties.)

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

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating);
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

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

11. The difficulty is, however, that simply relying on transfer pricing, as suggested by submitters, will not achieve the desired policy outcomes. It is clear that the international

consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. Commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions. Professor Richard Vann from Sydney University has said "transfer pricing has not proved up to the task of dealing with interest rates".

12. Accordingly, we recommend that the discussion document proposal be replaced by a *restricted transfer pricing* methodology. We consider this methodology is a better way of achieving the interest rate cap's objective and would have the same revenue impact. Like the cap, this approach will generally result in the interest rate on the related-party debt being in line with that facing the foreign parent. This is because, under the rule, debt will generally be required to be priced on the basis that it is "vanilla" (that is, without any features or terms that could push up the interest rate) and on the basis that the borrower could be expected to be supported by its foreign parent in the event of a default.

13. Implementing these restrictions in legislation will address the problem that the transfer pricing guidelines, in so far as they apply to related party debt, are open to interpretation, subjective, and fact intensive in their application.

14. We would recommend that the interest rate cap as initially proposed be available as a safe harbour. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable. We believe this would be an attractive option to many companies as it is both simple and provides certainty.

15. We also intend that access to the Mutual Agreement Procedure (MAP) under our Double Tax Agreements be available to taxpayers who consider that taxation under the new rule is inconsistent with the relevant treaty. This will address submitters' concerns about double taxation. We do not, however, expect many MAP cases will eventuate because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

16. We note that the Australian Taxation Office recently released draft guidelines, which are designed to incentivise Australian subsidiaries to structure their related-party loans into ordinary "vanilla" loans at interest rates similar to that facing their foreign parents. This will produce a similar result to the restricted transfer pricing approach we are recommending. However, the Australian guidelines are administrative measures – taxpayers are able to dispute them if they so choose.

Non-debt liability adjustment

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

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

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

20. We consider this non-debt liability proposal should proceed. This is because the core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a taxpayer is limited to a commercial level of debt. A third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities. Moreover, the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. We note that Australia requires this same adjustment for non-debt liabilities.

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

22. While many deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future, given the concerns raised by submitters, we recommend that we consult further on this matter. We could explore, for example, whether particular deferred tax liabilities that will not result in future tax payments could be identified and carved out from any adjustment. Note that the deferred tax balances of some taxpayers are significant – if a deferred tax exemption were provided, we estimate that this would reduce the fiscal impact of the non-debt liability proposal by up to $10m per year (from $50 million per year to $40 million per year).

Other proposals

23. Finally, the discussion document proposed several minor changes to the thin capitalisation rules. One of these proposals, which was generally welcomed, is a special rule for project finance. This proposal will allow full interest on third party debt to be deductible even if the debt levels exceed the thin capitalisation limit if the debt is non-recourse with interest funded solely from project income. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously. However, some technical issues have been raised which we will consult further on.

24. The other minor changes to the rules are summarised in the table below. Some of these were supported by submitters while others were opposed. Where they were opposed, we are recommending changes to the proposals that, in general, will address submitters' concerns.

Proposal in discussion document	Recommended approach
That the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of $1 million or less, be made available also to foreign-controlled taxpayers provided they have no owned-linked debt.	Submitters generally supported this proposal. We recommend that the proposal proceed without modification.
That when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.	Few substantive comments were received on this proposal. We recommend that the proposal proceed without modification.
Removing the ability for a company to use a value for an asset for thin capitalisation purposes that is different from what is used for financial reporting purposes, provided the valuation would be allowable under GAAP.	Submitters did not support this change, arguing it would result in high compliance costs. We recommend modifying this proposal to allow taxpayers to retain the ability to use asset values for thin capitalisation that differ from those reported in their financial accounts, but that clearer legislative requirements be developed for when this is option is utilised.
Removing the ability for a taxpayer to use their year-end debt and asset values for thin capitalisation purposes, so that debt and assets can only be valued for thin capitalisation based on average values at the end of every quarter or day.	Submitters did not support this change, arguing it would result in high compliance costs. We recommend that the proposal in the discussion document should not proceed, and instead we recommend inserting an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year.
A remedial amendment to section FE 18(3B) (regarding financial arrangements and trusts) to ensure it operates clearly.	Few substantive comments were received on this proposal. We recommend that this proposal proceed without modification.

Recommended action

We recommend that you:

(a) **Agree** that ordinary transfer pricing should not be used to price inbound related-party loans.

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** that the original proposal for limiting the interest rate on inbound related-party loans – the interest rate cap – should not proceed at this time.

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

(d) **Note** that officials consider that, in general, this restricted transfer pricing approach would have a similar result to the interest rate cap that was originally proposed, and that therefore the original estimated forecast revenue of $40m per year from the 2018/19 year remains unchanged.

Noted Noted

(e) **Agree** that the precise design of this restricted transfer pricing approach should be subject to further consultation with submitters.

Agreed/Not agreed Agreed/Not agreed

(f) **Agree** that the proposed non-debt liability adjustment should proceed, so that a taxpayer's allowable debt level in the thin capitalisation rules is set with reference to its assets less its non-debt liabilities.

Agreed/Not agreed Agreed/Not agreed

(g) **Agree** that officials consult further on issues relating to deferred tax.

Agreed/Not agreed Agreed/Not agreed

(h) **Note** that if all deferred tax amounts were not included in the non-debt liability proposal, the revenue forecast from the proposal would be $10 million per year lower.

Noted Noted.

(i) **Agree** that other technical exclusions to the non-debt liability adjustment be subject to further consultation with submitters.

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

(k) **Agree** in principle to an exemption from the thin capitalisation rules for certain infrastructure projects funded entirely with third-party limited recourse loans.

Agreed/Not agreed Agreed/Not agreed

(l) **Agree** that the detailed design of this infrastructure exemption be subject to further consultation with submitters.

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

(n) **Agree** that existing arrangements affected by the change in (m) be grandparented.

Agreed/Not agreed Agreed/Not agreed

(o) **Agree** that taxpayers should continue to be able to use asset values for thin capitalisation that differ from those reported in their financial accounts, but that clearer legislative requirements be developed for when this option is utilised.

Agreed/Not agreed Agreed/Not agreed

(p) **Agree** that the proposed removal of the ability for a taxpayer to use their year-end debt and asset values for thin capitalisation purposes not proceed, and instead insert an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year.

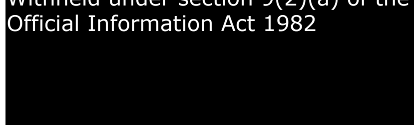
Agreed/Not agreed Agreed/Not agreed

(q) **Agree** that the minor remedial, relating to how section FE 18(3B) applies in relation to trusts, proceeds – that is, specifying that in order for a financial arrangement to be treated as owner-linked debt in relation to a trust, the owner must have made 5 percent or more (by value) of the settlements on the trust.

Agreed/Not agreed Agreed/Not agreed

(r) **Agree** that advance pricing agreements (APAs) existing prior to the application date of these changes be grandparented.

Agreed/Not agreed Agreed/Not agreed



Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

25. In March the Government released the discussion document *BEPS – strengthening our interest limitation rules*. This report provides advice on the 27 submissions the Government received on the discussion document. It also seeks policy decisions on the proposals, including a number of suggested modifications to address issues raised by submitters.

26. We have met with many of the submitters (CA ANZ, CTG, PwC, KPMG, EY, NZBA) to discuss their submissions and explain the proposals. A full list of submitters is included in the appendix to this report.

27. This report advises on the important issues relevant to the policy decisions to be made by Cabinet in July. Following this decision, we will design the detail of the proposals, on which there will be further consultation.

General comments on the proposals

Submitters support interest limitation but not the particular proposals

28. Submitters acknowledged that it was important to address BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, as detailed below, submitters did not agree with many of the proposed changes put forward in the discussion document.

Submission: wider economic concerns

29. Many submitters argued that the proposals have the potential to significantly impact the flow of capital to New Zealand and the willingness of non-residents to establish business in New Zealand. Submitters argued that many of the proposals contained in the discussion document could make New Zealand a less-attractive investment destination and, on this basis, should not be implemented (CTG, CA ANZ, Olivershaw).

Response

30. We disagree with submitters on this matter. The majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that deliberately attempt to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

Submitters do not support an EBITDA-based approach for New Zealand

31. Most submitters were strongly against adopting an EBITDA-based rule as recommended by the OECD. Only one submitter (SKYCITY) discussed the merits of New Zealand adopting this approach – namely that it is advantageous for firms with assets that generate revenue but that cannot be recognised under accounting standards (such as casino licenses).

32. A key reason the other submitters did not support an EBITDA-based approach is that earnings can be volatile. A taxpayer that has interest deductions within the allowable limits one year could breach those limits the next if its revenues fall – even if that is because of factors outside their control (such as poor global economic conditions). Other reasons given by submitters were that:

- some industries have particularly volatile earnings, and these would be especially impacted by an EBITDA-based rule;
- such a rule may disadvantage groups that are heavily capitalised and have tangible fixed assets with long depreciation periods; and
- such a rule is not appropriate for commodity-based economies such as New Zealand.

33. We find the first of these arguments (volatility of earnings) particularly compelling. Provided a reasonable rule for limiting the interest rates of related-party debt can be developed (as discussed below), we do not see merit in adopting an EBITDA-based rule.

34. We note that Craig Elliffe, a professor of tax at Auckland University, reaches this same conclusion in a forthcoming academic article. He writes "... contrary to the strong recommendation in the OECD's report, there is no compelling case for change to an earnings-based EBITDA method from an assets-based regime".[1]

Concerns about horizontal inequity

35. Some submitters raised concerns that the proposals will result in horizontal inequity between businesses owned or controlled by offshore investors as compared with those in New Zealand. This is because the proposals predominately affect foreign-owned businesses.

36. We do not share these concerns. Foreign-owned businesses are able to reduce their New Zealand tax payments through the use of interest deductions in a way that domestically-owned firms cannot. Indeed, we consider the proposals will increase horizontal equity between foreign-owned and domestically-owned businesses.

Application to outbound investment

37. 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

[1] Craig Elliffe, *Interest deductibility: evaluating the advantage of earnings stripping regimes in preventing thin* capitalisation, forthcoming in the New Zealand Law Review (number two).

thin capitalisation rules and the transfer pricing rules) apply to both foreign-owned and domestically-owned businesses.

38. Consistent with this approach, the discussion document proposed that any changes ultimately adopted would apply to both foreign- and domestically-owned businesses.[2]

39. Three submitters disagreed with this approach, suggesting instead that the proposals should initially apply only to foreign-owned businesses. In particular, they were concerned that New Zealand-owned businesses with foreign-operations could be negatively impacted by the non-debt liabilities proposal.

40. We consider that the proposals should apply to outbound investment as originally proposed – as above, base protection concerns can arise with domestically-owned firms.

41. However, one submitter in particular (SKYCITY) has raised concerns with how the thin capitalisation rules operate for domestically-owned firms – in particular, that fact the rules do not take into account the value of some of its assets when determining its allowable level of debt causes them particular problems. We think this issue should be a subject of further consultation.

Submission: application date

42. The planned application date for these measures is income years starting on or after 1 July 2018. At the time the discussion documents were released, this application date was not publicly known.[3] However, many submitters anticipated the Government would seek an early application date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary (PwC, CTG, EY, CA ANZ).

43. Several submitters (including PwC and Powerco) submitted that the application date for these proposals should be no earlier than 1 April 2019.

44. A number of submissions on the interest limitation discussion document also argued that transitional rules should be provided for existing investments for up to five years post enactment.

Response

45. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

46. We note that, in relation to the changes to the thin capitalisation rules (such as the non-debt liability adjustment), taxpayers would have until 30 June 2019 to adjust their balance

---

[2] Note that the proposal relating to the interest rate on related party debt applies to both foreign- and domestically-owned taxpayers, but applies only to inbound loans. We are not aware of any concerns regarding the pricing of outbound related-party loans.
[3] The discussion document proposed that the measures would apply from income years beginning on or after the date that the new legislation was enacted.

sheets as taxpayers have the ability to determine their thin capitalisation ratio based on their year-end asset and liability values.

Submission: grandparenting APAs

47. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. A large number of submitters expressed concern that APAs would be invalidated when the new legislation comes into effect. These submitters suggested that all existing APAs affected by the proposals in the discussion document should be preserved under transitional rules for the term of the APA.

48. Without grandparenting of existing APAs, taxpayers may be disincentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.

Response

49. We agree that APAs existing prior to the application date of these proposals should be grandparented. There is a high cost and a rigorous process involved in obtaining an APA and it would be unfair if the new proposals rescinded APAs issued before the 1 July 2018 application date – especially considering APAs only run for five years.

Submissions on the proposed interest rate cap

Summary of proposed rule

50. When borrowing from a third-party, commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

51. The discussion document proposed moving away from a transfer pricing approach, and instead limiting the interest rates on related-party loans from a non-resident to a New Zealand borrower ("inbound related-party loans") – one for when a company has a foreign parent and one where it does not:

- An *interest rate cap,* which would apply when a New Zealand company has a foreign parent (for example, it is a subsidiary of a multinational company). Under the interest rate cap, the allowable interest rate on related-party debt would be set with reference to the interest rate the parent company could borrow at.

- A *restricted transfer pricing rule* when a New Zealand company has no foreign parent (for example, it is owned by a group of non-residents acting together). Under the modified transfer pricing approach, the allowable interest rate on related-party

debt would be determined using transfer pricing, but with a presumed set of conditions (including that the debt is senior unsecured debt issued on standard terms).

52. The purpose of these proposed rules was to ensure that the interest rate on related-party debt is roughly in line with what the borrower would actually agree to if they were borrowing from a third party.

General reaction

53. This proposal – in particular the *interest rate cap* – was the focus of most submissions. Several submitters agreed that the rules for limiting the interest rate on related-party loans need strengthening, but only two submitters agreed with the proposed approach (Oxfam and the CTU).

54. The general view of submitters was that the proposed interest rate cap should not be adopted at all, or if it is adopted, that it should only be a safe harbour, meaning that an interest rate higher than that provided for under the cap would be allowed if it can be justified under transfer pricing.

55. The proposal has also attracted positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.[4]

56. Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".[5]

Submission: transfer pricing changes should be sufficient

57. A recurring theme in the submissions is that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Response

58. Relying on transfer pricing, as suggested by submitters, will not achieve the desired policy outcomes.

59. 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 appropriate as determined by the arm's length standard.

---

[4] *Government plan to target tax avoidance cops criticism*, National Business Review, May 12 2017.
[5] Hoke, William, *Australian Court Rejects Chevron's Transfer Pricing Appeal*, Tax Notes International, May 1 2017.

60. 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. We consider that, once amended as proposed in the *BEPS – transfer pricing and permanent establishment avoidance* discussion document, 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 payments that were, in our view, plainly excessive. [6]

61. 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[7] 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.

Submission: various concerns with interest rate cap

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

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

Inconsistency with arm's length standard

63. Many submitters argued that the proposal is not consistent with the arm's length standard (the approach that underpins how countries apply the transfer pricing rules).
They argued that it will result in double taxation: the lender jurisdiction will price the loan under traditional transfer pricing, which will produce a higher interest rate than what would be allowable under the rate cap. For example, suppose for a loan between Canada and New Zealand, the Canadian Revenue Authority expects the loan to produce interest income at 7% but the proposed cap would allow deductions only of 5%. In this example, double taxation of the 2% difference would result.

[6] Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62. The case involved a company owned by Chevron Australia borrowing in the USA at interest rates of about 1.2 percent in USD and on-lending the money to Chevron Australia at an interest rate of about 9 percent in AUD.

[7] Subordinated debt is a loan that ranks below other loans. In the case of borrower default, subordinated debt is repaid only once higher-ranked debt has been fully repaid.

64. As a more technical matter, submitters were concerned that if double taxation did arise, they would be denied the treaty resolution process if the interest rate cap was incorporated in the thin capitalisation regime rather than the transfer pricing rules.

65. Supporting the double taxation argument, submitters wrote that the New Zealand subsidiary of a multinational will generally have a higher credit risk than the parent. A traditional transfer pricing exercise would therefore result in a higher interest rate. Similarly, submitters saw the proposal as implicitly assuming that the New Zealand subsidiary would have the same credit risk as its foreign parent, and stated that this is not the case and does not represent commercial reality.

66. More generally, submitters were concerned that the interest rate cap would be inconsistent with our Double Tax Agreement (DTA) obligations. DTAs require arrangements (such as a loan) between a New Zealand company and a treaty-partner company to be treated for tax purposes as if it were entered into on arm's length terms – something submitters argued the cap would not do, since they submitted it would allow deductions for less than an arm's length amount of interest.

Compliance costs

67. Many submitters indicated that the proposed interest rate cap would increase compliance costs, even for firms with low gearing levels. They argued that the foreign jurisdiction in a cross-border loan transaction will still require a transfer pricing analysis of the loan for their own purposes (to ensure the interest rate on the loan is not too low), even if the same transaction was also priced using the interest rate cap in New Zealand.

68. Some submitters also wrote that the cap would be harder to apply when the foreign parent does not have a credit rating[8], as a credit scoring exercise for the foreign parent would have to be carried out (in contrast to when the parent had a credit rating – where the credit rating could simply be used).

Rule applies to firms at low risk of BEPS

69. Submitters were concerned that the interest rate cap would apply even if a firm had a very low level of debt. Submitters argued that this was inappropriate for two reasons:

- If a firm is concerned about the application of the interest rate cap (for example because of double taxation), there is no action the firm can take other than completely eliminating all related-party debt. Submitters contrasted this with the EBITDA rule as proposed by the OECD, which can also result in double taxation but firms are able to reduce the risk of this by reducing the amount of debt they hold.

- Firms with low debt levels, and therefore presenting a low risk of profit shifting using interest, could nevertheless suffer interest denial under the proposal (or alternatively incur costs in restructuring any related-party lending to ensure interest denial does not arise).

[8] Where the parent does not have a credit rating the application of the interest rate cap is not as straight forward. It is therefore not as appropriate as a safe harbour. About half of New Zealand's 300 largest foreign-owned companies have parents with credit ratings.

Rule has no international precedent

70. Some submitters were concerned that the proposed cap is novel and would not be well understood by foreign jurisdictions. Submitters argued that the proposed rules are not a co-operative approach to international tax policy and will be inconsistent with the OECD and all other countries.

Response

71. We do not agree with all the concerns raised but there were some valid issues to consider. Taking all the submissions, consultation, and subsequent analysis into account, we now recommend that the original proposal be replaced with a restricted transfer pricing approach. This alternative will still use, as a key component in the analysis, the cost of funds of the foreign parent; however, it will incorporate some limited flexibility, which we consider will address many of submitters' concerns. This alternative approach is discussed more below – following our analysis of key submissions which are still relevant to this alternative approach.

72. We do not agree with the argument that the interest rate cap is systematically inconsistent with the arm's length standard. On the contrary, we consider the cap 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.

73. Inland Revenue administers transfer pricing having regard to the concept of implicit parental support but some taxpayers do dispute it. Submissions on this were mixed. At one end of the spectrum, CTG said "An assumption of implicit parental support is not valid. A rational commercial lender would never rely on implicit support…" In general, the other submitters agreed that implicit support was a factor to be taken into account in applying the arm's length test. However, views varied on how important a factor it is.

74. We acknowledge that there would be cases when the interest rate cap 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 interest rate cap would frequently result in double taxation. This is partly because the cap is not arbitrary (unlike EBITDA). Moreover, in our view, the shift in the international consensus makes it less clear that our treaty partners (especially Australia, given their guidance discussed below) would dispute the result of the cap under a treaty.

75. We agree that, as originally proposed, the interest rate cap would have produced some arguably inappropriate results. In particular, we agree with submitters' concerns that the cap would have applied regardless of a taxpayer's debt level in New Zealand. Yet if a firm has low levels of debt in New Zealand, it is unlikely that the structure of their loans (including their interest rates) has been driven by tax. Were the cap to proceed, we would recommend that it would apply more generously to taxpayers with lower debt levels.

76. We also acknowledge that applying the cap for New Zealand subsidiaries with foreign parents that do not have credit ratings might not be straight forward. Where the foreign parent has a credit rating, the allowable interest rate under the cap would be derived from that rating. However, where the parent has no credit rating, the credit worthiness of the parent would first have to be determined by a third party expert before the rate allowed by the cap could be calculated. While the advice we have is that this is not a difficult exercise in the scheme of things, it does result in more compliance costs for some taxpayers compared to others and may give rise to integrity issues.

77. Finally, we note that 16 of foreign-owned firms covered by Inland Revenue's International Questionnaire[9] were owned by consortiums of non-residents (and therefore have no identifiable foreign parent). Because there is no identifiable parent, the interest rate cap cannot apply to these businesses. The discussion document proposal was to apply a restricted transfer pricing approach to determine the rate on their shareholder debt funding. But we acknowledge the argument that having two sets of rules (a cap and a restricted transfer pricing approach) is a sub-optimal feature of the original proposal given the problem of excessive interest rates can arise regardless of whether there is a foreign parent.

78. Overall, if the Government were to pursue the interest rate cap proposal, we would recommend some adjustments which would add significant complexity. For instance, as above we would recommend adjusting its application for New Zealand subsidiaries with low levels of debt. This would mean that the cap applied differently to taxpayers depending on their circumstances. These differences create perceptions of unfairness. In addition, boundaries can be difficult to administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange matters so that they fall within certain boundaries.

Modified approach

79. We recommend that the discussion document proposal – whereby the foreign parent's credit rating is the *sole* determining factor of the New Zealand interest rate for related party debt, be replaced by a *restricted transfer pricing* methodology. Like the cap, this approach involves a strong presumption that the interest rate on the related-party debt would be in line with that facing the foreign parent. However, unlike the cap, a taxpayer would be able to deviate from this if they can show that it would be appropriate.[10] In addition, all the circumstances, terms and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer (or its foreign parent) can demonstrate that they have third party debt that features those terms or conditions.

[9] Based on the International Questionnaire for the 2015 income year, which covered New Zealand's 314 largest foreign owned businesses (excluding banks and insurers).
[10] For example, if the New Zealand subsidiary is not wholly-owned by the parent, or if it operates in a substantially different industry to the parent.

80. We consider that this approach would, in general, achieve the same result as the interest rate cap but expect that it would be more acceptable to submitters. This is because it would only impact firms that do not have "vanilla" related-party debt. It also provides a limited amount of flexibility by allowing additional factors to be taken into account in addition to the foreign parent's credit rating when determining an appropriate interest rate in legitimate cases. This approach also has the advantage that it would apply consistently across taxpayers to the greatest extent possible.

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

- There is strong presumption that the New Zealand subsidiary would be supported by its foreign parent in the event of default;
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
    - That the loan has no exotic terms that are generally not seen with third-party lending[11]
    - That the loan is not subordinated
    - That the loan duration is not excessive
    - That the debt level of the borrower is not excessive.

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

83. If a taxpayer is able to demonstrate that it (or its parent) has substantial third-party loans with a particular feature, then that feature will not be required to be completely ignored. Instead, that feature will be an allowable factor in the pricing of the loan to the extent the taxpayer's third-party debt has that feature.

84. For example under this rule, an inbound related-party loan would generally be priced for tax purposes on the basis that it is not subordinated. However, if a taxpayer actually issues subordinated debt to third parties, then some amount of its related-party debt could also be priced as if it were subordinated. Similarly, a loan would generally be priced for tax as if its duration were not excessive, but if the taxpayer has third-party debt with a very long duration, its related-party debt could be priced as if it had a similarly long duration.

85. We consider that this approach would be effective in achieving the overarching objective of this project – which is to ensure that interest rates on related-party debt are

[11] The ATO's draft guidelines on related-party debt include a list of what could be considered an exotic term – including convertibility into equity, that the loan is repayable on demand, and contingencies (that is, interest is only repaid under certain conditions).

broadly similar to the interest rates that the borrower would actually agree to with third-party debt. The rule requires related-party debt to be priced as if it is an ordinary senior loan; however, if taxpayers can demonstrate that they raise debt from third-parties on other terms which result in higher interest rates, this can be taken into account.

86. We recommend that you agree in principle to the adoption of this restricted transfer pricing approach to determining the interest rate for related-party cross border loans. Its precise detail (for example, the wording of the required modifications, and what constitutes "excessive") would then be considered as part of further consultation.

87. This approach takes account of more factors than the interest rate cap, which focused solely on the foreign parent's cost of funds. However, this means the rule may be more costly for taxpayers to apply than the cap (particularly for subsidiaries of large multinationals that have credit ratings).

88. We recommend that the interest rate cap as initially proposed be available as a safe harbour. We believe this would be an attractive option to many companies as it is both simple and provides certainty.

89. This safe harbour could be provided either legislatively or administratively. We consider it likely that an administrative safe harbour is the best approach as it provides more flexibility. Nevertheless, we consider that would be a useful matter to consult on further.

90. We note that this rule would still apply in place of our standard transfer pricing rules. It could therefore be considered inconsistent with the arm's length principle, much like the interest rate cap. However, unlike the cap as originally proposed, we note that:

- if a taxpayer with a conservative level of debt borrows from its parent with a "vanilla" loan, there is no difference between this restricted transfer pricing approach and standard transfer pricing.

- lenders in countries that have a double tax agreement with New Zealand will be able to use the Mutual Agreement Procedure to alleviate any double taxation that may result because of this rule; however, as above, we do not consider this situation likely.

Australian guidelines

91. Since the release of the discussion document the Australian Tax Office released draft guidelines for the interest rates of cross-border related-party loans.[12] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, just like the restricted transfer pricing rule above, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The

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

ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

92. However, unlike what we have recommended, the Australian guidelines are administrative measures – taxpayers are able to dispute them if they so choose. Nevertheless, we think it appropriate to proceed with a law change as we are recommending. Given the manipulability of the general transfer pricing rules, we consider more robust measures are necessary to ensure related-party debt is appropriately priced.

Application of rule to banks

93. The discussion document did not propose exempting any particular industries from the interest rate cap.

Submissions

94. Following a discussion with the New Zealand Bankers Association (NZBA), we received submissions from NZBA and most of the large banks. These submitters argued that New Zealand banking groups should be excluded from the interest rate cap. The main arguments contained in these submissions are:

- Banks are subject to prudential regulation in both New Zealand (RBNZ) and Australia (APRA), which requires related-party loans to be priced on arms-length terms. These regulations also put restrictions on the type of debt that can be issued and the permitted level of support the Australian banks can provide to their New Zealand subsidiaries.

- Unlike most foreign-owned companies operating here, New Zealand's foreign-owned banks issue large amounts of third party debt. This makes transfer pricing exercises more straight-forward as there are clear comparable interest rates.

- Because banks are financial intermediaries (that is, in the business of borrowing from capital markets and then lending out that money), they will be most affected of all firms by a rule that limits the allowable interest rates on related-party debts.

Response

95. We agree that banks would have been disproportionately impacted by the interest rate cap as originally recommended. This is because banks, more than most businesses, rely on debt to fund their businesses, and because they regularly issue non-standard types of debt to third parties (such as debt that converts to equity in certain events). In addition, unlike most foreign-owned companies operating in New Zealand, New Zealand's foreign-owned banks regularly borrow significant amounts from third-parties. This means, when pricing a related-party loan between a New Zealand bank and its foreign parent, there are generally third-party comparables that can be used to ensure the interest rate on the related-party loan is not excessive.

96. We would have therefore recommended that registered banks be carved out from the interest rate cap. However, it is less clear that a carve-out from the approach we now recommend – the restricted transfer pricing approach – would be necessary. Under this method non-standard terms on related-party debt (such as convertibility into equity) would be allowable if the taxpayer can demonstrate that it (or its foreign parent) issues debt with those non-standard features. We consider that this is likely to be the case with the banks, as they (and their Australian parents) do regularly issue third-party debt with non-standard terms, for example.

97. Nevertheless, to ensure this rule would have no unintended consequences, we consider that the issue of whether banks should be subject to the restricted transfer pricing approach should be considered as part of the further consultation. We note that the original revenue forecast of $40m per year from the interest rate cap did not take into account any impact it might have on the banks; whether or not the restricted transfer pricing rule applies to them will have no impact on this revenue forecast.

Submissions on the treatment of non-debt liabilities

Summary of the proposal

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

99. The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts).[13] This is because the core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a taxpayer is limited to a commercial level of debt. We consider that a third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

100. Moreover, we are concerned that the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high 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, its allowable debt level under the thin capitalisation rules will increase (because its assets have increased but its interest bearing debts have not). We do not consider that this is an appropriate outcome.

General reaction

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

[13] Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

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

103. Some submitters also argued that the existing 60 percent thin capitalisation safe harbour is already too low for infrastructure businesses – which are by nature highly geared and capital intensive – and so this proposal would disproportionately affect this industry's ability to stay within the 60 percent safe harbour.

104. Similarly, some submitters suggested introducing an additional arms-length test to allow taxpayers to gear at higher levels than the 60 percent safe harbour where that can be supported as a commercial level of debt. Submitters used the infrastructure industry as an example, where they argued that it is normal for third party debt to be secured on economic terms in excess of the 60 percent safe harbour ratio. Submitters suggested that an arms-length test would also address industry-specific concerns as noted above.

Response

105. At present, the thin capitalisation rules ignore non-debt liabilities. This means that companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment also means that companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

106. With regard to the specific points raised by submitters:

- we agree that in some cases the non-debt liability adjustment will increase volatility in thin capitalisation ratios; however, in other cases the adjustment will reduce volatility (such as when both assets and non-debt liabilities increase).

- We do not agree that the proposal amounts to a significant adjustment in the thin capitalisation safe harbour. This change only impacts taxpayers that have large non-debt liability balances. A taxpayer with only small non-debt liabilities will see very little change in its thin capitalisation ratio. In addition, this change will have no impact on a taxpayer if their thin capitalisation ratio remains below the 60 percent safe harbour (for example, even if the change results in a large increase in a taxpayer's ratio – say from 30 percent to 40 percent – the taxpayer will have no additional tax to pay as its ratio is still within the 60 percent safe harbour).

107. Overall, we do not consider that any of the points raised by submitters provide a reason not to proceed with the non-debt liability adjustment (subject to the modifications discussed below).

108. We agree with submitters that the 60 percent safe harbour will not always be appropriate, but consider that the thin capitalisation rules already adequately deal with these

situations. For example, a New Zealand company's debt level can exceed the safe harbour if it is still in line with the debt level of the company's multinational group (under what is known as the worldwide group debt test).We acknowledge that the use of the worldwide group debt test is rare; in our discussions with submitters we mentioned that we would be happy to look at changes to that rule if there are particular problems with its application in practice. No submissions were received on this.

109. With regards to implementing an arm's length debt test, we note that this was considered by the OECD as part of its work on best-practice interest limitation rules. The OECD recommended against such a rule, concluding that it is not an effective method for preventing profit shifting using debt. We do not recommend an arm's length debt test.

Submission: deferred tax should be ignored

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

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

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

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

113. Many submitters referred to the removal of building depreciation in Budget 2010 in making their arguments. The 2010 changes meant that companies that owned previously depreciable buildings needed to record a (sometimes significant) deferred tax liability, which will never result in a future tax payment.

Response

114. We have considered these submissions carefully, including discussing them with the agency in charge of setting accounting standards in New Zealand (the External Reporting Board or XRB) and the Australian Treasury.

115. Accounting standards require the recognition of deferred tax liabilities because a taxpayer may recognise a profit for accounting purpose that will not be taxable until a later period – the deferred tax liability represents that latent tax liability. However, we acknowledge in some cases deferred tax liabilities on a taxpayer's balance sheet will not accurately represent future tax payments the taxpayer will be required to make.

116. Our contact at the XRB made a similar remark, commenting that:

> "In many cases deferred tax balances are simply a timing difference between when income tax is expensed in the financial statements and when income tax becomes payable to the IRD; and in other cases, deferred tax balances recognised in the financial statements may have no impact on the current or future amount of income tax payable to the IRD.
>
> Many users of general purpose financial statements, which include significant deferred tax balances, consider the deferred tax balances and movements to be accounting entries that should be ignored when evaluating the financial performance and financial position of an entity. [...] The recognition of deferred tax adds a level of complexity and volatility to the financial performance reported, which many CFO's feel are unnecessary and result in deferred movements which are difficult to explain to shareholders."

117. Nevertheless, the fact remains that accounting standards require the deferred tax to be recognised – suggesting that they do often represent something real. Moreover, while some deferred tax liabilities will not result in future tax payments, not carving out deferred tax is consistent with the general policy taken in the thin capitalisation rules of following accounting principles.

118. The Australian Treasury commented that a key reason they carved out deferred tax from their non-debt liability adjustment is because of volatility concerns (mirroring comments made by submitters above). We agree that not carving out deferred tax could increase volatility of a taxpayer's thin capitalisation ratio in some instances, though consider that in many other situations it would also reduce it.

119. We recommend that we consult further on issues relating to deferred tax and the non-debt liability proposal. We could explore, for example, whether particular deferred tax liabilities that will not result in future tax payments could be identified and carved-out from any adjustment.

120. Deferred tax balances of some taxpayers are significant. If there was a carve-out for deferred tax, we estimate that this would reduce the fiscal impact of the non-debt liability proposal by up to $10 million per year (from $50 million per year to $40 million per year).

Submission: other technical adjustments

121. Submitters also wrote that it would be appropriate to make other exclusions from the non-debt liability adjustment, for example certain types of derivatives and redeemable preference shares. This was because, for example:

- they are more akin to equity;
- they are not used to fund a taxpayer's balance sheet; or
- that not excluding them would mean that taxpayers' thin capitalisation ratios would become inappropriately volatile.

Response

122. We consider that these other minor exclusions be considered as part of further consultation.

Submissions on other matters

De minimis for inbound thin capitalisation rules

Proposal

123. Many countries provide an exemption for companies with little interest expense, on the basis that they present a low BEPS risk. New Zealand has a de minimis in its outbound rules (of $1 million of interest deductions), but it does not currently have a de minimis in its inbound thin capitalisation. The discussion document proposed extending the existing de minimis so that it applies to inbound entities as well, provided none of the entity's debt is owner-linked debt (that is, debt from the owner, or that has been guaranteed by the owner).

Submissions

124. Submitters generally supported a de minimis rule on compliance cost saving grounds but wrote that limiting the proposed de minimis to firms with no owner-linked debt would make the de minimis very limited in application. CTG suggested that consideration should be given to adopting Australia's flat de minimis of $2 million which applies regardless of whether any lending is from related parties. Further to this, CA ANZ submitted that the outbound de minimis rule should be extended to $2 million as in Australia.

Response

125. If a firm has owner-linked debt, they present a higher BEPS risk than a firm with only third-party debt. On this basis, we consider that the proposed de minimis for inbound entities strikes the right balance between reducing compliance costs and BEPS risk.

126. Submitters did not provide any evidence that the current de minimis threshold in the outbound rules is too low. We do not consider it necessary to increase the current threshold from $1 million to $2 million as some submitters suggested.

Infrastructure projects

Summary of the proposal

127. The discussion document proposed adopting a rule presented in the OECD's final report on best-practice interest limitation rules, which would exempt certain infrastructure projects

funded entirely with third-party limited recourse loans from interest limitation rules. This exemption recognises that such funding presents little risk of BEPS.

Submissions

128. Submitters strongly supported this proposal. They wrote that it would make New Zealand a more attractive place for Public Private Partnership (PPP) investment and provide more flexibility in how such investments can be structured.

129. Submitters did make several technical submissions, primarily with a focus on ensuring the exemption works with the various commercial structures adopted by PPPs. We are currently working through these submissions. We note that further consultation with submitters may be necessary.

Response

130. We recommend that you seek Cabinet approval to this proposal in principle.

Non-resident owning body change

Proposal

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

- 60 percent; and
- 110 percent of its third-party debt.

132. We were concerned that allowing a company to have total debt of 110% of its third-party debt would allow entities to be funded through inappropriately high levels of debt. For example, a project funded 90 percent with third-party debt could have 9 percent shareholder debt and only 1 percent equity.

133. Accordingly, the discussion document proposed changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. The discussion document proposed grandparenting existing arrangements.

Submissions

134. This proposal was not a focus of many submissions. The main comments received were:

- That the proposed grandparenting of existing arrangements was appropriate; and
- That the way the proposal was worded implied it was unnecessarily restrictive.

Response

135. We recommend that this proposal proceed.

Asset valuations

Proposal

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

137. The discussion document proposed removing the net current valuation method from the list of available asset valuation methods for the purposes of the thin capitalisation rules. This change would mean that a company would only be able to use values as reported in its financial statements.

138. We proposed this change because we considered that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets. In addition, financial reporting valuations are subject to a higher level of scrutiny than asset valuations adopted solely for thin capitalisation purposes.

Submissions

139. No submissions on this proposal supported the removal of the net current valuation method. Many submitters argued that the flexibility to adopt an alternative valuation method is appropriate. They noted adopting a current valuation approach for financial reporting purposes means that the asset needs to be independently valued every year - an expensive exercise. In contrast, the current approach (where taxpayers can value assets at historic cost for financial reporting but based on current values for thin capitalisation) means taxpayers need to incur the costs of a valuation only when necessary (that is, when relying on an asset's financial value would mean the company would breach the thin capitalisation safe harbour).

140. Most submitters on this proposal suggested explicitly requiring revaluation of assets by an independent expert valuer, which is a feature of Australia's rules[14]). One submitter (CTG) also suggested that taxpayers should be required to disclose on their returns if the net current valuation method has been used. This would allow Inland Revenue to better target its resources while ensuring that taxpayers using the net current valuation method for genuine reasons are not unfairly penalised.

141. A few submitters suggested that the thin capitalisation rules should include all measurable assets, including intangible assets. This is consistent with Australia's approach. One submitter with significant intangible assets indicated that lenders look at the earning potential of intangibles and with sufficient rigour imposed on the process, there is no reason for intangible assets to be excluded from the thin capitalisation calculation.

Response

142. We are concerned about the robustness of the current rules (such as the risk that taxpayers are valuing assets without seeking an independent valuation) and the change

[14] The legislation at present currently prescribes no such requirement, though we understand from submitters that it is standard practice to get an independent valuation.

proposed in the discussion document is aimed at ensuring asset values used by taxpayers for thin capitalisation purposes are robust. However, we understand that removing the net current valuation method could increase compliance costs for a number of firms.

143. On this basis, we recommend modifying this proposal to allow firms that meet certain conditions to use the net current valuation method. This modified approach would also be subject to robust legislative requirement (such as requiring revaluation of assets by an independent expert valuer as suggested by submitters, and ensuring a consistent valuation method is used year-to-year) to ensure asset valuations that are being used are robust.

144. We do not support the proposal of including intangible assets in thin capitalisation calculations. These assets – for example, internally-generated intellectual property – are very difficult to value, which is why they are not recognised as assets under New Zealand's accounting standards. We have discussed this suggestion with the Australian Treasury – they have informed us that the Australian Taxation Office has significant difficulty determining the value of intangible assets, and that they are seeing taxpayers increase their reported values for these assets in response to the recent tightening of their rules (thereby diminishing the impact of the tightening).

145. We note that the safe harbour rule that submitters are referring to is only one option available to taxpayers in the thin capitalisation rules. The worldwide group debt test can alternatively be used by those taxpayers concerned about breaching the 60 percent safe harbour due to the exclusion of intangible assets.

Measurement date for assets and liabilities

Proposal

146. Taxpayers can currently choose to value their assets and liabilities on the last day of the income year, or use an average of their values at the end of each quarter, or each day, in the income year.

147. The first of these methods, valuing assets and liabilities on the last day of the income year, is the simplest and most widely-used approach. However, there is the potential for a taxpayer to use this method to breach the thin capitalisation debt limits for up to one year without facing any interest denial, by partly repaying a loan or converting it to equity on or before their balance date.

148. The discussion document proposed removing the first of these asset valuation methods so that assets can only be valued for thin capitalisation based on the average values at the end of every quarter or at the end of every day. This would ensure that the thin capitalisation rules apply effectively to a loan that was substantially repaid just before the end of the year.

Submissions

149. No submissions on this proposal supported the removal of the year-end valuation option. In particular, submitters were concerned that requiring valuations on a quarterly or daily basis would impose significant and unnecessary compliance costs for the majority of

taxpayers subject to the thin capitalisation rules. Submissions indicated that the year-end valuation option is almost always used and that removing this option would require taxpayers to prepare audited financial statements solely for tax purposes at points in the year when they are not required for financial reporting purposes.

150. Submitters presented two alternative approaches:

- Calculating an average of the opening and closing values of assets and liabilities each income year. This approach features in Australia's rules.
- Implementing an anti-abuse rule in the thin capitalisation regime to tackle this type of tax-driven behaviour.

Response

151. We accept the submission that the proposal to require quarterly or daily valuation would impose significant compliance costs on the majority of corporate taxpayers. We note that both alternative approaches proposed by submitters have advantages and disadvantages. In particular, adopting the Australian approach would require most corporate taxpayers to change their measurement method, whereas a strengthened anti-abuse rule is far more targeted at taxpayers that present a higher BEPS risk.

152. We agree with submitters that the proposal in the discussion document should not proceed. Instead, we recommend adopting the suggestion by submitters to implement an anti-abuse rule that targets situations when a taxpayer substantially repays a loan just before the end of the year. This approach most directly targets the behaviour of concern.

Minor remedial

153. Finally, the discussion document proposed a minor remedial to how section FE 18(3B) applies in relation to trusts. Very few submitters commented on this proposal – the few that did (for example, CA ANZ) supported it.

154. We recommend that the proposal proceed without amendment.

Other issues not progressed

Finance companies

155. One submitter suggested that special rules for non-resident owned finance companies should be developed. For technical reasons, the thin capitalisation rules are not currently very effective for these companies.

156. We agree that special rule for finance companies (similar to the special regime currently in place for registered banks) is necessary to ensure the thin capitalisation rules apply effectively to them. However, such rules would be complex to develop. Furthermore, a review of Inland Revenue data indicated that foreign-owned finance companies do not present much BEPS risk at present. Accordingly, in developing the proposals for the discussion document

we focused on other, more pressing areas of reform. We recommend the development of a special rule for foreign-owned finance companies be considered for a later time.

Non-residents acting together with New Zealand residents

157. Broadly, the inbound thin capitalisation rules apply only to companies where 50% or more of the ownership interests are held by:

- a single non-resident; or
- a group of non-residents acting together.

158. This means that the thin capitalisation rules do not necessarily apply if a company is owned by a group of residents and non-residents acting together, even though similar profit shifting risks can arise. Two submitters questioned this result.

159. We agree that it would be desirable to review whether the situations when the thin capitalisation rules apply should be broadened further. However, this matter was not discussed in the original discussion document. Submitters have had no opportunity to comment on the appropriateness or otherwise of such a broadening. As such, we consider that a change at this time would not be appropriate.

160. We recommend that this be considered in any subsequent review of the rules.

Link to recent NRWT reforms

161. The Government recently bolstered the withholding tax rules on interest payments to non-residents, ensuring they cannot easily be structured around. Four submitters suggested that this means the proposals put forward in the discussion document are unnecessary.

162. We do not agree. NRWT on interest payments is taxed at either 10 or 15 percent (depending on whether the payment is to a jurisdiction New Zealand has a DTA with). This rate is much lower than the company rate of 28 percent. It is therefore important for New Zealand to have robust rules to ensure that excessive interest deductions are not taken in New Zealand, as this still substantially reduces the overall tax take in New Zealand.

Appendix: List of submitters

Abbreviation	Full name	Description	TP[15]
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓
AMP (Aus)	AMP Capital Investors Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	
AMP (NZ)	AMP Capital Investors (New Zealand) Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓
ANZ	ANZ Bank New Zealand Limited	ANZ is a major bank in New Zealand and Australia.	
BNZ	Bank of New Zealand	BNZ is a major bank in New Zealand and Australia (NAB).	
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓
First Gas	First Gas Limited	First Gas is one of NZ's largest gas networks.	
First State	First State Investments	First State Investments (FSI) is the investment management business of the Commonwealth Bank of Australia.	
InfraRed	InfraRed Capital Partners Limited	InfraRed is an active equity investor in the New Zealand PPP sector, currently holding interests in the Auckland South Correctional Facility and Transmission Gully Motorway projects.	

[15] Submission also received on *BEPS – transfer pricing and permanent establishment avoidance*.

Abbreviation	Full name	Description	TP
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓
Methanex	Methanex New Zealand Limited	Methanex produces and sells methanol globally. Methanex NZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China	
NZBA	New Zealand Bankers Association	NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks.	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCTU is made up of 30 unions and has 320,000 members.	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓
Olivershaw	Olivershaw Limited	Olivershaw provides tax advisory services for corporate clients, corporate boards, high net worth individuals and accounting firms.	
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty. Oxfam NZ is the New Zealand arm of the global organisation.	✓
Plenary	Plenary Origination Pty Ltd	Plenary Group is an independent long-term investor, developer and manager of public infrastructure in Australia.	
Powerco	Powerco Limited	Powerco is New Zealand's largest electricity distributer. It also has the second largest gas distribution network.	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓
QIC	QIC Private Capital Pty Limited	QIC is an investor in global infrastructure markets and manages a 58% interest in Powerco NZ Holdings Limited.	
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓

Abbreviation	Full name	Description	TP
SKYCITY	SKYCITY Entertainment Group Limited	SKYCITY is an entertainment and gaming business owning and operating casinos in New Zealand (Auckland, Hamilton and Queenstown) and Australia (Adelaide and Darwin).	
TPEQ	TP Equilibrium | AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓
Westpac	Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch	Westpac is a major bank in New Zealand and Australia.	

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

RECEIVED

6 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1577 IR2017/330

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations	29 June 2017
Minister of Revenue	**Agree** to the recommendations	29 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Gordon Witte	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Sam Rowe	Senior Policy Advisor, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	
Carmel Peters	Policy Manager, Inland Revenue	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions

Executive summary

1. In March this year the Government released a tax discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed the introduction of a package of transfer pricing and permanent establishment (PE) avoidance rules targeted at countering large multinationals engaged in aggressive tax practices. This report provides advice on the 16 submissions we have received on this discussion document. It also seeks policy decisions on the reform package following this consultation.

2. In summary, we recommend proceeding with all but one of the proposals in the discussion document (we do not recommend proceeding with the proposal to require large multinationals to pay disputed tax earlier). We recommend making a number of refinements to some of the original proposals in response to submissions. These refinements will make the proposals more certain for taxpayers and better targeted at the base erosion and profit shifting (BEPS) arrangements we are concerned about.

3. Agreeing to our recommended changes will not change the previously estimated forecast tax revenue from the transfer pricing and PE proposals (which is $25m in 2018/19 and $50m per annum thereafter).

Summary of submissions

4. Two submitters (Oxfam and NZCTU)[1] expressed support for all the proposals on the grounds that they would help ensure multinationals pay their fair share of tax.

5. Most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more workable and better targeted. Many submissions focused on when the PE avoidance rule would apply and when Inland Revenue would reconstruct a transfer pricing arrangement. We are confident we can refine the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

[1] A full list of all the submitters, together with a brief description, is included in the appendix to this report.

6. Some submitters were opposed to proceeding with any of the proposed measures as they considered the new rules were unnecessary and would make New Zealand's tax environment more uncertain and unattractive for multinational investment.

7. Most of the submitters are tax advisors or represent businesses that could be negatively affected by the proposals. Therefore, the submissions are understandably critical of some of the measures. As expected, submitters strongly opposed the proposals that increased Inland Revenue's powers to investigate large multinationals. These administrative proposals included:

- extending the transfer pricing time bar from 4 years to 7 years. This is the period within which Inland Revenue can adjust a transfer pricing tax position taken by a taxpayer;
- allowing Inland Revenue to request information that is held by an offshore group member; and
- requiring large multinationals to pay disputed tax upfront (rather than at the end of a dispute).

Our response

8. We agree with submitters that the proposal to make large multinationals pay disputed tax upfront is unnecessary, and recommend not proceeding with the proposal. Inland Revenue already charges "use of money interest" on tax owing, which provides a strong incentive for paying tax which is in dispute.

9. We recommend proceeding with all of the other proposals in the discussion document, subject to a number of refinements to make the proposals more certain for taxpayers and better targeted. These refinements should not reduce the overall effectiveness of the proposed reforms.

10. Otherwise, we consider the measures are well-targeted at the specific problems that Inland Revenue has actually observed in its investigations of multinationals. Currently only a small number of multinationals use the aggressive PE avoidance or transfer pricing arrangements which are targeted by the proposals. This suggests the new rules will only increase uncertainty or tax costs for a small number of multinationals.

11. The following table summarises the main issues raised by submitters and our recommended responses:

Submission	Recommended response
The anti-avoidance threshold for the application of the PE avoidance rule should be narrowed so it does not apply to ordinary commercial arrangements.	**Accept** the submission. We consider the rule should be more narrowly targeted at avoidance arrangements. We could do this either by requiring a more than merely incidental purpose of tax avoidance, or by adopting into domestic legislation the OECD's widened PE definition. We would like to give further

	consideration as to which approach we should adopt.
The PE avoidance rule is not necessary in light of the OECD's new widened PE definition (which New Zealand is implementing with some countries through the Multilateral Instrument and through future double tax agreement (DTA) negotiations).	**Accept** the submission in part. In cases where the applicable DTA includes the OECD's new widened PE definition, the proposed PE avoidance rule seems unnecessary. However the OECD's widened PE definition will not be included in most of our DTAs under the MLI (although it may be included under subsequent bilateral DTA negotiations). To reflect this, we recommend that the proposed PE rule apply only where an applicable DTA does not include the OECD's widened PE definition.
The PE avoidance rule should not override New Zealand's DTAs.	**Decline** the submission. For the rule to be effective it needs to override those DTAs which do not include the OECD's new widened PE definition. This is consistent with the Australian and UK approaches.
The proposed anti-avoidance source rule is too broad and should be more targeted at the perceived problem.	**Accept** the submission. We consider the rule should be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
The life insurance proposals represent an unfair and unilateral reconstruction of the tax treatment of life insurance premiums and should not proceed.	**Accept** the submission in part. We consider that the proposed reinsurance amendments are necessary to ensure that the rules apply as intended and to protect the tax base. However, there is little revenue at risk in relation to the foreign investment fund amendments and a significant likelihood of accidental non-compliance under the proposed change. Accordingly, we recommend that the foreign investment fund related life insurance changes do not proceed (meaning that any life insurance policies issued in New Zealand by life insurers from Singapore, Russia, and Canada would remain exempt from the foreign investment fund rules).
The time bar which limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position should remain at 4 years (not be extended to 7 years as proposed).	**Decline** the submission. We consider there is still a good justification for extending the time bar to 7 years for transfer pricing issues (consistent with Australia and Canada).
The burden of proof for transfer pricing matters should remain with Inland Revenue (rather than being shifted onto the taxpayer as proposed).	**Decline** the submission. The burden of proof is on the taxpayer for transfer pricing matters in most OECD and G20 countries, including Australia. This means most multinationals already have to prepare transfer pricing documentation that satisfies the burden of proof for other countries. Also, the burden of proof is on the taxpayer for other tax matters.

The test for reconstructing a transfer pricing arrangement should align with the OECD's transfer pricing guidelines.	**Accept** the submission. New Zealand's legislative test for reconstructing an arrangement should be based on the corresponding test in the OECD's transfer pricing guidelines.
The proposal to make large multinationals pay disputed tax upfront is unnecessary and should not proceed.	**Accept** the submission. We recommend not proceeding with this proposal as Inland Revenue already charges "use of money interest" on tax owing, which provides a strong incentive for multinationals to pay tax that is in dispute.
The proposal to require a New Zealand member of a multinational group to pay tax owed by a related non-resident group member should not proceed.	**Decline** the submission. However, we agree that the rule should only apply if the non-resident fails to pay the tax itself.
The proposed extension of Inland Revenue's information collection powers to allow Inland Revenue to request information that is held offshore by a related group member should not proceed. Submitters also raised concerns about the new civil penalty of up to $100,000 for failing to provide requested information (which replaces the current $12,000 maximum criminal penalty).	**Decline** the submissions. We consider that these information proposals are necessary to ensure that the multinational group is required to provide Inland Revenue with the requested information and has appropriate incentives to comply with these requests. However, we recommend allowing the multinational to appeal the penalty.

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

13. Officials are available to discuss this report at your joint Ministers' meeting on 29 June. Further information about the next steps is set out in the cover report included in this package (*BEPS – submissions on March 2017 discussion documents – covering report* T2017/1578 / IR2017/329).

Recommended action

We recommend that you:

(a) **Agree** that the proposal in the discussion document to require large multinationals to pay disputed tax upfront should **not** proceed as it is not necessary given that Inland Revenue already charges "use of money interest" on tax owing.

Agreed / Not Agreed Agreed / Not Agreed

(b) **Note** that the recommendations below agree to implement all the other proposals in the discussion document, subject to some refinements in response to submissions (as identified in this report).

Noted Noted

(c) **Note** that the recommended refinements will provide more certainty for taxpayers without reducing the overall effectiveness of the proposed reforms. Therefore agreeing to officials' recommendations will not affect the estimated forecast tax revenue from implementing the transfer pricing and PE avoidance measures, which is $25m in 2018/19 and $50m per annum thereafter.

Noted Noted

(d) **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure to avoid having a permanent establishment (taxable presence) in New Zealand. The rule will only apply to multinationals with over EUR €750m of consolidated global turnover.[2] The rule will not apply if the relevant DTA already includes the OECD's new widened PE definition.

Agreed / Not Agreed Agreed / Not Agreed

(e) **Note** that, in designing the detail of the new PE avoidance rules, officials will consider options for narrowing the original scope of the PE avoidance rules without reducing their effectiveness. We will report back with our recommendations on this matter.

Noted Noted

(f) **Note** that we will consult further on a new source rule which will deem an amount of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA.

Noted Noted

[2] The EUR €750m threshold has been chosen to align application of the proposed rule with the OECD's threshold for requiring large multinationals to file country-by-country reports

(g) **Agree** to introduce an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source. (This is more narrowly targeted at the existing issues Inland Revenue has identified with the source rules than the original proposal.)

Agreed / Not Agreed Agreed / Not Agreed

(h) **Agree** to address a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life insurance policies if the premium income on that policy is not taxable in New Zealand including where the income is not subject to New Zealand tax under a DTA.

Agreed / Not Agreed Agreed / Not Agreed

(i) **Agree** that the proposal to amend the FIF life insurance rules should not proceed as there is little revenue at risk and a significant likelihood of accidental non-compliance under the proposal.

Agreed / Not Agreed Agreed / Not Agreed

(j) **Agree** that the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position should be increased to 7 years (in line with Australia).

Agreed / Not Agreed Agreed / Not Agreed

(k) **Agree** that the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions should be shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters).

Agreed / Not Agreed Agreed / Not Agreed

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

- they disregard legal form if it does not align with the actual economic substance of the transaction;
- they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;
- the legislation specifically refers to arm's length conditions and using the latest OECD's transfer pricing guidelines as guidance material for how the rules are applied; and

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

Agreed / Not Agreed Agreed / Not Agreed

(m) **Agree** that New Zealand's legislative test for reconstructing a transfer pricing arrangement should be based on the corresponding test in the OECD's transfer pricing guidelines.

Agreed / Not Agreed Agreed / Not Agreed

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

Agreed / Not Agreed Agreed / Not Agreed

(o) **Agree** that if a large multinational group (over EUR €750m worldwide revenues) does not cooperate with Inland Revenue, then Inland Revenue may more readily dispute the multinational's tax position based on the information available to Inland Revenue at the time.

Agreed / Not Agreed Agreed / Not Agreed

(p) **Agree** that tax owed by any member of a large multinational group can be collected from any wholly-owned group member provided the non-resident fails to pay the tax itself (this is slightly narrower than the original proposal in the discussion document).

Agreed / Not Agreed Agreed / Not Agreed

(q) **Agree** to extend Inland Revenue's information collection powers so that in respect of large multinational groups, Inland Revenue can request information that is held offshore by a related group member.

Agreed / Not Agreed Agreed / Not Agreed

(r) **Agree** to extend Inland Revenue's information collection powers so that Inland Revenue can deem an amount of income to be allocated to a New Zealand group member or New Zealand PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand-sourced income. (Currently the existing power only applies in respect of deductible payments.)

Agreed / Not Agreed Agreed / Not Agreed

(s) **Agree** to create a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty), but clarify that the taxpayer would be able to appeal this penalty.

Agreed / Not Agreed   Agreed / Not Agreed

(t) **Agree** that advance pricing agreements (APAs) existing prior to the application date of these proposals should be grandparented.

Agreed / Not Agreed   Agreed / Not Agreed

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

Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

14. In March this year the Government released a tax discussion document called *BEPS – transfer pricing and permanent establishment avoidance.* This report provides advice on the 16 submissions (from 15 submitters) we have received on this discussion document. It also seeks policy decisions on the proposals, including a number of suggested refinements to address issues raised by submitters.

15. We have met with six of the main submitters (CA ANZ, CTG, PwC, KPMG, EY, DEG) to discuss their submissions and explain the proposals. We will continue to work with these and other submitters to develop the detailed design of the legislation.

16. This report advises on the important issues relevant to the main policy decisions to be taken by Cabinet in July. Following these decisions, we will design the detail of the proposals, on which there will be further targeted consultation in August to October of this year. A number of the submissions related to the detail of the proposals or to Inland Revenue's operational approach. For example many taxpayers asked that Inland Revenue develop practical guidance on how the proposed new rules would apply. We will advise you on these detailed design and operational submissions following the next round of consultation.

General views on the proposals

17. The proposed transfer pricing and PE avoidance rules are targeted at countering large multinationals engaged in aggressive tax practices.

18. Some submitters welcomed these proposals as a positive step by the Government to ensure that all large multinationals pay their fair share of tax (Oxfam and CTU).

19. Most submitters accepted in principle the need for measures to address the transfer pricing and permanent establishment (PE) avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more workable and better targeted. Many submissions focused on when the PE avoidance rule would apply and when Inland Revenue would reconstruct a transfer pricing arrangement.

20. Other submitters argued that the proposals will have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented (CTG, CA ANZ, and NFTC). These submitters argued that the proposals introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, which would reduce GDP and lower employment levels.

21. We disagree with these submissions. First, the majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that set out to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the transfer pricing and PE rules to achieve a competitive

advantage over more compliant multinationals or domestic firms. Second, 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.

22. The transfer pricing and PE proposals introduce a set of rules to reinforce the integrity and efficiency of the tax system so that there is a level playing field for multinationals and domestic firms.

PE avoidance

Summary of proposed rule

23. Where a DTA applies, New Zealand is only able to tax a non-resident on its income from sales to New Zealand customers if the non-resident has a PE in New Zealand. The discussion document proposed a rule to prevent non-residents from structuring their affairs to avoid having such a permanent establishment in New Zealand where one exists in substance.

24. The rule proposed in the discussion document would deem a non-resident to have a PE in New Zealand if:

- the non-resident supplies goods or services to a person in New Zealand;
- the non-resident is part of a multinational group with more than EUR €750m of consolidated global turnover;
- a related entity (either associated or commercially dependant) 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 non-resident; and
- the arrangement defeats the purpose of the relevant DTA's PE provisions.

General reaction

25. Submitters were not strongly opposed to a new PE rule in principle, with 2 submitters supporting the proposal (Oxfam and NZCTU) and the remainder mostly accepting the need (or inevitability) for some form of PE avoidance rule. However 7 submitters considered that we should not adopt any PE avoidance rule at this stage. These submitters argued that:

- The OECD's Multilateral Instrument (MLI)[3] includes a widened definition of a PE so any PE avoidance issues should be addressed under this. Alternatively, we should defer consideration of a PE avoidance rule until the impact of the OECD's BEPS measures has been determined (EY, AmCham, DEG, CA ANZ).

- The rule is unnecessary, as any current issues with PE avoidance can be addressed through our transfer pricing rules (NZLS, DEG, CA ANZ).

- The rule will apply to non-abusive transactions, is outside the OECD's BEPS initiatives, and will erode taxpayer certainty (CTG, NFTC, Deloitte).

26. In response to these submissions, we consider that:

- Where the widened definition of a PE in the MLI applies, a domestic PE avoidance rule would not be necessary. However the widened definition applies only under the MLI where both countries choose to adopt it. We are aware that most countries do not intend to adopt the widened definition under the MLI (including the US, the UK, and Australia). We note that the widened definition is being added to the OECD's model treaty, and we expect it to eventually be incorporated into most of our DTAs (including DTAs with countries that did not elect to adopt the widened definition under the MLI) as each DTA is bilaterally renegotiated. However it will be many years before all our DTAs are bilaterally renegotiated. Therefore a domestic rule is necessary now to address PE avoidance by taxpayers resident in these countries.

- 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 (depending on the circumstances). In addition, deeming a PE to exist will allow us to charge non-resident withholding tax 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 correct amount of tax for New Zealand in many cases where a PE is being avoided.

- Our proposed PE avoidance rule is broadly consistent with the OECD's BEPS initiatives, as it should have a similar effect to the widened PE definition in the MLI. We recommend below some changes to our PE rule which should ensure it is better targeted at abusive transactions. Finally we acknowledge that the rule will reduce taxpayer certainty, which is undesirable. However we consider that this disadvantage is outweighed by the benefits of the proposed rule in terms of protecting the integrity of the tax system, fairness, revenue, and economic efficiency.

---

[3] The *Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting*. The MLI is a multilateral convention which is intended to prevent DTAs from being used to facilitate cross-border tax avoidance. The MLI amends a large number of each signatory's DTAs at once, and so implements the OECD's recommended DTA changes much faster than a succession of bilateral negotiations could. New Zealand signed the MLI on 7 June 2017.

27. We therefore recommend proceeding with the introduction of a PE avoidance rule.

Threshold for the application of the new measures

28. The discussion document proposed that the PE avoidance rule would only apply to arrangements which defeated the purpose of the PE provisions in the applicable DTA. The explanation of this test in the discussion document focussed on the economic substance of the non-resident's activity in New Zealand, and particularly whether a PE would arise if the non-resident and its local New Zealand subsidiary were treated as a single entity.

29. A majority of submitters (EY, NFTC, DEG, Deloitte, CTG, CA ANZ, PwC, KPMG, Russell McVeagh) considered that this proposed PE avoidance test was too broad. They considered that it would widen the PE definition in substance rather than just prevent its abuse. They were also concerned that it could capture ordinary commercial arrangements and discourage foreign investment. Some submitters considered that the PE avoidance rule should either be targeted at abusive or artificial arrangements or should adopt the wording of the OECD's widened PE avoidance definition in the MLI (CTG, PwC, Deloitte, CA ANZ, DEG).

30. We agree with these submissions. We recommend that the rule be more narrowly targeted so that it does not apply to ordinary commercial arrangements, and so does not unduly discourage non-residents from doing business in New Zealand.

31. Submitters suggested two options for narrowing the scope of the rule:

- **Option 1:** Replace the current requirement that the rule defeats the purpose of the PE article in a DTA with a purpose of avoidance test. Under this new test, the rule would only apply if the relevant arrangement had a more than merely incidental purpose of tax avoidance. This would target the rule at avoidance transactions and align the rule with similar rules in Australia and the UK, each of which requires the taxpayer to have a purpose of avoiding tax. Because it is an express anti-avoidance rule, it would also be consistent with our DTAs. The rule would apply more broadly in the context of PE avoidance than our current general anti-avoidance rule[4].

- **Option 2:** Replace the PE avoidance rule proposed in the discussion document with the OECD's widened definition of a PE, which we would add to our domestic legislation as a standalone rule. The OECD's widened definition provides that a PE arises if a representative of the non-resident plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the non-resident. The widened definition also includes some supplementary provisions to counter particular avoidance strategies observed overseas. This rule is an objective test and it is the result of the OECD's BEPS Action Plan, which included a report on "Preventing the Artificial Avoidance of Permanent Establishment Status" (Action 7). As indicated by the title of the report, the purpose of the rule is to prevent the artificial avoidance of PE status under various BEPS strategies. The widened PE definition would apply in respect of a DTA regardless

[4] This is because the general anti-avoidance rule applies only if an arrangement both uses the relevant provisions in a way that is outside of Parliament's contemplation (the Parliamentary contemplation test) and has a more than merely incidental purpose of tax avoidance. The proposed PE avoidance rule would not incorporate the Parliamentary contemplation test. Instead it would only require that an arrangement had a more than merely incidental purpose of tax avoidance.

of whether the other country elected to adopt it under the MLI. This test would be more certain for foreign investors than option 1 and would replicate the OECD's recommended measure.

32. We consider that either option would be effective in addressing the PE avoidance arrangements we have seen in New Zealand. Accordingly adoption of either option would not affect the previously forecast revenue estimates for the measures. We would like to further evaluate the merits of the two options before recommending one.

Interaction with MLI

33. Several submitters questioned how our proposed PE avoidance rule would interact with the widened definition of a PE in the MLI. As noted above, some submitters considered that PE avoidance should be dealt with under the MLI (EY, AmCham, DEG, CA ANZ). Other submitters questioned how our domestic PE rule would work in relation to a DTA that included the MLI's widened PE definition, or considered that any domestic rule should be consistent with the OECD's BEPS actions (KPMG, CTG, NZLS, PWC).

34. There is merit in these submissions. The widened PE definition from the MLI should address PE avoidance, provided it is included in the relevant DTA. Accordingly it is not necessary for our domestic PE avoidance rule to apply where there is an applicable DTA that includes the MLI's widened PE definition. We also generally prefer to follow the OECD's approach where that is practicable.

35. Accordingly, we recommend that our domestic PE avoidance rule apply only in respect of DTAs that do not include the widened PE definition from the MLI (or an equivalent definition that is negotiated bilaterally).

Overriding DTAs

36. A majority of submitters considered that our PE rule should not override our DTAs (CTG, KPMG, CA ANZ, NFTC, NZLS, EY, Russell McVeagh, DEG). This is because DTAs are important to international trade, and New Zealand exporters also need to rely on them. Submitters also considered that we should not depart from the OECD's agreed BEPS measures, particularly where the country of the non-resident has declined to adopt the widened PE definition in the MLI.

37. The OECD's Commentary to the Model Tax Convention (the 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). In the present case, our first option for a PE rule is an anti-avoidance measure that only applies if there is a purpose of tax avoidance. Accordingly it should not conflict with New Zealand's DTAs in the vast majority of cases. The second option is also an anti-abuse measure however it functions as a black letter amendment to the terms of our PE articles. Accordingly we would like to further consider its consistency with our DTAs before deciding which option to recommend.

38. In either case we consider that the PE 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 avoidance rules override their DTAs.

39. 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.

40. We note that in relation to the second option (which incorporates the OECD's widened PE definition into our domestic legislation), the widened PE definition will be added to the OECD's model tax treaty, 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 failure to adopt the widened PE definition under the MLI does not mean that they object to such a provision in their DTA with New Zealand.

Source rules

PE avoidance source rule

41. The rule proposed in the discussion document stated that an amount of income would have a New Zealand source if we had a right to tax the income under the PE or royalty article of a DTA. Only 2 submitters opposed this rule, on the basis that it was circular (CTG) and could result in a breach of our DTAs (EY). We do not consider there is any circularity to the proposal – the proposal will ensure that we are not prevented from taxing income under our domestic legislation where we have an agreed right to tax that income under our DTAs. Also, for this reason, the rule would never apply in contravention of our DTA rights.

42. We note the rule proposed in the discussion draft applied only in respect of income covered by the PE article and the royalty article of our DTAs. This was because we were only aware of issues with our domestic legislation in relation to these kinds of income. On reflection, we consider the rule should apply in respect of all types of income we can tax under an applicable DTA (e.g. interest, dividends, income from alienation of property, etc.). This is sensible because it ensures that we do not negotiate taxing rights under a DTA that we cannot exercise because of differences in the formulation of the source rules in our DTAs and our domestic law source rules. This is the same position which Australia takes under its DTAs, and the proposed rule already applies to all income covered by an article of our DTA with Australia. Since we are broadening our original proposal we should consult further with stakeholders as part of the generic tax policy process (GTPP).

Anti-avoidance source rule

43. The rule proposed in the discussion document provides that a non-resident's income would have a source in New Zealand (and therefore give us a domestic law taxing right) if it would have a New Zealand source, treating the non-resident's multinational group as a single entity. This would stop non-residents from dividing their activities between wholly-owned group members in order to prevent their income from having a New Zealand source.

44. Some submitters considered that this rule should not proceed in its current form (CTG, EY, CA ANZ, Russell McVeagh). They considered that it was unnecessary, as our existing source rules were already adequate. Submitters also considered that the rule was too broad and struggled to understand how it would work in practice. Two submitters noted that a more targeted rule could be more appropriate (CA ANZ, EY).

45. The rule was partly intended to address an existing technical issue with the source rules, and partly intended to prevent possible future attempts to circumvent the source rules. In light of submitters' concerns, we consider that the rule should be more narrowly targeted at the existing issues with the source rules. In particular, the rule should broadly provide that, where a group member carries on a non-resident's business in New Zealand, the non-resident is also deemed to carry on business in New Zealand to that extent. This will prevent non-residents from being able to avoid a New Zealand source for their income from sales to New Zealand customers by arranging for a wholly owned subsidiary to carry out their local business activities. If the rule applied, only the portion of the sales income that is attributable to the group member's activities in New Zealand would generally be taxable here.

Life insurance rules / FIF rules

46. Life insurance premiums can be used to shift income out of New Zealand. As such, the Income Tax Act denies a deduction for reinsurance premiums when the corresponding premium income is not taxable in New Zealand.

47. Life insurance can also be used as a type of investment savings. For this reason, the foreign investment fund (FIF) rules apply to life insurance policies owned by New Zealand residents.

48. New Zealand's DTAs typically preserve New Zealand's entitlement to tax insurance premiums whether or not a permanent establishment exists. However, under New Zealand's DTAs with Canada, Russia, and Singapore, New Zealand is unable to tax life insurance premiums if a resident of those countries does not have a permanent establishment in New Zealand. New Zealand's inability to tax life insurance premium income under these DTAs means that the rules denying reinsurance deductions and the application of the FIF rules may not work as intended when the premium is paid to a non-resident life insurer or reinsurer from these countries. Furthermore, non-resident life insurers who are residents of Canada, Russia, or Singapore, are able to receive an unintended tax advantage by being able to deduct life reinsurance premiums.

49. The discussion document proposed an amendment to the Income Tax Act to specifically provide that no deduction is available for the reinsurance of policies if the premium income on that policy is not taxable in New Zealand (including under a DTA). An amendment to the

definition of a FIF was also proposed to specifically provide that New Zealand residents are subject to the FIF rules in respect of any policies that are not subject to New Zealand tax under the life insurance rules or any applicable DTA.

50. Submitters argued that the life insurance proposals should not proceed as they represent an unfair and unilateral reconstruction of the tax treatment of life insurance premiums (KPMG, EY, Deloitte, CTG, CA ANZ). Submitters argued that during treaty negotiations with Canada, Russia, and Singapore, New Zealand must have either accepted to change its standard practice of taxing insurance premiums, or inadvertently made the change – neither reason providing sufficient justification for the proposals. The submitters considered that the correct approach would be for New Zealand to renegotiate the relevant provision with Canada, Russia, and Singapore.

51. Submitters also argued that the proposals unfairly penalise the reinsured party by placing a significant burden on them to have completeness of information regarding their insurer's place of tax residence and PE status in NZ (CTG and Deloitte). Should the proposals advance, Deloitte considers that appropriate grandparenting should be provided.

52. We agree with the submissions in part. We consider that the proposed reinsurance amendments are necessary to ensure that they apply as intended. These proposals will also ensure that life insurance businesses operating out of Canada, Russia, and Singapore will no longer benefit from more favourable tax treatment compared with those operating in New Zealand or other countries. However, we recommend that the FIF life insurance changes do not proceed as there is little revenue risk involved and a significant likelihood of accidental non-compliance under the proposed changes. This means that any life insurance policies issued in New Zealand by life insurers from Singapore, Russia, and Canada would remain exempt from the foreign investment fund rules.

Transfer Pricing

53. Transfer pricing rules guard against multinationals using related party payments to shift profits offshore by requiring these payments to be consistent with an arm's length/market price that unrelated parties would agree to. Chapter 5 of the discussion document outlined a package of proposals to strengthen the transfer pricing rules.

General reaction

54. Three submitters (CTG, EY, KPMG) considered the transfer pricing proposals were unnecessary as the existing transfer pricing rules were sufficient. We disagree as New Zealand's existing transfer pricing legislation would not allow us to fully implement the OECD's new transfer pricing guidelines (that were developed to combat BEPS) as it does not explicitly require transfer pricing practices to align with the actual economic activity (if this differs from the legal contracts) and does not include a reconstruction provision.

55. Other submitters generally accepted that there was a need to update New Zealand's transfer pricing legislation so it aligns with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. However, as expected, there was strong opposition to the

administrative proposals to extend the time bar for transfer pricing adjustments to 7 years and to shift the burden of proof onto the taxpayer for providing evidence that they comply with the transfer pricing rules.

Extending the time bar to 7 years

56. Inland Revenue currently has 4 years from the end of the tax year in which a taxpayer files an income tax return to investigate and amend the tax position taken by the taxpayer in their return. This 4 year limit is known as the time bar. The discussion document proposed that transfer pricing issues should have a longer time bar of 7 years (consistent with fact that Australia and Canada have 7 year time bars for transfer pricing).

57. Eight of the 15 submitters (CTG, PwC, KPMG, CA ANZ, EY, AMP (NZ), Russell McVeagh, NFTC, DEG, NZLS) opposed this proposal. The main reasons for opposing a longer time bar were:

- A longer time bar increases uncertainty for taxpayers and does not promote efficiency in transfer pricing disputes (will delay timely resolution).
- The discussion document argued that a longer time bar is needed because transfer pricing issues are complex and fact-specific, but this is also true of other areas of tax such as tax avoidance, the capital/revenue boundary and complex financial arrangements.
- Most countries have the same time bar for transfer pricing and other tax issues, and in most cases this was less than 7 years.
- If a transfer pricing dispute is resolved in favour of Inland Revenue, the taxpayer will be at risk of double tax in jurisdictions where the time bar has already passed.
- Imposing a longer time bar is inconsistent with Inland Revenue's Business Transformation goals of real-time review and helping taxpayers get it right from the start.
- Inland Revenue should invest more resource into its transfer pricing team if the investigations are taking longer than 4 years.

58. Officials are not convinced by these arguments and consider there is still a good justification for extending the time bar to 7 years for transfer pricing issues. There are a number of reasons why transfer pricing investigations can take more time than other types of tax investigation:

- 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.

59. Currently, most transfer pricing investigations take less than 4 years and we expect 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.

60. One concern with a longer time bar is that it could lead to more years of income being part of a dispute, which could reduce incentives for taxpayers and Inland Revenue to agree on a settlement to the dispute. However, Inland Revenue is increasingly picking up the vast majority of the arrangements it wants to challenge on a relatively real-time basis (often year two, taking into account filing timeframes which generally mean a return is not filed until the start of year two) which should lead to fewer years being under dispute.

61. New Zealand is adopting Article 17 of the MLI which will update our DTAs so that they require our DTA partners to make appropriate corresponding adjustments in transfer pricing cases. This will ensure that double taxation does not arise due to New Zealand making a transfer pricing adjustment, even if this is beyond the other country's time bar.

62. This also 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 7 year time bar for transfer pricing so New Zealand must provide up to 7 years of tax relief to Australian businesses, whereas we can only currently go back 4 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 7 years after tax returns have been filed.

63. Having a longer time bar for transfer pricing does not preclude having shorter time bars in other areas where there is less risk or complexity. The discussion document noted that

Australia and Canada both have 7 year time bars for transfer pricing even though their standard time bars are 4 years. Australia also has a shorter 2 year time bar for individuals and small businesses. Therefore we consider that having a longer time bar for transfer pricing is not inconsistent with Inland Revenue's Business Transformation objectives.

64. 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, we 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.

Shifting the burden of proof from Inland Revenue to the taxpayer

65. The discussion document proposed shifting the burden of proof onto the taxpayer for providing evidence that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length.

66. 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.

67. Four submitters (CTG, KPMG, CA ANZ, Russell McVeagh) argued that the burden of proof for transfer pricing should remain with Inland Revenue. The main arguments raised by submitters were:

- Shifting the burden of proof will increase compliance costs, especially in conjunction with the other transfer pricing proposals.

- Inland Revenue should provide more guidance on what transfer pricing documentation they expect to be prepared (or explicitly mandate for transfer pricing documentation to be prepared), rather than shift the burden of proof.

- The current ability for Inland Revenue to shift the burden of proof to the taxpayer when a transfer pricing position is undocumented is an effective way to encourage documentation.

- Inland Revenue may have better information on comparables than the taxpayer and should not be able to use secret information (that it cannot share with the taxpayer) to adjust a taxpayer's transfer pricing position.

68. The burden of proof is on the taxpayer for transfer pricing matters in most OECD and G20 countries, including Australia. 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.

69. When New Zealand's transfer pricing rules were introduced in 1995, most multinational transactions in New Zealand closely resembled easily observable market transactions. Two decades later, related party transactions and transfer pricing practices have become a lot more complex, specialised and sophisticated.

70. Multinationals typically have better information than Inland Revenue 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.

71. One submitter (KPMG) suggested the legislation should explicitly mandate the type of transfer pricing documentation that taxpayers have to prepare as an alternative to shifting the burden of proof. Others (EY, PwC, AmCham) suggested that Inland Revenue should prepare additional guidance on what documentation would be required to satisfy the burden of proof.

72. We consider that taxpayers are best placed to consider the amount of documentation or evidence that is required to demonstrate compliance (as this will vary based on the tax effect or materiality of the transaction). Imposing a minimum standard for documentation could impose additional compliance costs in respect of lower-risk transactions (which may require no or little documentation) and may not lead to adequate documentation for higher-risk transactions (which should require a higher standard to discharge the burden of proof). 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.

73. Three submitters (CTG, KPMG, Russell McVeagh) raised concerns that Inland Revenue could potentially use information that it held on comparable transactions to adjust a taxpayer's transfer pricing position and then not share this information with the taxpayer on the ground that it was tax secret. They considered this was a reason why the burden of proof should remain with Inland Revenue (either more generally, or just in this particular scenario).

74. However, in the 22 years since the transfer pricing rules were introduced, Inland Revenue has never used a secret comparable to adjust a taxpayer's transfer pricing position. In practice, because New Zealand is a small market, Inland Revenue mainly sources comparable information from commercial databases that can also be purchased/accessed by taxpayers (as opposed to its own tax information). In any case, if Inland Revenue did in fact ever make an adjustment based on information that was not accessible to the taxpayer, it would be able to anonymise the relevant information in order to share the basis for the adjustment with the affected taxpayer.

The test for reconstructing a transfer pricing arrangement

75. Consistent with Australia's rules and the OECD's transfer pricing guidelines, the discussion document proposed providing Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to.

76. Two submitters (TPEQ and Russell McVeagh) argued that New Zealand should not include a specific reconstruction rule in our transfer rules as New Zealand's existing general anti-avoidance rule already allows the Commissioner to challenge and reconstruct tax avoidance arrangements. We note that the general anti-avoidance rule would be more difficult to apply as it requires an explicit purpose of tax avoidance, whereas the proposed rule (and the OECD's transfer pricing guidelines) would not. Therefore, we consider that a specific transfer pricing reconstruction rule is still necessary.

77. Eight of the 15 submitters (CTG, KPMG, TPEQ, CA ANZ, EY, PwC, AMP (NZ), Deloitte) raised concerns about the potentially broad scope of the proposed reconstruction rule and submitted that the proposed reconstruction rule should only apply in the "exceptional circumstances" described in the OECD's transfer pricing guidelines.

78. The discussion document proposed that we adopt Australia's provision which allows transfer pricing arrangements to be reconstructed when: *"independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations."*

79. Australia's rule was developed in 2012 before the OECD's new transfer pricing guidelines were published in 2015. The OECD guidelines suggest that tax authorities should only reconstruct those arrangements that: *"differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties..."*

80. Although Australia's test is intended to be applied on a consistent basis to the test in the OECD's transfer pricing guidelines, Australia's wording is potentially broader, which creates uncertainty for taxpayers. Unlike the OECD's transfer pricing guidelines, it doesn't explicitly specify that the original arrangement should be commercially irrational to the extent that third parties wouldn't be able to reach such an agreement.

81. New Zealand endorses the OECD's transfer pricing guidelines. Therefore in order to provide more certainty for taxpayers, we recommend that New Zealand's legislative test for reconstructing an arrangement should be based on the corresponding test in the OECD's transfer pricing guidelines.

Administrative measures

Summary of measures

82. The discussion document proposed measures to help Inland Revenue investigate and assess un-cooperative multinationals. These included the following proposals:

- If a large multinational (over EUR €750m worldwide revenues) does not cooperate with Inland Revenue, then Inland Revenue may more readily issue a notice of proposed adjustment, and any subsequent documents under the disputes process, based on the information available to Inland Revenue at the time.

- Any disputed tax must be paid by a large multinational during the disputes process, rather than at the end of the final Court case. This only applies in respect of disputes over transfer pricing, the amount of New Zealand-sourced income, and the application of a DTA.

- Tax payable by any member of a large multinational can be collected from any wholly-owned group member (or the related New Zealand entity in case of the new PE avoidance rule).

- Inland Revenue will be empowered to collect more information from large multinationals, including information about its various non-resident group members. If the multinational does not provide the information, then penalties may be payable and Inland Revenue will be expressly authorised to assess the taxpayer based on the information available to it.

General reaction

83. Submitters were generally accepting of some form of administrative measures in relation to uncooperative multinationals.

84. Submitters did note that any legislation needed to make it clear when the measures applied, and there needed to be sufficient safeguards (both in terms of legislative requirements and Inland Revenue's internal processes) to ensure the measures were not misapplied (KPMG, PwC, TPEQ, AMP (NZ), Russell McVeagh, NFTC, DEG). Some submitters also stated that the rules should be narrowly targeted (CTG, NZLS, DEG, NFTC, PwC), while others called for an increase in Inland Revenue's resources to help taxpayers comply with the new BEPS measures (EY, CA ANZ, PwC). We note these concerns and will consider them when we design the detail of the measures.

Earlier payment of disputed tax

85. Submitters strongly opposed the proposal to advance the time at which multinationals must pay any tax in dispute (KPMG, EY, Russell McVeagh, NFTC, DEG, NZLS, AMP (NZ), CTG). Some submitters argued that the proposal to make large multinationals pay disputed tax upfront was unnecessary. This was because Inland Revenue already charges "use of money interest" on tax owing, which provides a strong incentive for multinationals to pay any tax that is in dispute. In addition, the "use of money interest" paid by Inland Revenue to

taxpayers on tax that is paid, but not legally owed, is significantly below market rates. This could unduly pressure taxpayers to settle.

86. We agree with the views of submitters. The proposal was based on similar rules in Australia's and the UK's diverted profits taxes, and was intended to disincentivise taxpayers from deliberately prolonging disputes. However in light of the current "use of money interest" rates, we consider the rule is not necessary, and may instead unduly pressure taxpayers to settle. In addition such a rule appears better suited to a diverted profits tax regime, which is intended to incentivise taxpayers to pay the correct amount under the ordinary income tax rules. It seems less appropriate to include it in the ordinary income tax rules themselves.

87. Accordingly we recommend that you do not proceed with the proposal.

Collection of tax from a local subsidiary

88. Some submitters opposed the proposal to allow tax owing by a non-resident to be collected from a wholly owned subsidiary in New Zealand (or the related entity where the proposed PE avoidance rule applies) (CTG, PwC, Russell McVeagh). They questioned the practical need for such a rule, noted that it undermined the separate legal identity of corporate subsidiaries, and were concerned that it could cause risk assessment and banking covenant issues for lenders. One submitter (PwC) noted that if the rule was to proceed, it should apply only where the non-resident did not pay.

89. We consider that such a rule is useful to allow the collection of tax from non-residents with no direct presence in New Zealand. We also think 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.

90. Accordingly we recommend that the rule be retained. However we agree that the rule should only apply if the non-resident fails to pay the tax itself, and if the non-resident and the New Zealand entity are part of the same wholly-owned group. This should mitigate some of the submitters' other concerns about risk assessment and banking covenant issues.

Collection of information

91. A majority of submitters considered that the information collection powers should not proceed (CTG, Russell McVeagh, PwC, NZLS, NFTC, AMP (NZ), AmCham, DEG). Submitters variously considered that the rules were unnecessary in light of enhanced international information sharing protocols (such as country-by-country reporting), would be unworkable in practice, and unfairly penalised the New Zealand resident, who may not be able to get the information from their multinational group members. Some submitters also considered the issue should be addressed by Inland Revenue improving its relationship with other tax authorities (AMP (NZ), Russell McVeagh, AmCham, DEG, NZLS).

92. Submitters raised further concerns about the new civil penalty of up to $100,000 for failing to provide requested information (which replaces the current $12,000 maximum criminal penalty) (CTG, CA ANZ, Russell McVeagh, PwC, NFTC, NZLS). Submitters considered the penalty should not be increased, given that the New Zealand subsidiary may

not control the relevant information. If the penalty was to apply, they considered that only a court should be able to apply it. Finally they considered that directors and company employees should not be liable for the penalty personally.

93. We recommend that the information gathering proposals proceed (with some changes), notwithstanding submitters' views. In our view it is unacceptable for Inland Revenue investigations to be frustrated because a multinational group fails to provide information that is under its control.

94. We do not think the New Zealand subsidiary's difficulty in obtaining the information is a valid objection to the proposals. The New Zealand subsidiary is simply part of the multinational's economic group. Therefore any consequences suffered by the New Zealand subsidiary are economically borne by the wider group and its shareholders. Accordingly our proposed measures effectively make the entity which controls the information liable for the economic consequences of its failure to provide that information.

95. Further, the inability of the New Zealand subsidiary to legally require the information to be provided is the reason the proposed measures are necessary in the first place. There must be incentives for the multinational group to provide Inland Revenue with the required information in the absence of any legal ability to compel its provision. This means that any failure to provide the necessary information must be to the multinational's detriment, not Inland Revenue's. Otherwise multinationals will be incentivised not to provide such information.

96. In relation to submitters' other points:

- The information shared under new international protocols, such as country by country reporting, is at a more general level and will not be sufficient for Inland Revenue to assess particular taxpayers. In fact, tax authorities are explicitly prohibited from using country-by-country reports as a basis for assessing taxpayers.

- We are committed to improving our relationship with other tax authorities, but this will not practically address the current issue. The required information may not be held by the other tax authority, or it may be slow to obtain it.

- The impracticality of a New Zealand subsidiary obtaining the required information from another group member seems to be caused by the internal processes and priorities of the multinational group. This impracticality may ameliorate once the inability to obtain the information starts having negative consequences for the group. In the event that it does not, it should be the multinational that bears the negative consequences arising from its own processes and priorities, rather than Inland Revenue.

- Inland Revenue should be able to charge the penalty for not providing information, without requiring court approval. This is the normal position for civil penalties under the Tax Administration Act 1994 and we do not see why an exception should be made here. Further, such a requirement would also significantly undermine the practicality of imposing the penalty, and it is difficult to see what additional benefit it would provide. We also note that Australia has recently introduced a similar

penalty, with a maximum amount payable of $450,000. However we agree that taxpayers should be able to challenge the penalty once it is applied (in common with other similar penalties). We will ensure this is provided for when we design the detail of the measures.

- We agree that the penalty should not apply to directors or employees of a company. We will clarify this when the detail of the rule is designed.

97. We also want to ensure that the proposed information gathering powers and penalties are used by Inland Revenue in a reasonable manner. Accordingly we will consider ways to ensure this is the case when we design the rules in more detail.

Application date and grandparenting APAs

Application date

98. The planned application date for these measures is the income year starting on or after 1 July 2018.

99. At the time the discussion document was released for public consultation, the planned application date was not publicly known.[5] For this reason, Inland Revenue has not received any submissions on the 1 July 2018 application date. However, some submitters expected the Government to seek an early application date and argued that it would be better to allow taxpayers time to consider the proposals and rearrange their affairs if necessary (PwC and CTG). PwC argued that the application date for these proposals should be no earlier than the first income year after 31 March 2019.

100. Cabinet has already noted that the reforms are expected to apply from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on the expectation that the legislation will be progressed to enactment before this date.

101. We expect to receive more submissions on, and opposition to, the application date once the public becomes aware it is proposed to be 1 July 2018.

Grandparenting APAs

102. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling confirming that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. Some submitters argued that existing APAs should be grandparented and allowed to run their course (PwC and CTG). This would reduce any uncertainty taxpayers may face in light of the changing environment. Without grandparenting, taxpayers may be disincentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.

103. We agree with this submission. There is a high cost and a rigorous process involved in obtaining an APA and it would be unfair if the new proposals rescinded APAs issued before the 1 July 2018 application date – especially considering APAs only run for five years.

104. We therefore recommend grandparenting all APAs existing prior to the 1 July 2018 application date.

Appendix One: List of submitters

Abbreviation	Full name	Description	IL[6]
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓
AMP (NZ)	AMP Capital New Zealand	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓
DEG	Digital Economy Group	DEG is an informal coalition of leading US and non-US software, information/content, social networking, and e-commerce companies that provide goods or services through digital and non-digital means.	
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓
NFTC	National Foreign Trade Council	NFTC is an association of approximately 250 United States business enterprises engaged in all aspects of international trade and investment.	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCT is made up of 30 unions and has 320,000 members.	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty.	✓

[6] Submissions also received on *BEPS – strengthening our interest limitation rules*

		Oxfam NZ is the New Zealand arm of the global organisation.	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓
TPEQ	TP Equilibrium | AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓

POLICY AND STRATEGY

RECEIVED

6 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS - Recommendations on addressing hybrid mismatch arrangements

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1604 IR2017/353

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to the recommendations in this report	29 June 2017
Minister of Revenue	**Agree** to the recommendations in this report	29 June 2017

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Steve Mack	Principal Advisor, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982
Matthew Gan	Tax Specialist, The Treasury	
Paul Kilford	Policy Manager, Inland Revenue	
Casey Plunket	Special Policy Advisor	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS - Recommendations on addressing hybrid mismatch arrangements

Executive summary

1. This report seeks your:

- agreement to detailed proposals for reforming the taxation of hybrid and branch mismatch arrangements, which implement in a New Zealand context Action 2 of the OECD Base Erosion and Profit Shifting ("BEPS") programme ("hybrid proposals"); and
- approval to prepare a paper requesting Cabinet's agreement to include the hybrid proposals in a BEPS tax bill.

Development of recommendations to date

2. On 6 September 2016, the Government released a discussion document seeking feedback on proposals to address hybrid mismatch arrangements (T2016/1319 IR2016/342 refers). Broadly speaking, these are cross-border arrangements where the application of different countries' tax rules results in either temporary or permanent non-taxation of income. Action 2 of the OECD BEPS Action Plan consists of recommendations for countries to address these arrangements. The discussion document proposals are closely modelled on the OECD recommendations as set out in its Final Report "Neutralising the Effects of Hybrid Mismatch Arrangements".

3. On 9 March we reported to you on submissions in response to this document, and sought your approval to undertake further consultation (T2017/406 IR2017/133 refers). We also sought your approval for that further consultation to include consultation on branch mismatches, which are closely related to hybrid mismatches and in relation to which the OECD has developed a report (the "Branch Report") with recommendations closely based on the hybrid mismatch recommendations. The draft branch report was published in August 2016 and the final branch report is expected to be available shortly.

4. We have now completed the further consultation. We have engaged in approximately a dozen workshops (with Corporate Taxpayers Group and Chartered Accountants Australia New Zealand) and attended various other meetings with private sector submitters (including

the New Zealand Bankers' Association). The consultation process was useful and we have made a number of changes to the proposals in the discussion document to take into account the concerns of submitters.

5. In particular, we have given careful consideration to the position of New Zealand businesses with foreign branches, to ensure that the proposed hybrid rules do not deny these businesses the ability to use any foreign branch losses in New Zealand except where there is a high likelihood of double non-taxation.

6. We have also consulted on the hybrid rules with counterparts in Australia and the United Kingdom, as well as the OECD secretariat, to ensure that the rules we propose work as intended, and do not give rise to inadvertent double taxation or non-taxation. Our proposals are very similar to Australia's hybrid proposals. We note in this report any significant points on which we are aware of a difference.

Budget 2017 decision on foreign hybrid entity double deductions

7. As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand (CAB-17-MIN-0164 refers). This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions. It is intended to come into force as part of the general hybrid rules dealt with in this report. Nothing in this report is inconsistent with that decision.

Format of this report

8. This report first provides a summary of the hybrids issue, the OECD solution, and officials' recommendation that New Zealand should implement that solution. The most significant issues arising from the recommendations of this report are separately commented on starting at paragraph 23.

9. The main body of the report goes through the OECD recommendations in numerical order. It discusses the general principles of each recommendation (or recommendations where they can logically be grouped) and then runs through a series of more detailed decisions that are consequential to the relevant principle. We consider these details will be important in creating a package that effectively counteracts the tax advantages of hybrid arrangements. There are some technical issues that we consider would still benefit from more consideration by officials before final decision are made. We have highlighted these areas both in the recommendations and in the body of the report.

10. We have included two appendices which are respectively a tabulated overview of the OECD recommendations and a glossary of some of the technical terms of this report.

Policy proposals

The issue: hybrid mismatches

11. The objective of the OECD hybrid rules is to prevent double non-taxation which arises because countries tax entities or arrangements in different ways. Broadly speaking, this double non-taxation can arise because:

- A payment is deducible to the payer in one country but not taxable to the payee in another country, if the reason for the mismatch is a conflict in tax rules. For example:
  - The tax rules applying to a corporate payee may treat the payment as a dividend on a share (which in many countries is exempt if the payer is a foreign company related to the payee), even though the tax rules applying to the payer in its home country treat it as interest on a loan. This is a hybrid financial instrument mismatch, and is dealt with in OECD recommendations 1 and 2;
  - The tax rules applying to the payee may treat the payer and the payee as a single taxable entity. An example of this is where a New Zealand unlimited liability company makes a deductible payment to its 100% US parent company. Under US tax rules, the New Zealand company can be treated as a branch of the US company, and therefore payments by the New Zealand company are disregarded for US tax purposes and so are not taxable. In this case the New Zealand company is a hybrid entity and the mismatch is dealt with by OECD recommendation 3; or
- A single payment is deducted against different income in two countries. An example is where a company with a tax loss is treated as tax resident both by New Zealand and another country. Suppose that the company has a profitable sister company resident in New Zealand, and another profitable sister company in the other country. If the loss can be grouped against the income of the sister company in both New Zealand and the other country, then the loss has been used twice, which means the group has been taxed on less than its full amount of net income. This is a dual resident company mismatch, and it would be dealt with by OECD recommendation 7.

12. Double non-taxation of this kind is difficult to deal with, because it arises even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues.

The OECD Action 2 response

13. It is not feasible for all countries to have identical tax rules. Accordingly the only way to avoid double non-taxation of the kind referred to above is for countries to take a "tax without borders" approach by adopting, for cross border arrangements, tax rules which take into account in some way the tax rules of the other country involved. The OECD recommends two kinds of rules. The first kind are rules to reduce the likelihood of such mismatches arising. The second are "linking rules", which apply only to arrangements

between related parties (25% or more commonly owned) or structured arrangements (generally, arrangements between non-associated parties which intentionally exploit such mismatches). These linking rules apply to situations when there is a mismatch which has not been prevented by any other domestic rules, and provide for a primary and defensive response to the mismatch. This is explained further below.

14. The OECD hybrid recommendations are as follows:
- recommendation 1 deals with D/NI (deduction/no inclusion) payments under hybrid financial instruments which are either structured or between related parties;
- recommendation 2 deals with deductible dividends, which can also produce a D/NI outcome;
- recommendation 3 deals with D/NI payments by a branch or a hybrid payer entity to a person in the same control group (50% or commonly owned). A hybrid entity is treated as a separate person under its own tax rules, but disregarded/transparent under the rules of the payee country;
- recommendation 4 deals with deductible payments to a reverse hybrid in an arrangement which is either structured or between members of a control group (a reverse hybrid is an entity which is transparent for tax purposes in its own country but treated by an owner as a separate entity);
- recommendation 5 proposes modifications to the existing domestic law rules to prevent reverse hybrid mismatches being available;
- recommendation 6 deals with payments by branches or hybrid entities which are deductible in two countries;
- recommendation 7 deals with payments by dual resident companies which can be deductible in two countries;
- recommendation 8 deals with imported mismatch payments, which are ordinary payments that can be regarded as funding hybrid mismatch payments in the same group that do not directly impact on New Zealand;
- Recommendations 9-12 support the earlier recommendations, and relate to design and definitions.

15. An overview of the recommendations (with description and proposed counteraction) is in Appendix 1.

Submissions on the hybrids discussion document and our response

16. In our previous report, we noted that while most submitters accepted the need for some hybrid rules, they also advocated a targeted or phased approach to New Zealand's implementation of the OECD hybrids package, focussing on countering arrangements of the most concern to New Zealand.

17. On balance, we are not convinced by these submissions, and recommend implementing the full suite of OECD rules, subject to modifications summarised below. We note that some of the rules only require minor legislative amendment, as they are already part of our law.

18. The reasons for making this recommendation are set out fully in our report on submissions. In summary, we believe that enacting the OECD rules will:
- improve fairness;

- reduce harmful distortions in investment patterns; and
- have a negligible effect on the cost of capital in New Zealand, particularly given the adoption of the rules by the UK, Australia and the EU;
- (as compared to a partial adoption)
  - avoid the need for further piecemeal amendments
  - avoid giving the appearance of blessing those mismatches not dealt with;
- involve acceptable compliance costs, particularly given
  - the expectation that the effect of the rules in most cases will be to drive taxpayers to simpler non-hybrid arrangements (an important exception is branch structures, which are discussed in detail in this report);
  - the adoption of similar rules by other countries.

19. It is also important to appreciate that tax avoidance and tax planning using a range of hybrid structures is well known in New Zealand.
- The bank conduit cases (*Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 and *BNZ Investments Ltd v CIR* (2009) 24 NZTC 23,582), the optional convertible note structures (see *Alesco New Zealand Ltd v CIR* (2013) 26 NZTC) and certain mandatory convertible note disputes are all examples of hybrid financial instruments, the subject of OECD recommendations 1 and 2. While they were all held to be ineffective under the general anti-avoidance provision, the process to get to that point was often protracted and economically inefficient. Hybrid rules would have made these transactions clearly tax-ineffective, and they would not have occurred if we had such rules;
- Arrangements are currently in place which exploit hybrid mismatches but are not generally subject to the general anti-avoidance provision. Examples are:
  - The deductible/frankable instruments issued by Australian owned banks out of New Zealand – again these are hybrid financial instruments subject to OECD recommendations 1 and 2;
  - Financing through Australian limited partnerships, which generate double deductions – this is an example of a hybrid payer mismatch subject to OECD recommendation 6;
  - Investment into New Zealand using New Zealand incorporated companies with unlimited liability. Unlimited liability companies can be treated as transparent for US tax purposes, leading to deduction/no inclusion mismatches dealt with under OECD recommendation 3;
- Going further back, New Zealand has also experienced tax planning using dual resident company double deduction arrangements, subject to OECD recommendation 7. As a result we now have provisions which deal with most, but not all, of the hybrid mismatches which can arise from dual resident companies.

20. Mismatches that we are not aware of being used more than rarely are structures that use:
- payments to reverse hybrids subject to OECD recommendation 4, although under current settings there is no particular reason for Inland Revenue to look for them;
- reverse hybrid entity mismatches to achieve double non-taxation of outbound investment (which would be subject to OECD recommendation 5.1);
- imported mismatches (subject to OECD recommendation 8), where funding is channelled into New Zealand using a structure where there is a hybrid mismatch occurs higher up the funding chain, in a transaction not directly involving a New

Zealand taxpayer. We are aware of one such structure and there may be more since, under current settings, there is no particular reason for Inland Revenue to look for them;
- branch mismatches other than those subject to recommendation 6.

21. Despite the fact that not all the types of mismatches dealt with in the OECD Report are currently seen in New Zealand, we consider that given the history touched on in paragraph 19, it is likely that some of the hybrid mismatches that are not addressed in New Zealand's response will be exploited at some point in the future. Addressing everything comprehensively now means the process of amending the legislation will be a very large and complex project that will have to be undertaken alongside the other BEPS projects in a relatively short timeframe. However, as stated above, on balance officials recommend implementing a comprehensive set of hybrid rules.

22. As will be evident from this report, the hybrid rules are complex, and require amendment to many aspects of our tax law. It is important to emphasise that for the vast majority of businesses they should have no impact whatsoever. The hybrid rules will have no impact on purely domestic firms owned by New Zealand residents. Even of those firms that are international, most do not enter into hybrid arrangements directly with New Zealand. Those who do have mostly done so because of the existing tax benefits. Once those benefits are removed, they will likely revert to much simpler and less costly structures. Where application of the rules is unavoidable, for example in relation to New Zealand businesses with foreign branches, we have paid particular attention to simplicity and compliance costs.

Significant issues

23. In this section we have highlighted the recommendations which are likely to attract most comment from submitters, and are therefore significant for more than merely technical reasons.

Application of hybrid rules to foreign branches

24. Particularly in the course of our recent workshop consultations, submitters were very concerned about the fact that the hybrid rules can deny a New Zealand company the ability to reduce the tax on its New Zealand income by offsetting against that income the loss from a foreign branch.

25. We have made various modifications to the OECD proposals to address this issue, including ensuring there is clearly no loss denial for taxpayers who have not entered into more complex structures. However, these modifications may not be to the satisfaction of all in the business or advisory community. In particular, some submitters wanted a de minimis rule of some sort, but we consider our suggested modification to make it clear that simple structures are not impacted by the hybrid rules makes this unnecessary.

Application of hybrid rules to foreign trusts

26. We recommend that the hybrid rules should apply to income of a New Zealand trustee of a foreign trust. This may make it less attractive for New Zealand residents to act as trustees of trusts with non-resident settlors and non-resident assets.

27. As a result of the recommendations of the 2016 Government Inquiry into Foreign Trust Disclosure Rules (Shewan Report), foreign trusts with New Zealand trustees have recently been required to comply with new and more thorough registration and disclosure requirements. This is likely to lead to a significant diminution in the number of such trusts, but we expect there will still be a sizeable number in existence – the number will not be known until 30 June, which is the due date for the new registrations.

28. It is likely that the foreign trust service providers will object to foreign trusts being subject to the hybrid rules. This could be on:

- a technical basis; and/or
- the basis that they have now spent the time and effort to become fully compliant with internationally best-practice disclosure requirements. They may argue it would be unfair for the Government to then make a substantive tax change which for many would make their efforts redundant.

29. We have outlined two options to address the potential hybrid mismatches arising from foreign trusts in paragraphs 123 to 128 below.

Imported mismatches

30. The OECD recommends that countries include imported mismatch rules. These deny a deduction for a payment which is not directly a mismatch between the New Zealand payer and the payee, but which funds the payee (or a higher level "payee") to make a payment in a hybrid mismatch to a person not directly transacting with the New Zealand taxpayer. Many submitters viewed this as over-reach, highly complex and impractical.

31. We have responded to these submissions by recommending that the imported mismatch rule be enacted in full, but that its implementation be partially deferred.

- When the payment from New Zealand is part of a structured arrangement which includes a hybrid mismatch, applying the imported mismatch rule is both more straightforward and more important to the integrity of the rules. We recommend that this structured aspect of the rule be implemented along with the rest of the hybrid rules.
- When the payment from New Zealand is not part of a structured arrangement, applying the rule is more difficult and less important to the integrity of the New Zealand rules. Delaying the implementation of this rule until there are more countries that have hybrid rules would be sensible. We suggest a delay until 1 January 2020, by which date the EU countries, the UK, and Australia should all have hybrid rules.

Over-taxation by reason of the imposition of NRWT

32. There is no doubt that if a deduction is permanently denied under the hybrid rules for a payment where New Zealand also imposes non-resident withholding tax, there is an element of over-taxation.

33. The OECD does not recommend any adjustment be made to prevent this over-taxation. The UK has followed this approach, though it does not apply withholding tax as widely as New Zealand. Australia has not shown any interest in departing from the OECD approach. Accordingly, there are strong precedents for not addressing this issue.

34. This approach can be justified on the basis that in the majority of cases there should be simpler alternatives to hybrid arrangements giving rise to NRWT. Furthermore, in the case of hybrid financial instruments, if the payee country adopts recommendation 2, there will be no denial under recommendation 1, and therefore no over-taxation. This is expected to resolve the issue in most cases where a New Zealand taxpayer makes a payment under a hybrid financial arrangement to an Australian payee.

35. Nevertheless, we recommend that in the case of a hybrid financial instrument denial, we consider whether taxpayers could be permitted to treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We need to give further consideration to the flow on effects of this recommendation.

36. This recommendation is likely to go some way to addressing submitters' concerns on hybrid financial instruments, if upon further consideration the measure proceeds. However, they may still be concerned about the treatment of other non-deductible amounts.

Grandparenting for certain instruments issued by banks to the public

37. Generally the hybrid rules will apply to income and deductions arising after the effective date (expected to be some time on or after 1 July 2018), without regard to when the arrangement giving rise to that amount was entered into. This is the OECD recommendation, which was followed by the UK, and is proposed in the EU and Australia.

38. We recommend an exception for certain hybrid instruments ("regulatory capital hybrids") issued by banks and insurance companies either directly or indirectly to third party investors, mostly in Australia, in partial satisfaction of the capital requirements imposed on those companies by regulators. We recommend that instruments issued before the discussion document was released (6 September 2016) should not be subject to the hybrid rules until after the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

39. No special treatment was proposed for such instruments in our discussion document. However, we received submissions that such instruments either should not be subject to the hybrid rules at all, or that if they were so subject, there should be some grandparenting relief. Generally the latter submission was based on the publicly issued nature of the instruments. Mostly, the hybrid rules only apply to arrangements between parties who are related or in the same group.

40. Australia announced that it would apply the hybrid rules to such instruments on its Budget day this year. For that reason, it has decided to grandparent regulatory capital instruments issued before 8 May 2017.

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

Opaque election for foreign hybrid entities

42. The private sector has proposed that New Zealand investors in foreign hybrids be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand. This would mean the New Zealand tax treatment would match the company treatment overseas. This opaque election would take the entity outside the scope of the rules and achieve roughly the same tax effect with lower compliance costs.

43. This opaque election regime, if included in the rules, is most likely to be used by an Australian limited partnership, which is treated as flow-through by New Zealand such that its income and expenditure is attributed to its partners.

44. Administratively, this would likely require some sort of declaration made to the Commissioner. Our current thinking is this declaration would be irrevocable and would continue to apply in the event of a change of ownership. Officials are still working through the details of this idea and whether to recommend its inclusion in the rules. If it does not form part of the final package, this may be viewed unfavourably by the private sector.

Application of rules to branch mismatch arrangements

45. Taxpayers may be concerned to hear that "branch mismatches" are subject to the hybrid rules, since branches are relatively common for a business to have. Accordingly it may be important to be clear about the limits of branch mismatches.

46. Branch mismatches arising from foreign branch losses are a double non-taxation risk. The remainder of the branch mismatch concerns are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

De minimis rule

47. Officials are not recommending a general de minimis for the hybrid rules. The reason for this is that we are comfortable that the proposals will ensure that simple offshore branch structures are not within the scope of the rules. In addition, a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules.

48. However, officials have provided for a specific de minimis-type rule for reverse hybrid entities established in New Zealand (likely to be limited partnerships and foreign trusts).

Recommended action

We recommend that you:

(a) **Agree** that a Cabinet paper should be prepared recommending that the general principles of proposals to counteract hybrid mismatches in line with the recommendations in the OECD *Neutralising the Effects of Hybrid Mismatch Arrangements* report are drafted into a bill, subject to the modifications and further detail contained in this paper.

Agreed/Not agreed   Agreed/Not agreed

(b) **Agree** that the Cabinet paper in recommendation (a) should delegate authority to the Minister of Finance and the Minister of Revenue for the detailed design relating to the general principles of the hybrid mismatch arrangements rules discussed in the recommendations below.

Agreed/Not agreed   Agreed/Not agreed

OECD recommendations 1 and 2: general principles

(c) **Agree** the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principles in accordance with OECD recommendations 1 and 2:

a. In relation to a payment under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:

(i) deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (recommendation 1 primary rule);

(ii) if a non-resident payer has not been denied a deduction for the payment under similar rules, tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (recommendation 1 defensive rule)

Agreed/Not agreed   Agreed/Not agreed

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

Agreed/Not agreed | Agreed/Not agreed

OECD recommendations 1 and 2: detailed design

(d) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (c) are effective:

a. A person who receives a payment which is deductible to the payer in another country should not be entitled to the benefit of any imputation credit attached to the payment.

Agreed/Not agreed | Agreed/Not agreed

b. When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency:

(i) the deduction denied should take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes;

(ii) any net income from the instrument including any foreign currency fluctuations should be non-taxable.

Agreed/Not agreed | Agreed/Not agreed

c. When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the person should not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.

Agreed/Not agreed | Agreed/Not agreed

d. To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee country under another country's controlled foreign company (CFC) regime, the payer should be allowed a deduction for the payment.

Agreed/Not agreed | Agreed/Not agreed

e. If a New Zealand resident share lender lends shares in a transaction subject to the hybrid rules:
   (i) Officials should give further consideration to whether the lender should be taxable on a dividend substitution payment (since such a payment will generally be deductible to the payer);
   (ii) The lender not be allowed an imputation credit on any replacement payment in respect of New Zealand shares, if the share borrower is entitled to a deduction for that payment.

Agreed/Not agreed Agreed/Not agreed

f. If a person holds, pursuant to a share repo arrangement:
   (i) a FIF interest, that person should be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest;
   (ii) New Zealand shares, where the borrower is a non-resident the person is not entitled to the benefit of an imputation credit attached to any replacement payment which is deductible to the borrower.

Agreed/Not agreed Agreed/Not agreed

g. OECD recommendation 1 should only apply to deny a deduction, or include amounts in income, as a result of a timing mismatch between resident and non-resident parties if:
   (i) the mismatch arises on an instrument with a term of 3 years or more or which has been extended to beyond 3 years; and
   (ii) the mismatch is in relation to a payment which the lender is not accounting for, for tax purposes, on a reasonable accrual basis; and
   (iii) it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months of the end of the period in which the expenditure is incurred.

Agreed/Not agreed Agreed/Not agreed

h. Officials give further consideration to the idea that, when a person makes a payment under a hybrid financial arrangement for which a deduction is denied under the hybrid rules, the person may choose at the time of making the payment to treat it as a dividend for purposes of both (but not one only) of the non-resident withholding tax and imputation credit rules.

Agreed/Not agreed Agreed/Not agreed

i. Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.

Agreed/Not agreed Agreed/Not agreed

j. Clarify, if necessary, that interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed Agreed/Not agreed

k. There should be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 3: general principles

(e) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principles, in accordance with OECD recommendation 3, in relation to payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognized under the tax law in the payee country because the payment is disregarded under that law:

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

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 3: detailed design

(f) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (e) are effective:

a. in applying the primary rule only, the amount for which a deduction is denied should take into account any foreign currency fluctuations recognized for tax purposes in relation to a financial arrangement denominated in a foreign currency

Agreed/Not agreed Agreed/Not agreed

b. dual inclusion income should be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it should not include income which is protected from New Zealand tax by a foreign tax credit

Agreed/Not agreed Agreed/Not agreed

c. for purposes of the primary rule, full taxation of income under a CFC regime should:

(i) prevent income being treated as not taxable to a payee, and

(ii) qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.

Agreed/Not agreed Agreed/Not agreed

d. when an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that should be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible

Agreed/Not agreed Agreed/Not agreed

e. the ability to claim a deduction in relation to a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred (primary rule) or deemed expenditure arose (defensive rule)

Agreed/Not agreed Agreed/Not agreed

f. amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted

Agreed/Not agreed Agreed/Not agreed

g. denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules;

Agreed/Not agreed Agreed/Not agreed

h. a deduction be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs

Agreed/Not agreed Agreed/Not agreed

i. where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income should be reversed in a later year when there is dual inclusion income earned through the hybrid entity

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 4: general principle

(g) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principle, in accordance with recommendation 4, in relation to payments made to a reverse hybrid entity in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid:

a. deny a deduction for the payment if made by a New Zealand payer (recommendation 4);

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 4: detailed design

(h) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (g) are effective:

a. Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.

Agreed/Not agreed | Agreed/Not agreed

b. Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.

Agreed/Not agreed | Agreed/Not agreed

c. To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.

Agreed/Not agreed | Agreed/Not agreed

d. Non-resident withholding tax should continue to be applied to payments, despite the denial of the deduction.

Agreed/Not agreed | Agreed/Not agreed

e. Clarify that interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed | Agreed/Not agreed

OECD recommendation 5.1

(i) **Agree** that Officials give further consideration to whether New Zealand should modify its controlled foreign company (CFC) rules to include as attributable foreign income all income of the reverse hybrid which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is fiscally transparent (recommendation 5.1).

Agreed/Not agreed | Agreed/Not agreed

OECD recommendation 5.2

(j) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand restrict the tax transparency of reverse hybrids established under New Zealand law (recommendation 5.2) by taxing the partnership income of a non-resident partner of a New Zealand limited partnership if:

a. the total foreign-sourced income of the limited partnership exceeds the greater of $10,000 or 20% of the total reverse hybrid income; and
b. the non-resident partner is in a control group with the partnership; and
c. the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not the partner.

(k) **Agree** that:

Inland Revenue recommendation

The Cabinet paper in recommendation (a) should recommend that New Zealand restrict the tax transparency of reverse hybrids established under New Zealand law (recommendation 5.2) by taxing the foreign source beneficiary income of a non-resident beneficiary of a trust with a New Zealand trustee if:

a. the total foreign-sourced income of the trust exceeds the greater of $10,000 or 20% of the total reverse hybrid income; and
b. the non-resident beneficiary is in a control group with the trust; and
c. the non-resident beneficiary is not taxed on their share of the foreign source income of the trust in their residence country because that country views the income as earned by the trustee and not the beneficiary.

Agreed/Not agreed Agreed/Not agreed

Or

Treasury recommendation

New Zealand should tax the New Zealand and foreign sourced income of a trustee if either the settlor is resident in New Zealand or the trustee is resident in New Zealand, subject to transitional relief for a foreign trustee that migrates to New Zealand to give time to arrange a new trustee for the trust.

Agreed/Not Agreed Agreed/Not agreed

Or

The tax treatment of trusts should stay as it is.

Agree/Not agreed Agreed/Not agreed

OECD recommendation 6: general principles

(l) **Note** that in Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand (CAB-17-MIN-0164 refers).

Noted Noted

(m) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principles, in relation to recommendation 6, and consistent with the Budget 2017 decision on foreign hybrid entity double deductions:

a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branches if there is another entity in that foreign country whose income is:
(iii) capable of being offset against the losses of the hybrid entity or branch; and
(iv) not taxable in New Zealand
(recommendation 6 primary);

b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (recommendation 6 defensive);

c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

Agreed/Not agreed Agreed/Not agreed

Detailed design

(n) **Agree** to the following detailed rules to ensure that the general principles contained in recommendations (m) are effective:

a. provide for a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity

Agreed/Not agreed Agreed/Not agreed

b. allow a deduction in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country

Agreed/Not agreed Agreed/Not agreed

c. income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit

Agreed/Not agreed Agreed/Not agreed

d. double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch should be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit should not be regarded as dual inclusion income

Agreed/Not agreed Agreed/Not agreed

e. the ability to claim a deduction in relation in a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred (recommendation 6 primary rule) or deemed expenditure arose (recommendation 6 defensive rule)

Agreed/Not agreed Agreed/Not agreed

f. amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are deducted

Agreed/Not agreed Agreed/Not agreed

g. denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules;

Agreed/Not agreed Agreed/Not agreed

(o) **Agree** that officials consider further whether it is possible to design a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 7: general principles

(p) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principle, in relation to recommendation 7:

Disallow a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 7: detailed design

(q) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (p) are effective:

a. New Zealand amend its existing rules as to consolidation and loss grouping of dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.

Agreed/Not agreed Agreed/Not agreed

b. double deduction amounts and dual inclusion income amounts should be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit should not be regarded as dual inclusion income.

Agreed/Not agreed Agreed/Not agreed

c. the ability to claim a deduction in relation in a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred

Agreed/Not agreed Agreed/Not agreed

d. denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules

Agreed/Not agreed　　　　　　Agreed/Not agreed

OECD recommendation 8: general principles

(r) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principle, in relation to recommendation 8:

a. deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand;

Agreed/Not agreed　　　　　　Agreed/Not agreed

b. do not deny deduction such a deduction if the payment is made to a country that has hybrid mismatch rules

Agreed/Not agreed　　　　　　Agreed/Not agreed

OECD recommendation 8: detailed design

(s) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (r) is effective:

a. When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied should ignore any foreign currency fluctuations on the instrument.

Agreed/Not agreed　　　　　　Agreed/Not agreed

b. Clarify that interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed　　　　　　Agreed/Not agreed

OECD recommendations 9-12: general design and definitional matters

(t) **Agree** that a coordination rule be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.

Agreed/Not agreed Agreed/Not agreed

(u) **Agree** that a specific anti-avoidance rule be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.

Agreed/Not agreed Agreed/Not agreed

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

Noted Noted

(w) **Agree** that the effective date of rule relating to unstructured imported mismatches which should be delayed until 1 January 2020.

Agreed/Not agreed Agreed/Not agreed

(x) **Agree** that the effective date of the rules relating to limited partnerships and foreign trusts which are reverse hybrid entities (subject to the decision at Recommendation 5.2 (k) on foreign trusts above) should be income years beginning on or after 1 April 2019

Agreed/Not agreed Agreed/Not agreed

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

a. issued directly to, or are traceable to, issues to the public; and
b. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

Agreed/Not agreed Agreed/Not agreed

(z) **Note** that the fiscal impact of agreeing to recommendation (y) is an estimated revenue increase of approximately $71 million over the four years from 2018/19 to 2021/22.

Noted — Noted

(aa) **Note** that the fiscal impact set out in recommendation (z) is contingent on Withheld under section 9(2)(b)(ii) of the Official Information Act 1982

Noted — Noted

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

Matthew Gan	Paul Kilford
Tax Specialist	Policy Manager
The Treasury	Policy and Strategy
	Inland Revenue

Steven Joyce	Hon Judith Collins
Minister of Finance	Minister of Revenue

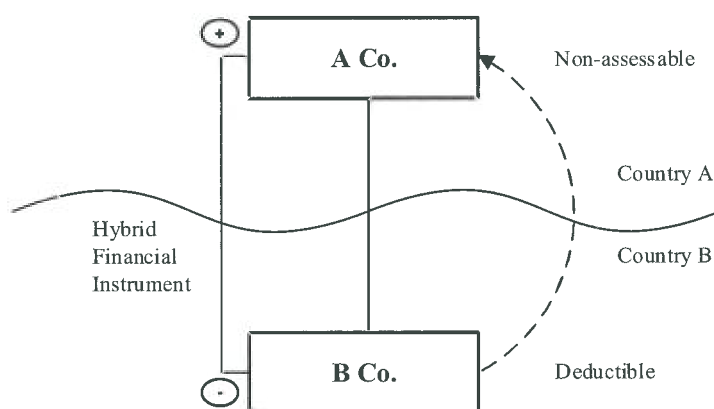
Detailed recommendations

49. We now set out our recommendations for implementing hybrid rules in New Zealand.

Hybrid financial instruments (OECD recommendations 1 and 2)

General

50. We recommend that New Zealand introduce rules, in line with OECD recommendations 1 and 2, to prevent double non-taxation arising from hybrid financial instruments. The following diagram illustrates a typical hybrid financial instrument.



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

51. The OECD recommends that in relation to payments made in connection with financial instruments, countries (in the following order):

- tax dividend payments as ordinary income, if the payments are deductible to the foreign payer (recommendation 2);
- deny a deduction for a payment which is not taxed as ordinary income to the foreign payee and therefore subject to no or a reduced amount of foreign tax (recommendation 1 primary rule); and
- if a payment which is not taxed as ordinary income is deductible to the payer in another country (i.e. that country has not implemented the primary rule), impose tax on that payment as if it were ordinary income (recommendation 1 defensive rule)[1].

52. Recommendation 1 applies only to arrangements between related parties, or which are structured.

[1] If a country has enacted recommendation 2, the defensive response under recommendation 1 would only apply in relation to mismatches where the payee is not treated as receiving a dividend. An example is a sale of property with deferred payment, where the buyer is entitled to a deduction for deemed interest, but the seller is not taxable on that amount as ordinary income.

Recommendations relating to OECD recommendation 2

53. New Zealand already has a rule achieving most of the OECD recommendation 2. This rule denies the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. To ensure that this rule is fully effective, we recommend that it be expanded to:

- tax a dividend if the payment of the dividend triggers a tax credit for the payer in its country of residence, giving the same effect as a deduction, This is proposed in the OECD Final Report[2] and our discussion document; and
- where a deductible dividend has an imputation credit attached, deny the payee the ability to use the imputation credit to reduce their tax liability. The Australian Government announced in its recent Budget that it would also be making this change.

Instruments denominated in a foreign currency

54. We recommend that when the instrument is denominated in a foreign currency (e.g. a loan in a foreign currency), the amount of the recommendation 1 primary rule denial includes the effect of foreign currency gain or loss. Under New Zealand's comprehensive financial arrangements rules, foreign currency gain or loss on a financial arrangement is taxable and (subject to the usual restrictions) deductible, often on an accrual basis. If the arrangement is a hybrid financial instrument in respect of which a deduction for interest is denied under recommendation 1 primary rule, we recommend that this also apply to the foreign currency loss or gain. In the case of a gain, this means the gain is tax exempt. This approach will simplify compliance and is consistent with the conceptual basis for financial arrangement taxation and the hybrid rules. This approach was widely supported in our workshop consultation.

55. We do not recommend taking the same approach to income inclusion under recommendation 2 (except insofar as that will occur through application of the comparative value method under the FIF rules) or the recommendation 1 defensive rule. In those cases, only the actual amount of the deductible payment should be included in the payee's income. Since the payee is not otherwise recognising income in these cases, there is no compliance saving from including foreign currency in the counteraction. Currently, when we apply our domestic rule that corresponds to recommendation 2, we do not include foreign currency, and this does not seem to have caused any difficulty. This approach was also widely supported in workshop consultation.

Whether CFC taxation in a third country is treated as income inclusion

56. We recommend that to the extent that a payment on a hybrid financial instrument can be shown to give rise to taxation of an investor in the payee under another country's controlled foreign company (CFC) regime, the payer should be allowed a deduction for the payment. This was strongly supported in consultation. However, given the complexity involved in demonstrating that this is the case, we recommend that taxpayers who believe a deduction is justified on this basis be required to indicate that (including stating the amount of the

[2] We understand this is based on a tax treatment that applies in Malta.

deduction so justified) when filing their tax return, so the Commissioner is alerted and can audit this claim if she wishes to do so.

Hybrid transfers

57. OECD recommendation 1 is intended to apply to financial instrument lending and financial instrument repo arrangements. We recommend that New Zealand's rules also apply to these transactions. This appears to require a number of technical amendments to the current rules.

58. In relation to share lending (see glossary at Appendix 2) by a New Zealand resident share lender who lends shares in a transaction subject to the hybrid rules (which means it must be with a related party or be a structured arrangement):

- we are considering whether to require that the lender be taxable on a dividend substitution payment, since such a payment will generally be deductible to the payer. This will require over-riding their current ability to use the fair dividend rate method, as if they continued to own the shares;
- we recommend that the lender not be allowed an imputation credit on any replacement payment in respect of New Zealand shares, if the share borrower is entitled to a deduction for that payment.

59. In relation to share repos (see glossary at Appendix 2) we recommend in particular that regardless of whether the transaction is structured or between related parties:

- when the shares are subject to the FIF rules, the money lender (who acquires the shares under the repo, and must re-deliver them at the end of the arrangement) be required to use the comparative value method to determine its income from the shares. This is the same treatment as applies in other situations where shares produce a debt-like return; and
- when the shares are New Zealand shares, the money lender not be entitled to an imputation credit with respect to the dividend. This is already the case as a practical matter, but it ensures that foreign borrowers are not subject to the hybrid rules with respect to any payment they are deemed to make to a New Zealand lender under a share repo.

60. We have consulted on these recommendations both generally and with the Crown entities engaged in share lending. The Crown entities do not see any difficulty with them.

Timing

61. A timing mismatch arises where payments under an instrument are taxable and deductible, but the payer is entitled to a deduction much earlier than the payee has to return income. The OECD recommendation is that timing mismatches should give rise to a hybrid counteraction under recommendation 1 only where the mismatch is not corrected within 12-24 months and there is no reasonable expectation that it will not be corrected within a reasonable period of time. Mismatches arising only from foreign currency movements will not bring an instrument into this rule.

62. We recommend a more clear-cut, less discretionary rule. Under this rule, a timing mismatch would be counteracted under the hybrid rules if it is:

- on an instrument with a term of 3 years or more or which has been extended to beyond 3 years; and
- in relation to a payment for which the lender is not accounting, for tax purposes, on a reasonable accrual basis; and
- not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months of the end of the period in which the expenditure is incurred.

63. If these criteria are met, any timing mismatch will be counteracted, but the counteraction will be reversed as the mismatch reverses. So, for example, a deduction denied under the primary rule will be allowed if and when the income is recognised in the payee country.

64. Our timing approach was widely supported in consultation, and is broadly in line with what we understand Australia is currently proposing.

Interaction with non-resident withholding tax

65. When non-resident withholding tax ("NRWT") (generally at a rate of 10%) is imposed on an interest payment which is non-deductible as a result of the application of OECD recommendation 1, there is an element of double taxation. Taxpayers can avoid this by not issuing hybrid financial instruments. In consultation, this was not regarded as an adequate response to the issue. Accordingly, we recommend that we give further consideration to the idea of allowing taxpayers to choose to treat such a payment as a dividend for withholding tax purposes. The rate of NRWT on a dividend is generally 15%, but this can be reduced or eliminated by attaching imputation credits to the dividend. There are some cases where the rate is as low as 0%. This treatment will have to be elected before the payment is made.

66. We also recommend amending the rules, enacted this year, which prevent deferral of NRWT. These rules apply if a New Zealand borrower from a related party foreign lender calculates its interest expense on an accrual basis, but the relevant interest is not paid for some time, leading to a deferral of the corresponding NRWT. The most significant amendment we propose to this rule is that where interest expense is not deductible under recommendation 1, that interest should not be taken into account when deciding whether or not to apply the anti-deferral rule. This amendment was widely supported in consultation.

Interaction with thin capitalisation regime

67. The thin capitalisation regime denies deductions for a proportion of a group's interest expenses if the group has debt-funded its New Zealand operations above a permissible level. Debt funding will only be taken into account to the extent it gives rise to a deduction. Accordingly, we recommend that where payments under a hybrid financial instrument are subject to permanent deduction denial under recommendation 1 primary rule, they will not be treated as debt for the purpose of this rule. Instruments where there is a timing mismatch would still be treated as debt, but the interest expense would only be subject to the thin

capitalisation rules in the year it is deductible under the hybrid rules. This was supported in consultation, and our initial assessment is that it requires no amendment to the law.

Application to regulatory capital issued by banks and insurance companies

68. Some of the Australian owned banks with New Zealand branches have undertaken significant issues of hybrid financial instruments. These are generally treated as debt in New Zealand but equity in Australia. Although the dividend is taxable in Australia, that tax is generally eliminated because the dividend carries a franking credit which is generated by the payment of Australian tax on other income. These instruments have generally also counted towards the bank's regulatory capital requirements for Australian or New Zealand purposes.

69. We recommend that the New Zealand hybrid rules not exclude regulatory capital (i.e. that required to be issued by banks and insurance companies). The OECD Final Report notes that countries may choose to have such an exclusion. The UK has chosen to do so, though it has other anti-tax arbitrage rules that have applied to bank regulatory capital for some time. Australia has decided not to exclude regulatory capital from its hybrid rules, in its recent Budget. The EU requires member states to include regulatory capital in their hybrid rules by 1 January 2022. Our discussion document also recommended no exclusion.

70. We received several submissions in favour of an exclusion. These submissions and our reasons for not accepting them are contained in Tax Policy Report: Consultation on Addressing Hybrid Mismatches (T2017/406 IR2017/133). Given Australia's decision, New Zealand's position is now largely moot in relation to the trans-Tasman hybrid issues referred to above (with the exception of transitional issues). Because Australia will tax the return on such instruments with no allowance for an imputation credit, New Zealand will continue to allow a deduction.

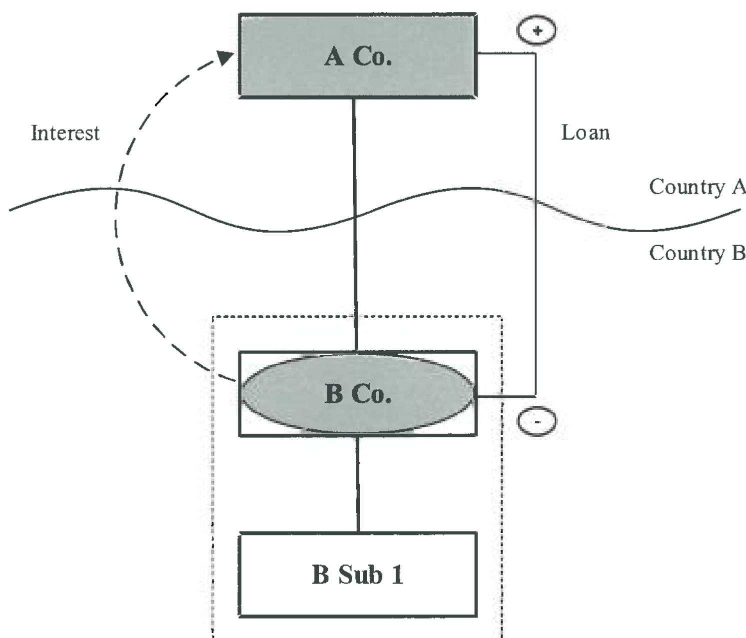
71. We recommend grandparenting from recommendation 1 for deductions claimed in New Zealand by banks and insurance companies in respect of certain capital issued before the release of the discussion document on 6 September 2016. This is discussed more fully under the heading *Effective Date and Implementation.*

Hybrid entities – disregarded payments (OECD recommendation 3)

General

72. We recommend that New Zealand introduce rules in line with OECD recommendation 3 to prevent double non-taxation arising when a hybrid entity makes a payment which is deductible to the payer but disregarded by the payee. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor but opaque for tax purposes in

another country, generally where it is established. A diagram follows, where A Co is the investor and B Co is the hybrid entity.



73. The interest payment by B Co is deductible in the hybrid entity country but disregarded in the investor country. In the New Zealand context, B Co could be a New Zealand company with unlimited shareholder liability, and A Co could be a US company which has chosen to treat B Co as fiscally transparent.

74. Because the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

75. OECD recommendation 3 is that Country B should defer a deduction for such a payment until it is offset by dual inclusion income (discussed immediately below). This is the primary rule. If it does not defer the deduction, Country A should tax the payment, under the defensive rule. Neither rule applies unless the payer and payee are in the same control group (50% or more commonly owned) or the arrangement is structured.

76. Unlike recommendations 1 and 2, recommendation 3 can apply to any kind of deductible payment, e.g. rent, royalties, payments for services, etc.

77. Denial of a deduction under recommendation 3 should be reversed to the extent that the hybrid entity has dual inclusion income. Dual inclusion income is generally speaking income that is taxable in Country A and Country B. If B Co in the above diagram in the same year earns a separate stream of dual inclusion income equal to the amount of the interest payment, it would have:

- no gain or loss in Country B (since the income and interest offset each other); and

- income equal to the amount of the interest payment in Country A (since the income is taxable with no deduction for the disregarded payment).

78. The existence of taxable income in Country A would mean that the tax result is appropriate without the need to apply any hybrid counteraction.

79. The same outcome should apply if the dual inclusion income is earned in a later year. Accordingly the OECD recommends that deductions denied under recommendation 3 be able to be deducted in a later year if there is dual inclusion income. Accordingly, denial under recommendation 3 is in fact only deferral, though the deferral may be permanent if no dual inclusion income ever arises.

Application to deemed payments by branches

80. In line with the OECD branch mismatch report, we recommend that recommendation 3 also apply where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs. So far as policy officials are aware, New Zealand allows a deduction for a deemed payment only in relation to interest on deemed loans by non-resident banks and insurance companies to their New Zealand branches. Where the taxpayer is resident in Australia, our understanding is that the deemed payment is recognised for Australian tax purposes. From a practical perspective, the application of the primary rule of recommendation 3 in a branch context is therefore unlikely.

Carry forward of recommendation 3 defensive counteraction

81. The OECD Final Report does not discuss the possibility of allowing a reversal of amounts of income deemed to arise under the defensive rule in recommendation 3. However, for reasons of principal and consistency, we proposed in our discussion document that where a New Zealand taxpayer has recognised income as a result of receiving a disregarded payment from a foreign hybrid entity, that income should be reversed in a later year when there is dual inclusion income earned through the hybrid entity. We recommend that this reversal be part of the New Zealand hybrids legislation. This is a taxpayer friendly measure, though we do not anticipate the defensive rule often applying in New Zealand.

Foreign currency loans

82. We recommend a similar approach to foreign currency loans subject to recommendation 3 primary rule as the approach set out above in relation to recommendation 1. If the loan is to a New Zealand hybrid, the amount of the deduction subject to denial should take into account foreign currency fluctuations. In this case though, any net income to the NZ hybrid borrower due to foreign currency gain will be taxed as dual inclusion income, rather than exempt.

83. We recommend a different approach to foreign currency loans subject to the recommendation 3 defensive rule to the approach set out above in relation to recommendations 1 and 2. Consistent with the primary rule recommendations, we recommend that foreign currency fluctuations should be taken into account in determining the amount of additional income arising under the defensive rule counteraction. That is because they will also be recognised in determining dual inclusion income, as discussed further below.

Simple implementation solution

84. Foreign currency loans are one aspect of a larger issue in implementing OECD recommendation 3, which arises from the fact that different countries have different rules for calculating income and expense. This poses a challenge for recommendation 3, in particular in relation to the measurement of dual inclusion income.

85. We recommend that dual inclusion income be determined in such a way as to simplify the application of recommendation 3 as far as possible. This means that when applying the primary rule in recommendation 3, dual inclusion income would include all income earned by the hybrid entity from activities the income of which is taxable in the investor country. This income would be calculated in NZ$ and using New Zealand tax principles, without regard to the amount of income actually returned in the investor country from those same activities.

86. Similarly, when applying the defensive rule, New Zealand would treat as dual inclusion income all income from the hybrid as calculated for New Zealand tax purposes, except where that income is protected from New Zealand tax by a foreign tax credit.

87. This simplifying approach was widely supported in consultation.

Whether CFC taxation in a third country is treated as income inclusion

88. As for the OECD recommendation 1, we recommend that to the extent that a payment by a hybrid entity which is disregarded by the payee can be proven to give rise to taxation of an investor in the payee under another country's CFC regime, the payer should be allowed a deduction for the payment. Similarly, amounts which are included in income under another country's CFC regime can qualify as dual inclusion income. However, because of the complexity of CFC taxation, in these cases, we propose that the taxpayer would have to demonstrate that the amounts are fully taxable for CFC purposes in the relevant period.

89. We do not propose that CFC taxation be taken into account when New Zealand is applying the defensive rule in recommendation 3. That is because in that case any taxation imposed in New Zealand under the hybrid rules should be available as a credit against CFC taxation.

Effect of deferred deductions on foreign tax credit limitation

90. A person's ability to claim a credit against New Zealand income tax for foreign income tax imposed on foreign source income is limited to the amount of New Zealand income tax imposed on the net foreign income, i.e. taking into account deductions claimed in New Zealand in relation to that income.

91. This will naturally mean that when a deduction which has been deferred under recommendation 3 primary rule is later allowed, it will lower the foreign tax credit limitation. We recommend that the same outcome should apply when a New Zealand taxpayer has income under the defensive rule in recommendation 3, and that income is reversed in a later year by virtue of dual inclusion income arising in the hybrid entity.

92. The effect of reversing the recommendation 3 counteraction on the foreign tax credit limitation was discussed in consultation, and generally accepted. Submitters did comment that there are already similar existing anomalies in the calculation of foreign tax credits, some of which give results which are unfavourable to taxpayers, and suggested that a more general policy review of the foreign tax credit rules would be appropriate. However, this would have to be undertaken as a separate policy proposal.

Effect of loss of ownership continuity on carry forwards

93. As set out above, deductions deferred under the recommendation 3 primary rule should be carried forward and allowed when and if there is dual inclusion income in a future year. However, we recommend that if the taxpayer is a company, and there is a 51% or greater change in the taxpayer's ownership after the time when the deduction would ordinarily be claimed, the deductions would not be able to be claimed in the future. The same rule would apply to income deemed to arise under the recommendation 3 defensive rule.

94. This is the same rule as applies to deductions for carried forward losses. It ensures that it is not possible for owners of a company to profit from the sale of the company as a tax shelter. That rationale applies in the case of deductions denied under the hybrid rules in just the same way as it applies to deductions which are unusable in the year incurred because they exceed current income. While such deductions are able to be carried forward and used in future years for the benefit of the shareholders who owned the company when the expenses were incurred, they should not be able to be used for the benefit of other shareholders.

95. One of the reasons for making this recommendation is that in some cases, deductions denied under the recommendation 3 primary rule would, if allowed, have formed part of a net loss to carry forward in any event, and thus been subject to elimination on an ownership change in the ordinary way. It would be anomalous in that case for the hybrid rules to have the effect of protecting the carry forward of those expenses from elimination.

96. While officials' position was understood in consultation, it was not entirely accepted by all parties, and may be subject to a degree of criticism. Submitters felt the deferral of a deduction was more like a timing rule (e.g. cash deduction for an accrued expense) which is not subject to carry forward elimination if there is an ownership change between accrual and deduction.

Interaction with NRWT

97. When a payment for which a deduction is deferred under recommendation 3 is subject to New Zealand NRWT, we do not propose that any adjustment be made for that. Recommendation 3 does not permanently deny the deduction – it defers it until there is income in the hybrid. So it would not be appropriate to adopt the same solution being considered for a payment in a recommendation 1 hybrid financial arrangement mismatch and allow the payer to eliminate the NRWT permanently by treating the payment as a dividend. An alternative would be to reflect the imposition of NRWT by allowing a portion of the payment to be deducted. But this would create further complexity, particularly if the payee country has hybrid rules.

98. Accordingly we do not recommend any amendment to the NRWT rules or the hybrid rules to adjust for the imposition of NRWT on a payment for which a deduction is denied under OECD recommendation 3. This may be a point which parts of the private sector will be unhappy with. However, we believe it will generally be possible for businesses to plan around the issue.

99. As for the new rules imposing NRWT on an accrual basis, we propose a similar modification to that proposed as a consequence of enacting OECD hybrid recommendation 1. That is, expenditure for which a deduction is deferred under recommendation 3 would not trigger application of NRWT on an accrual basis.

Interaction with thin capitalisation

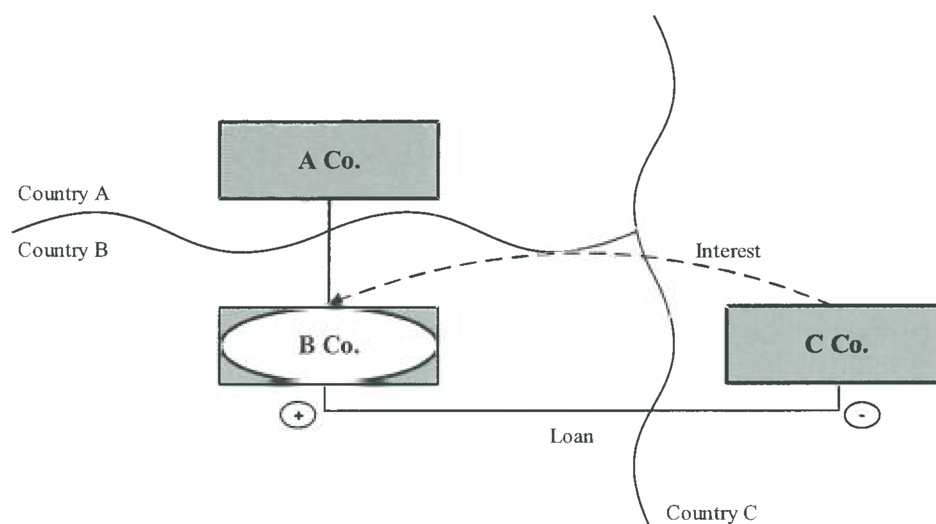
100. We recommend that denial of a deduction under recommendation 3 should have no effect on the thin capitalisation regime. Because interest deductions are only deferred under recommendation 3 rather than denied, there is less reason to amend the application of the thin capitalisation regime than there is in recommendation 1. In addition:

- when a hybrid entity has both interest and non-interest disregarded expenses, only some of which are deferred, an apportionment rule would be necessary to determine the amount of the deferred interest;
- taxpayers will generally manage their thin capitalisation position to avoid any interest denial under the regime.

Deductible payment to a reverse hybrid (OECD recommendations 4)

General

101. We recommend that New Zealand introduce rules, in line with OECD recommendation 4, to prevent double non-taxation arising from a payment to a reverse hybrid where payer, payee and the relevant investor are in a control group. The following diagram illustrates a typical example of the situation proposed to be addressed.



If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co. In this diagram, New Zealand is Country C, and would apply the recommendation 4 counteraction to deny a deduction for the interest payment.

102. OECD recommendation 4 is that countries deny a deduction for a payment to a reverse hybrid if:

- the payment would have been taxed if made directly to the investor (A Co in the case above); and
- the payer, payee and investor are all in a control group or the payment is pursuant to a structured arrangement.

Application to payments to branches

103. In line with the recommendations in the OECD branch mismatch report, we recommend that recommendation 4 also apply to a payment to a control group member which is not taxed to the payee because:

- the payment is a "diverted branch payment". As defined in the OECD branch report, this is a payment which is treated:
  - in the payee country as attributable to a branch in another country and therefore not taxed
  - in the branch country as not attributable to the branch; and
- the payment is to a "disregarded branch". As defined in the OECD branch report, a disregarded branch arises when a payment is treated in the payee country as attributable to a branch in another country, but the branch country does not treat the payee as having a branch which would give the branch country a right to tax.

104. We are not aware of such structures being used in New Zealand. However, UK and OECD officials advised us that structures making use of these types of branch mismatches were widely used in Europe, and that the effectiveness of a country's hybrid measures would be significantly compromised if they were not addressed.

105. Applying the recommendation 4 counteraction to these branch mismatches was accepted in consultation.

Instruments denominated in a foreign currency

106. As for recommendation 1 we recommend that when the payment is on a loan denominated in a foreign currency, the amount of the recommendation 4 denial includes the effect of foreign currency gain or loss.

CFC inclusion

107. As for recommendations 1 and 3 primary rule, we recommend that to the extent that a payment to a reverse hybrid can be proven to give rise to taxation under the owner country's CFC regime, or the CFC regime of a higher tier owner, a deduction should be allowed.

Interaction with non-resident withholding tax

108. As noted in relation to recommendation 1, denial of a deduction under recommendation 4 is permanent, and accordingly the imposition of non-resident withholding tax on the payment will involve a degree of over-taxation. However, because the mismatch does not necessarily arise in relation to hybrid financial instrument (indeed, it may arise on a royalty payment, which is not in relation to a financial instrument at all), there is no basis for recharacterising the payment as a dividend for withholding tax purposes. Accordingly, we do not recommend any adjustment to the imposition of NRWT. This is the approach taken by other jurisdictions. In general the outcome can be avoided by not using reverse hybrid entities.

Interaction with thin capitalisation regime

109. To the extent that a deduction is denied for a payment of interest under recommendation 4, we recommend that the debt corresponding to that deduction, and the payment itself, be treated in the same way as if the deduction were denied under recommendation 1, i.e. it will not be treated as debt for purposes of the rules. .

Reverse hybrids – recommendation 5

110. OECD recommendation 5 is in three parts.

- Recommendation 5.1 suggests countries consider changes to their domestic law so that they tax residents on income which is not taxed in another country due to its being earned by a reverse hybrid;
- Recommendation 5.2 suggests countries consider changes to their domestic law so they tax income which is earned by a reverse hybrid entity established in their country; and
- Recommendation 5.3 suggests countries consider improvements to record keeping and disclosure rules for tax transparent entities established in their country.

111. We propose making changes consistent with recommendation 5.2 and considering further recommendation 5.1. In respect of recommendation 5.3, we believe that New Zealand's record keeping and disclosure rules meet current international standards noting that our rules for foreign trust disclosure have recently been strengthened following the recommendations of the Shewan Report in 2016.

112. However, we note that Australia has indicated that it is unlikely to implement recommendations 5.1 and 5.2 at this point. In respect of recommendation 5.1 this is largely because they see their existing rules as adequate. For recommendation 5.2, we understand that Australia does not see a significant domestic problem that needs to be addressed. By contrast, we consider that the existence of New Zealand limited partnerships and foreign

trusts (discussed below) means it is preferable for New Zealand to follow the OECD recommendations.

Reverse hybrids with a New Zealand investor – recommendation 5.1

113. New Zealand already has a CFC regime which applies to a New Zealand resident holding 10% or more of a foreign company which is controlled by New Zealand residents. Under the CFC regime, such a shareholder is taxed on its share of the foreign company's income of certain kinds, referred to as attributed income. Attributed income includes interest income and certain other passive income, but excludes active income. Accordingly, where a New Zealand resident is an investor in a reverse hybrid, non-taxation by reason of reverse hybridity would only arise in relation to such active income.

114. In consultation, submitters observed that in most cases, active income would already be taxed by the source/establishment country. They therefore questioned the need for any change. However, they accepted that adding to the definition of income subject to attribution under the CFC regime income which is not taxable to the CFC because it is treated by the CFC country of establishment as earned by the New Zealand investor could be the outcome of this project.

115. We note also that there is a de minimis rule in the CFC regime (generally, there is no attribution of income unless potentially attributable income is more than 5% of total income), so attribution will not in most cases be triggered by a relatively small amount of untaxed reverse hybrid income.

116. A rule which taxed CFC income in these circumstances would also apply to a New Zealand resident who uses the attributable FIF income method to calculate FIF income. This method uses the same mechanics as the CFC regime.

117. Although recommendation 5.1 is recommended by the OECD, it is not expected to be adopted by Australia, and it raises some conceptual and practical issues. We would like to consider this matter further and report back.

Reverse hybrids established in New Zealand – recommendation 5.2

118. There are two entities in New Zealand which present a real risk of giving rise to non-taxation as a result of reverse hybridity. They are:

- New Zealand limited partnerships; and
- Trusts with a New Zealand trustee and a foreign settlor or beneficiary.

119. Although a look through company (LTC) may also be a reverse hybrid, the risk of non-taxation is already addressed. A company cannot be an LTC if its foreign income exceeds the greater of $10,000 or 20% of the company's gross income, if more that 50% of the LTC's shares are held by non-residents.

120. In relation to limited partnerships, we recommend that income which is earned by a limited partnership and attributed to a partner who is not taxable on that income and who is in the same control group as the partnership, should be taxable in New Zealand , on the same

basis as if the non-resident partners were resident in New Zealand. This liability should be on both the limited partner and the general partner (who will have a right of indemnity against the limited partner). We recommend a de minimis at the same level as the LTC de minimis referred to above.

Foreign trusts

121. Foreign trusts have been controversial recently because New Zealand's regime for taxing them is unusual internationally and they have been used as a vehicle for investing offshore by some non-resident settlors and the income was not taxed (nor disclosed) anywhere. This was the topic of the Shewan Inquiry which made recommendations (adopted by the Government) to greatly strengthen disclosure requirements. This addressed the use of foreign trusts to disguise illegal activity, but tax advantages through their hybrid nature remain.

122. We describe below two options for addressing the hybrid mismatch. However, given that the Shewan Inquiry found no conceptual basis to disagree with the fundamental tax treatment of foreign trusts, Ministers could want to retain the current treatment. That said, the frame of reference for the Shewan Inquiry was New Zealand tax principles and international disclosure principles, while the reference for the hybrids mismatch proposals is closing arbitrage options between tax treatments of different countries without inquiring whether any country's treatment is correct from its own domestic perspective.

Hybrid mismatch for beneficiary and trustee income (Inland Revenue recommendation)

123. In relation to foreign trusts a reverse hybrid mismatch can arise in relation to beneficiary income in the same way as it can arise for a limited partnership, if income which is treated for New Zealand tax purposes, and on which the beneficiary would be taxed in its country of residence if it derived the income directly, is not taxed because the residence country regards the income as derived by the trustee. Accordingly, if the beneficiary who is not taxable on beneficiary income due to a reverse hybrid mismatch is in the same control group as the trust, and the trust derives more than the greater of $10,000 or 20% of its income from foreign sources, we recommend that the beneficiary income be subject to New Zealand taxation, in accordance with recommendation 5.2.

124. A reverse hybrid mismatch can arguably also arise in relation to trustee income New Zealand does not impose tax on the income of a New Zealand trustee of a foreign trust because of what is often referred to as a settlor approach to trust taxation. We tax foreign source income earned by the foreign trustee of a trust with a New Zealand settlor, on the basis that the income is more appropriately treated as belonging to the settlor (who is a New Zealand resident taxable on worldwide income) than the trustee (who is ordinarily not subject to New Zealand tax on foreign source income). Similarly we do not tax the foreign source income earned by the New Zealand trustee of a trust with a foreign settlor, on the basis that the income is more appropriately treated as earned by the foreign settlor, who is not subject to New Zealand tax on non-New Zealand source income.

125. Since the trustee income of a New Zealand trustee of a foreign trust is taxed as if it were derived by the foreign settlor, there is arguably a hybrid mismatch if the income is not taxed

to the foreign settlor in its residence jurisdiction, and the reason for that non-taxation is that the income has been derived by the New Zealand trustee rather than the settlor directly. Accordingly, if the settlor who is not taxable on trustee income due to a hybrid mismatch is in the same control group as the trust, and the trust derives more than the greater of $10,000 or 20% of its income from foreign sources, we recommend that the trustee be subject to New Zealand taxation in accordance with recommendation 5.2.

Hybrid mismatch comprehensive foreign trust proposal (Treasury recommendation)

126. New Zealand is relatively unusual in having a settlor regime for trust taxation. As far as we know from research undertaken during the Shewan Inquiry, the settlor basis for trust taxation applies only for settlors resident in New Zealand, Japan, and the United States (for some trusts only) (there could be some other jurisdictions that we are not aware of). This means that there may be many cases where recommendation 5.2 applies.

127. A simpler option would be for New Zealand to tax the New Zealand trustee of all trusts with a New Zealand resident trustee, as well as retaining the settlor regime. This would apply a taxing nexus for trustee income that almost all other countries that recognise trusts apply. It would be a simpler test than having to inquire what the settlor and beneficiary tax regimes are for all trusts with a resident trustee, and would largely pick up the same income.

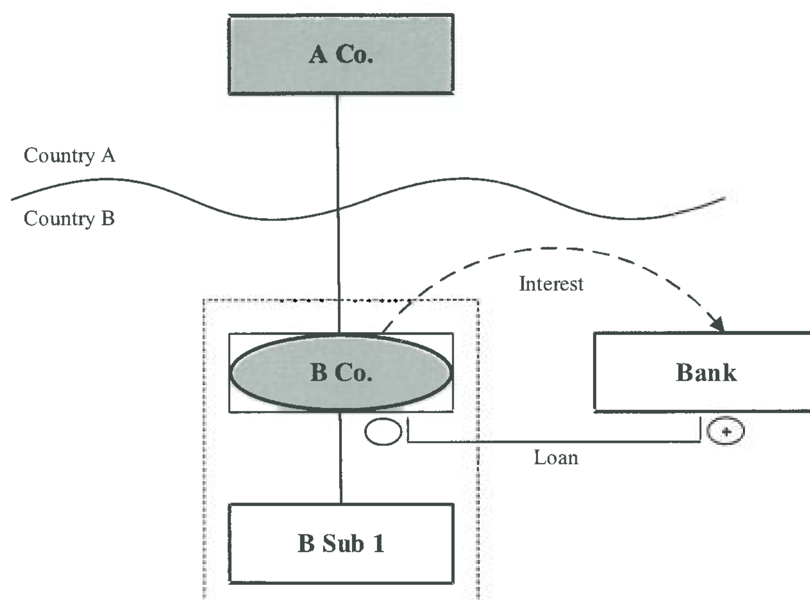
128. Some form of transitional rules may be required in relation to these rules, to deal with events such as trustees who migrate to New Zealand or who become trustees of testamentary trusts. For example, the rules may allow a foreign trustee who migrates and becomes resident in New Zealand up to two years to find a substitute foreign trustee to keep the trust out of the New Zealand tax base. This situation is common internationally for trustees who migrate to another country.

129. In relation to these rules implementing OECD recommendation 5.2, both Inland Revenue and the Treasury recommend that the implementation date be later that for the other measures. Submitters suggested that the private sector may not fully appreciate that trust and partnership structures are within the terms of the hybrid rules. In order to ensure that those affected have adequate time to deal with the proposals, we suggest an implementation date of income years beginning on or after 1 April 2019.

Hybrid entities – double deductions (OECD recommendation 6)

General

130. We recommend that New Zealand introduce rules, in line with OECD recommendation 6, to prevent double non-taxation arising when a hybrid entity makes a payment that is deductible in two countries against non-dual inclusion income. (As discussed elsewhere in this report, this kind of mismatch is currently being used to reduce New Zealand tax, in the Australian limited partnership structures which the Government has already decided to address). A diagram illustrating this possibility follows, where B Co is the hybrid entity.



131. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment is treated as made by a separate company, which is in a tax consolidated group with B Sub 1. Accordingly the interest payment can offset income earned by B Sub 1. This means that each $1 of interest payment can offset $2 of income. The outcome is similar to the outcome of a deductible/non-includible mismatch countered by recommendation 3, but in this case it is caused by a payment being deductible in two countries, rather than deductible and disregarded.

132. OECD recommendation 6 is that:

- The investor country (Country A in the diagram) should deny a deduction for the interest payment (the primary rule); and
- If Country A does not do so, then Country B should deny the deduction (the defensive rule).

133. As noted above, Cabinet has already agreed to implement the primary rule (CAB-17-MIN-0164 refers).

134. Recommendation 6 applies to any kind of expenditure, including allowances such as depreciation.

135. As with recommendation 3, denial of a deduction under recommendation 6 should be reversed to the extent that the hybrid entity has dual inclusion income, either in the same period or a later one.

Application to branches

136. The OECD Hybrids Report was explicit that recommendation 6 applies to expenses incurred by a branch if those expenses are deductible in both the branch and parent countries. For many branches, that is not the case, because the legal entity is established in a country (such as Australia) which exempts active branch income. However, expenses incurred by foreign branches of New Zealand companies will be deductible in two countries. Accordingly, this recommendation is particularly relevant to New Zealand companies.

137. The OECD proposes that recommendation 6 apply if there is any potential for expenditure to be offset against non-dual inclusion income, whether or not it is so offset. This could have made foreign branch losses unavailable to be used against New Zealand source income. A blanket denial of deductions for foreign branch losses would not be a comfortable fit with our current policy settings for taxing branch income, and officials have put considerable effort into consultation designed to ensure that recommendation 6 can be implemented in a way that ensures it does not affect the vast majority of New Zealand companies which have foreign branches that are in loss, but are not using the deduction in the branch country against non-dual inclusion income.

Recommendation for scope of recommendation 6 primary rule

138. Officials accordingly recommend that the primary rule in recommendation 6 apply to expenditure of a foreign branch/hybrid entity with a New Zealand parent/investor only where there is another entity with income that is not taxable in New Zealand but able to be offset in any way by any branch/hybrid entity loss (including where such offset requires an election or other similar step having tax significance only).

139. This restriction means that a New Zealand company with a foreign branch would in most circumstances not be denied a deduction in New Zealand for any branch/hybrid loss under recommendation 6. There would be no denial, for instance, in the case of a New Zealand company with one or more Australian branches if:

- the New Zealand group does not own any other Australian entities; or
- if it does own other Australian entities, those entities' income cannot be offset by any branch loss. We understand that in Australia a loss incurred by an Australian branch of a non-resident company cannot offset income earned by a resident company. On that basis, ownership of an Australian company by the New Zealand group also would be consistent with the non-application of recommendation 6 primary rule.

140. The restriction explained above was generally accepted in consultation, and officials believe that it produces a sensible policy outcome. It does not go so far as denying the branch/hybrid loss only to the extent it is used against non-dual inclusion income. Consultation established that such a rule, though also potentially producing an appropriate outcome, would be much more complex to design and administer.

Recommendation for transitional situations

141. This recommendation means that a rule is required to deal with the situation where a New Zealand resident with a loss-making foreign branch or hybrid at some point becomes subject to recommendation 6 primary rule by virtue of acquiring an interest in an entity in the branch country whose income is not taxable in New Zealand but can be offset by the branch losses. Officials recommend that:

- if the branch loss arising before the acquisition of the interest in the second entity cannot be offset against the new entity's income (as will often be the case, including we understand in Australia), then the only consequence is that subsequent branch losses are subject to the recommendation 6 primary rule; and

- otherwise, all losses of the branch which have been used against New Zealand income should be recaptured, since they are now available to be used against non-dual inclusion income.

142. Officials do not believe this rule will often apply, but it is important for the integrity of the hybrids package.

143. We also recommend a similar rule to operate in favour of a New Zealand resident with a hybrid entity or branch which has been subject to loss denial under recommendation 6. If it becomes impossible for the loss to be used in the branch/hybrid jurisdiction, then it should be allowed in New Zealand. This could occur if, for example, the hybrid is wound up in the foreign country, or if the entity with non-dual inclusion income is sold. In that case the suspended losses would be deductible in New Zealand to the extent of the carried forward loss, as calculated under the rules of the hybrid or branch country, that has become unusable in that country.

Simple implementation solution

144. As with recommendation 3, in order to simplify compliance, we recommend that the amount of double deductible expenditure and dual inclusion income be the amount calculated under New Zealand tax principles, without close regard to whether such amounts match the amounts which are deducible or taxable in the other country. This possibility is referred to in the OECD final report and was strongly supported in consultation.

145. As with recommendation 3 defensive rule, we recommend that when New Zealand is applying the primary rule, income protected from tax by a foreign tax credit would not be dual inclusion income.

CFC taxation in investor country can give rise to dual inclusion income

146. We recommend that income which can be shown to be taxable both in the branch/hybrid country and under CFC rules in the investor country should be able to be treated as dual inclusion income. Again this would not be the case if the CFC taxation is reduced by a credit for tax paid in the branch/hybrid country.

Effect of deferred deduction on foreign tax credit limitation

147. Deductions deferred under recommendation 6 will under existing law reduce the foreign tax credit limitation in the year the deductions are allowed. No change is required.

Effect of loss of ownership continuity on carry forwards

148. As for OECD recommendation 3, we recommend that if a taxpayer subject to recommendation 6 denial is a company and there is a 51% or greater change in its ownership after the time when the deduction would ordinarily be claimed, the deductions would not be able to be claimed in the future.

Interaction with NRWT

149. In relation to the new rules imposing NRWT on an accrual basis, we recommend a similar modification to that recommended for OECD recommendation 3.

Interaction with thin capitalisation

150. We make the same recommendation as for OECD recommendation 3.

Opaque election

151. In consultation, there has been a strong submission that a New Zealand owner of a foreign hybrid entity should be permitted to treat the hybrid as a company, in line with its foreign treatment. Recommendation 6 would then no longer apply to it. This submission was based on a desire for simplicity.

152. Officials understand the reasons for the submission. However we are concerned that it might lead to significant administrative and legislative complexity, for what might be a small handful of taxpayers. Accordingly, we recommend that we consider further whether it is possible to design a tightly targeted and simple opaque election, with a view to reporting back on our recommendations before the proposed bill is finalised.

Dual resident entities (OECD recommendation 7)

General

153. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

154. Dual resident companies give rise to the same double deduction possibilities as hybrid entities. Expenditure incurred by such a company may be able to be used in each residence country to offset non-dual inclusion income, i.e. income taxed only in that country.

155. New Zealand's rules already prevent dual resident companies from grouping their losses or forming part of a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (in many instances) a New Zealand limited liability partnership.

156. Submitters made the point that dual residence can arise inadvertently. For example, a corporate group in New Zealand may incorporate a subsidiary in Australia (which would therefore be an Australian tax resident company) but exercise sufficient director control in New Zealand that the company is arguably also New Zealand tax resident. Officials observe that if this is indeed a problem, it is a problem under the existing rules denying dual resident companies the ability to group losses, be part of a tax consolidated group, or even maintain an imputation credit account.

Similar rules to that applying to changes implementing OECD recommendation 6

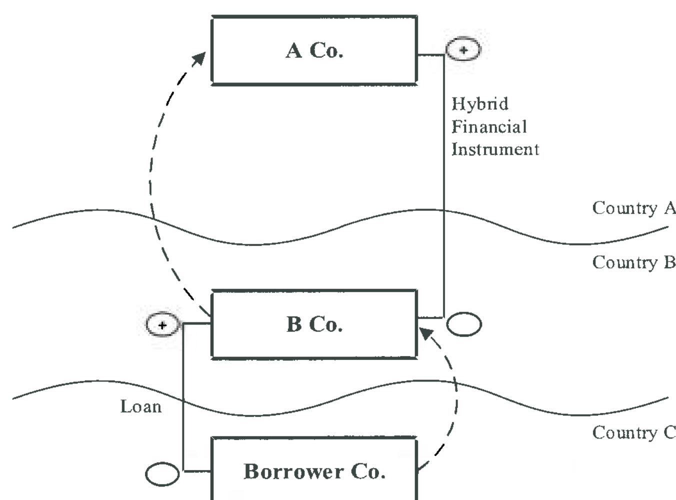
157. The following recommendations made in relation to OECD recommendation 6 also apply in relation to recommendation 7:

- simple implementation solution;
- the effect of deferred deductions on the foreign tax credit limitation;
- the effect of loss of ownership continuity on carry forwards; and
- interact with thin capitalisation.

Imported mismatches (OECD recommendation 8)

General

158. We recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment between members of a control group that funds a payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



159. The interest payment by Borrower Co to B Co does not in isolation give rise to a hybrid mismatch. The loan is treated the same way in both Country B and Country C (which could be New Zealand). However, B Co makes payments to A Co under a hybrid financial instrument. The tax mismatch is not counteracted, because neither country has hybrid rules. If Country C makes no hybrid counteraction in such a case, the hybrid rules are ineffective to deal with arrangements between Country A and Country C. Businesses can avoid the rules simply by going from A to C via B.

160. In order to prevent its hybrid rules being circumvented, Country C can treat the loan from B Co to Borrower Co as an imported mismatch arrangement, and deny a deduction for the interest payments by Borrower Co to the extent that they do not exceed the payments under the hybrid financial instrument between B Co and A Co.

161. The OECD imported hybrid mismatch rule applies to both structured and unstructured imported mismatches.

- A structured imported mismatch arises when a deductible payment is part of a structured arrangement involving a hybrid mismatch – for example if the funding chain the above diagram was entered into deliberately, in order to move money from

A Co to Borrower Co. A structured imported mismatch rule prevents a country's hybrid mismatch rules being deliberately circumvented.

- An unstructured imported mismatch arises when there is no such intention. There is simply a deductible payment by a person resident in a country with hybrid rules, where the payee in turn makes a deductible payment under a hybrid mismatch arrangement (which may itself be an imported mismatch arrangement). The unstructured imported mismatch rule is intended to extend the reach of the hybrid rules, rather than to prevent their deliberate circumvention.

162. The OECD proposes complex apportionment rules which may need to be applied to determine the amount of denial in an unstructured hybrid mismatch.

163. The imported mismatch rule will not need to be applied in respect of payments to a person in a country with the hybrid rules. The payee's country can be relied on to address any hybrid mismatches in that case. Furthermore, as more countries adopt hybrid rules, there should be fewer hybrids and hybrid mismatches in existence, and so less need for the imported hybrid rule to apply.

164. Those we consulted were not generally in favour of countering imported mismatches, on the basis that the hybrid mismatch was not directly with New Zealand. That said, they generally understood the need for a structured imported mismatch rule, but were concerned about the complexity and uncertainty around the unstructured rule. We recommend that this concern be addressed by deferring the application date for the unstructured imported mismatch rule. This recommendation is discussed in more detail under the heading *Effective date*.

Foreign currency instruments

165. When an imported mismatch payment is a return on a foreign currency loan, the issue of how to deal with foreign currency fluctuations arises as it does for the other recommendations. In this case we recommend that the foreign currency is not taken into account. The basis for the counteraction is that the New Zealand payment is funding in some way a hybrid mismatch payment by another entity. The extent of this funding may differ from year to year. Thus it is best measured by reference to the amount of the coupon payment alone, rather than including as well any foreign currency movements, which will generally have no cash flow impact in the relevant year..

Interaction with non-resident withholding tax

166. We do not recommend adjusting any non-resident withholding tax on a payment for which a deduction is denied under the imported mismatch rule. Because the payment will be treated as ordinary income in the payee country, any withholding tax will generally give rise to a tax credit in the payee country.

167. As with the other mismatch denial rules, we recommend that deductions disallowed under the imported mismatch rule not be taken into account when deciding whether or not to apply the anti-NRWT-deferral rule.

Interaction with thin capitalisation regime

168. As with a recommendation 1 (non-timing) and recommendation 4 denial, to the extent that interest on a financial arrangement is subject to denial under the imported mismatch rule we recommend that it not be treated for purposes of the thin capitalisation regime as debt.

Co-ordination rule

169. We recommend that the hybrid legislation includes a rule to deal with the situation where a hybrid mismatch arrangement which is subject to counteraction in one country (say New Zealand) ceases to be so subject, for example because the other country introduces hybrid rules, and is responsible applying taking the primary response. We recommend that this rule be consistent with the approach taken to this issue in the OECD Final Report. We did not receive any submissions against this approach.

Definitions

170. The hybrid rules may require some new definitions to be added to the Income Tax Act, and the amendment of some existing definitions. In particular, a definition will be required of a structured arrangement, and the importance of this was stressed in submissions. We did not receive any submissions against the definitional approach proposed in the discussion document, and recommend that we approach the tax of drafting supporting definitions in line with what was proposed there.

Specific anti-avoidance rule

171. We recommend that the hybrid rules include a specific anti-avoidance rule, allowing the Commissioner to counteract arrangements having a purpose or effect of defeating the intent or application of the hybrid rules.

Effective date, transitional and grandparenting

172. Cabinet has already agreed that OECD recommendation 6 primary rule should apply to New Zealand residents for income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is on the basis that a bill is introduced to Parliament before the end of 2017, and in force before 1 July 2018. We recommend the same start date for all of the hybrid recommendations in this report other than that relating to unstructured imported mismatches and reverse hybrids, discussed below.

173. This may be:
- a similar timetable to that in the UK (where the effective date was 8 months after introduction of the legislation into Parliament); and
- shorter than that proposed in Australia, which has announced that its effective date will be at least six months after its legislation is enacted.

174. In general, we do not see any need for a longer lead time than that we propose. The target and effect of the hybrid rules is has been identified with some specificity, and has not changed in any significant way (other, perhaps, than the addition of branch mismatches

beyond those in recommendation 6). Parties should be able to plan their affairs already with a high degree of confidence as to what the effect of the rules will be.

175. In relation to unstructured imported mismatches:

- there is still considerable uncertainty as to how this rule should apply, given that it requires a co-ordinated counteraction of mismatches that may themselves be difficult to find and to quantify;
- there will be less need to apply the rule as the hybrid rules are enacted in more countries. The unstructured imported mismatch rule does not apply to payments to a country with hybrid rules, and the adoption of the rule by more countries will reduce the number of hybrids in any event;
- the adoption of the rules by more countries may assist in developing an understanding of how the unstructured imported mismatch rule should apply; and
- the rule is more about extending the reach of the hybrid rules than ensuring their integrity.

176. The UK has introduced hybrid rules including an unstructured imported mismatch rule effective 1 January 2017. Australia has not made any announcement. The EU directive includes an unstructured imported mismatch rule which must be effective from 1 January 2020.

177. We recommend that the effective date of the unstructured imported mismatch rule be delayed until 1 January 2020. By that time, all of the EU member states are expected to have hybrid rules, and so the application of the unstructured imported rule will be both less frequent and, we expect, better developed. We do not make the same recommendation for the structured imported mismatch rule, as that would create an integrity issue for the rules.

178. We also recommend a delayed implementation date for the recommendations relating to limited partnerships and foreign trusts which are reverse hybrids. As discussed above, the private sector may not fully appreciate that trust and partnership structures are within the terms of the hybrid rules. In order to ensure that those affected have adequate time to deal with the proposals, we suggest an implementation date of income years beginning on or after 1 April 2019.

Transitional and grandparenting

179. All of the OECD Final Report, the Australian Board of Taxation report, and our discussion document, do not recommend any general transitional relief for existing arrangements. The hybrid rules generally apply to transactions between parties at least 25% commonly owned, or deliberately structured arrangements. They produce tax benefits that generally were not intended, but flow from the unintended interaction of different countries' rules. The effect of the rules will be to remove inappropriate benefits. They will not have a punitive effect (except in relation to the imposition of NRWT), and except to the extent that they do, no exception can reasonably be taken to their application to existing transactions.

180. The absence of transitional relief is the same approach as was taken, without adverse reaction, to certain related party NRWT minimisation structures in the recently enacted Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act

181. We recommend no transitional relief from the hybrid rules, subject to an exception for certain capital issued by banks (and insurance companies – for purposes of discussion we refer only to banks, but similar rules apply to both), as discussed further below.

182. A number of banks operating in New Zealand have issued debt instruments which are both:

- hybrid mismatch arrangements (or imported hybrid mismatch arrangements), in the sense that the return on the instruments is deductible in New Zealand but treated as a dividend in Australia or elsewhere; and
- regulatory capital for capital adequacy purposes, either in New Zealand or Australia.

183. Many of these issues have been made directly to the public in Australia. In some cases the instruments have been issued to a foreign branch of the New Zealand bank's foreign parent Most of them are able to be repaid by the issuer after 5 years.

184. The fact that these instruments raise regulatory capital does not in our view justify any grandfathering. In discussions with the Reserve Bank, they have told us that there is no particular benefit in these instruments from a regulatory perspective, and that they would be comfortable with the banks replacing these instruments with ordinary shares to the extent that the capital they raise is required for regulatory purposes. Accordingly, in our discussion document we did not recommend any special treatment for these instruments.

185. However, these instruments do differ from most hybrids insofar as they are held by third party investors, often retail rather than wholesale (the hybrid rules apply to them because they are structured, rather than related party). This in turn means that if the hybrid rules were to apply to them so as to:

- impose additional tax on the investors, the investors may have a right to be indemnified by the bank (this would be the case if recommendation 2, or recommendation 1 defensive rule applied to the investors); or
- increase the after-tax cost of the funding to the issuer (which might be the result if any of the rules applied), the issuer may have a right to terminate the investment early.

186. The banks have submitted that subjecting regulatory capital to the hybrid regime with no grandparenting would be inappropriate because:

- restructuring such capital would require regulatory approval, possibly from more than one regulator; and
- such restructuring might be disruptive to the financial markets in which bank capital is raised, especially if all the banks were looking to replace their existing issuances at the same time.

187. Different banks made different submissions on the date from which grandparenting should cease to apply, ranging from the date of release of the OECD Final Report (October 2015), through the date of release of the Government discussion document (6 September 2016) to the date of enactment of New Zealand's hybrid legislation. Co-ordination with Australia was also encouraged. In this respect we note that Australia announced in its 2017 Budget that it will:

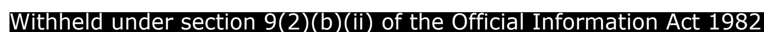
- apply recommendation 2 to dividends on hybrid regulatory capital, thus denying the payee the benefit of an imputation (or franking) credit; and
- grandparent instruments issued before 8 May 2017.

188. There are some grounds for treating the publicly issued instruments differently from most hybrid instruments. Australia's decision to grandparent also puts a heavy burden of proof on New Zealand to justify a decision to do otherwise. Accordingly we recommend providing some grandparenting. The issues then are:

- which transactions should be grandparented; and
- from what date.

189. As to the first of these, we recommend that only transactions which are directly to the public, or which are traceable to an issue to the public, should be grandparented. However, we have not yet had the opportunity to discuss this in detail with the banks, and may refine or expand this core recommendation as we do so.

190. As to the date, we recommend that grandparenting apply only to transactions entered into before the release of our discussion document on 6 September 2016. That document announced the Government's intention to enact hybrid rules with no regulatory capital exception. It was also a date that was indicated as acceptable in some written submissions, and in consultation.


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

APPENDIX 1: OVERVIEW OF OECD RECOMMENDATIONS

Linking rule recommendations:

Rec.	*Hybrid mismatch*	*Hybrid arrangement*	*Corresponding branch arrangement*	*Counteraction*	*Scope*
1	D/NI (deduction/ no inclusion)	Hybrid financial instruments (includes timing)		Primary: deny deduction for payment Defensive: include payment in income	Related parties (25%) or structured arrangements
3	D/NI	Disregarded payments	Deemed branch payments	Primary: deny deduction for payment to the extent expenditure exceeds DII Defensive: include payment in income to the extent exceeds DII	Control group (generally 50%) or structured arrangements
4	D/NI	Reverse hybrids – linking rule	Disregarded branch structure and diverted branch payments	Primary: deny deduction Defensive: None (Recommendation 5 acts as a defensive rule)	Control group or structured arrangements
6	DD (double deduction)	Double deductions (including those arising by virtue of a foreign branch)	(Recommendation 6 already applies to double deduction branch outcomes)	Primary: parent/head office country denies deduction to the extent exceeds DII Defensive: subsidiary/branch country denies deduction to the extent exceeds DII	No limit for primary rule. Defensive rule limited to control group or structured arrangements
7	DD	Payments by dual resident company		Deny deduction in both jurisdictions to the extent exceeds DII	No limit
8	Indirect D/NI	Imported mismatches	Imported branch mismatches	Primary: deny deduction for payment to the extent it funds the hybrid or branch mismatch payment Defensive: None	Control group or structured arrangements. Does not apply if payee subject to hybrid rules

Specific rule recommendations:

Rec.	*Hybrid mismatch*	*Hybrid arrangement*	*Corresponding branch arrangement*	*Counteraction*	*Scope*
2	D/NI	Hybrid financial instruments – specific rules		2.1 Payee country should turn off any exemption 2.2 Restrict FTCs to hybrid arrangement	No limit
5	D/NI	Reverse hybrids – specific rules	Disregarded branch structure and diverted branch payments	5.1 Improve CFC and other offshore rules 5.2 Turn off transparency/non-taxation 5.3 Improved disclosure	Specific to individual country's domestic law

APPENDIX 2: GLOSSARY

CFC rules	New Zealand has a controlled foreign companies (CFC) regime that attributes the passive income of CFCs to New Zealand owners. New Zealand's CFC rules are an important part of our international tax rules and are generally considered to be robust.
Deduction/ no inclusion (D/NI)	A hybrid result where a member of a group can claim a deduction for an intra-group payment and that deduction is not balanced by income inclusion for the recipient.
Double deductions (DD)	A hybrid result where a group can claim tax deductions against two different amounts of income for one item of expenditure.
FIF rules • fair dividend rate • cost • deemed rate of return • comparative value method • attributed FIF income method	New Zealand has a foreign investment fund (FIF) regime which seeks to tax New Zealand residents on their portfolio income from foreign share investment in a practical way. There are a number of methods to calculate FIF income, including: • The fair dividend rate (FDR) and cost methods which approximates total annual return as 5% of an investor's holding and taxes on that basis; • The deemed rate of return (DRR) method which approximates total annual return as a rate set by Order in Council each year; and • The comparative value (CV) method which measures change in value across the relevant year plus any other gain such as a dividend and taxes that amount. • The attributed FIF income method, which taxes the resident on a share of the underlying income of the
Foreign branch	A New Zealand company that operates in a foreign country through a permanent establishment in that country. Because New Zealand taxes the worldwide income of its residents, a New Zealand company with a foreign branch operation that is in loss has the potential to create a hybrid outcome as the loss can be used against New Zealand as well as (potentially) offshore income which New Zealand does not tax.
Foreign tax credit	New Zealand's tax law allows its residents to claim a foreign tax credit for tax paid overseas on a segment of foreign-sourced income. If that income is taxable in New Zealand, residents can claim the foreign tax credit against New Zealand tax to prevent double taxation.
Hybrid entities	An entity that is treated for tax purposes as transparent or disregarded (its income and expenditure is attributed to its owners or (in the case of payments to an owner) ignored) in the jurisdiction of its parent/investor and opaque (it is taxed as a separate entity on its income and expenditure) in the jurisdiction it is established in. This type of entity can produce double deductions and deduction/no inclusion outcomes.
Hybrid financial instrument (permanent)	A financial arrangement between two parties (e.g. a convertible note) that is regarded as debt in one country and equity in another. The effect of this misalignment in characterisation is that payments under the arrangement are treated as tax deductible interest to the payer and (generally) tax exempt dividends for the

	recipient.
Reverse hybrid entity	The reverse of a hybrid entity; an entity that is treated for tax purposes as transparent in its establishment jurisdiction and as opaque in the jurisdiction of its parent/investor. This type of entity has the potential to create a double non-taxation result.
Share lending	A transaction where the owner of a share lends that share to another person. Typically the share borrower will transfer collateral to the lender and will pay the share lender a replacement or substitute payment for any dividends rpaid on the shares during the term of the share lending arrangement (which is often very short) if applicable. Share lending has the potential to fall within the hybrid mismatch rules if the arrangement is between related parties or is a structured arrangement, is cross-border, and the two jurisdictions involved take inconsistent views of the substitute payment. Share repos are similar transactions and can produce similar results.
Share repo	Similar to share lending, but this time the shares are provided as collateral for a loan from the share borrower to the share lender. A share repo differs from secured lending because the money lender can sell the shares during the term of the loan, remaining subject of course to an obligation to redeliver them.
Tax consolidation / loss grouping	Tax consolidation refers to the ability of related party entities to consolidate their tax returns. This can have the effect of enabling hybrid outcomes, as hybrid losses (double deductions and unbalanced deductions) can be consolidated with the ordinary income of a related entity. Similarly, loss grouping rules allow a hybrid loss to be transferred into a related party entity that is in profit, thus reducing their taxable income.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

RECEIVED
21 JUL 2017
MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Cabinet paper - tax measures to prevent base erosion and profit shifting

Date:	6 July 2017	Priority:	Medium
Security level:	In Confidence	Report no:	T2017/1847 IR2017/410

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations. **Authorise** the attached Cabinet paper for lodgement with the Cabinet Office.	10am, Thursday 20 July 2017
Minister of Revenue	**Agree** to the recommendations. **Authorise** the attached Cabinet paper for lodgement with the Cabinet Office	10am, Thursday 20 July 2017

Contact for telephone discussion (if required)

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

6 July 2017

Minister of Finance
Minister of Revenue

Tax policy report: Cabinet paper - tax measures to prevent base erosion and profit shifting

1. This report recommends that you authorise the attached Cabinet paper for lodgement with the Cabinet Office by 10am Thursday 20 July 2017 for the Economic Growth and Infrastructure Committee to consider at its meeting on 26 July 2017. This report also recommends you agree to a change to our previously recommended hybrids measures in respect of foreign trusts.

2. The attached Cabinet paper provides an overview of three other Cabinet papers which seek approval for a package of measures to address base erosion and profit shifting (BEPS) in New Zealand. The Cabinet paper also summarises the background to the other papers, highlights the most important aspects of the proposals, and discusses matters common to all three papers (including application dates, publicity, and financial implications). The other papers are:

- BEPS – interest limitation submissions and policy decisions;
- BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions; and
- BEPS – recommendations on addressing hybrid mismatch arrangements.

3. At the request of your office we have prepared the attached Cabinet paper in advance of the other three. We are currently working on the other papers and will provide those to you next week.

4. We reported to you on the package of BEPS measures to which all four Cabinet Papers relate on 22 June 2017 (T2017/1576, IR2017/325; T2017/1577, IR 2017/330; T2017/1578, IR2017/329; T2017/1604, IR2017/353).

5. If you agree with the drafting of the attached Cabinet paper, we recommend you authorise it for lodgement with the Cabinet Office (together with the other 3 Cabinet papers) by 10am Thursday 20 July 2017 for consideration at the Economic Growth and Infrastructure Committee meeting of 26 July 2017.

Foreign Trusts

6. In regards to foreign trusts, the Cabinet paper is consistent with our recent hybrids policy report (T2017/1604 / IR2017/353), but it also reflects some further policy development as well as filling in a gap in the recommendations contained in the policy report. As set out in that report, in principle we believe that New Zealand foreign trusts can result in double non-taxation due to a hybrid mismatch, where:

- New Zealand does not tax the New Zealand trustee because the beneficiary or settlor is non-resident; and
- the beneficiary's or settlor's residence country does not tax that person because the trustee is non-resident.

7. We now recommend amending that proposal slightly, to clarify that the New Zealand trustee should not be taxable on income so long as someone is required to include that income in their taxable income. So, for example, New Zealand should not tax an amount allocated to a beneficiary if the settlor is required to include that amount in its tax return in its own jurisdiction in that year. Similarly, we should not impose tax on unallocated income retained by the trustee if a beneficiary is required to include the amount in their tax calculation for that year. This clarification is important to avoid our proposed rules imposing two layers of tax on the trust income.

8. Accordingly, we recommend taxing a New Zealand trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that:

- the beneficiary is in the same control group as the trustee (many family trusts would meet this requirement);
- the beneficiary would be taxed on the trust income if it held the trust assets directly; and
- the income is not subject to tax as the income of any person other than the trustee (such as the beneficiary or settlor).

9. We also recommend taxing the New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that:

- the settlor is in the same control group as the trustee (again this would often be the case);
- the settlor would be taxed on the trustee income if it held the trust assets directly; and
- the income is not subject to tax as the income of any person other than the trustee.

10. In error, our policy report did not include any recommendations on trustee income (see recommendation (k)). We therefore take this opportunity to clarify that trustee income is within the scope of the proposed rules, subject to the modifications discussed above.

11. We recommend a de minimis, so that neither of these rules applies if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

12. Importantly, we do not consider any of the changes proposed here are inconsistent with the discussion between officials and Ministers at our meeting on 29 June. We are still only proposing to tax income of foreign trusts to the extent they are "reverse hybrids" and we are not proposing to impose tax on all income of trustees of foreign trusts.

Recommended action

We recommend that you:

(a) **Agree** that New Zealand should tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that:

- the beneficiary is in the same control group as the trustee; and
- the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and
- the income is not subject to tax as the income of any person other than the trustee (such as the beneficiary or settlor)

Agreed/Not agreed　　　　　　　　　　Agreed/Not agreed

(b) **Agree** that New Zealand should tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that:

- the settlor is in the same control group as the trustee;
- the settlor would be taxed on the trustee income if it held the trust assets directly; and
- the income is not subject to tax as the income of any person other than the trustee.

Agreed/Not agreed　　　　　　　　　　Agreed/Not agreed

(c) **Agree** that a de minimis apply, so that neither of the rules in recommendation (a) and (b) applies if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

Agreed/Not agreed

Agreed/Not agreed

(d) **Authorise** the attached Cabinet paper for lodgement with the Cabinet Office by 10am Thursday 20 July 2017 for the Economic Growth and Infrastructure Committee to consider at its meeting on 26 July 2017.

Signed and referred

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

Steve Mack
Principal Advisor
Tax Strategy
The Treasury

Signed and referred

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

In Confidence

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

Economic Growth and Infrastructure Committee

TAX MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING

Proposal

1. This paper provides an overview of three attached Cabinet papers seeking approval for measures to address base erosion and profit shifting in New Zealand. This paper also summarises the background to the attached papers, highlights the most important aspects of the proposals, and discusses matters common to all three papers (including application dates, publicity, and financial implications). The attached papers are:

- BEPS – strengthening our interest limitation rules;
- BEPS – transfer pricing and permanent establishment avoidance; and
- BEPS – addressing hybrid mismatch arrangements.

Background

2. Since late 2012, there has been significant global media and political concern about evidence suggesting that some multinationals pay little or no tax anywhere in the world. Initially matters surfaced in the context of Parliamentary and Senate inquiries in the UK, US and elsewhere into the tax avoidance strategies used by multinationals. In 2013 the issue formed part of the G20 agenda who asked the OECD to report back to it on global strategies to address countries' concerns.

3. The OECD reported back to the G20 in July 2013 highlighting the aggressive tax practices used by multinationals to exploit gaps and mismatches in countries' domestic tax rules to avoid tax, now known as "base erosion and profit shifting" (BEPS). They found that BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

4. The end result was the adoption of a G20/OECD 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.

New Zealand's response to BEPS

5. On the whole, New Zealand is fairly well placed when we assess our tax system against the OECD/G20 recommendations. However, while the majority of multinationals operating in New Zealand are compliant, there are some that adopt BEPS strategies to minimise or eliminate their New Zealand tax obligations. It is important to address these BEPS activities without reducing the general attractiveness of New Zealand as an investment destination.

6. In June last year the Government released its own programme to address BEPS issues in New Zealand (CAB-16-MIN-0218 refers). This programme presented a measured approach that prioritises the problems observed in relation to New Zealand's laws. At the same time, it is a coherent package of measures. Stripping the tax benefits from one type of arrangement is ineffective if multinationals can get the same benefit from switching to a different type of arrangement.

7. In summary the Government's package of New Zealand domestic law measures:

- prevent multinationals from using artificially high interest rates on loans from related parties (interest limitation);
- prevent multinationals from using artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand;
- prevent multinationals from using transfer pricing payments to shift profits to their offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore; and
- remove the tax advantages of exploiting hybrid mismatches between different countries' tax rules.

8. New Zealand's response to BEPS is generally aligned with Australia's response. It is also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment. Appendix One provides a table that compares New Zealand's and Australia's response to the OECD's BEPS Action Plan.

9. The detail of the BEPS proposals was subsequently set out in three Government discussion documents, which were released for public consultation in September 2016 and March 2017:

- *BEPS – Strengthening our interest limitation rules;*
- *BEPS – Transfer pricing and permanent establishment avoidance;* and
- *Addressing hybrid mismatch arrangements.*

10. Our officials have since received a significant amount of feedback on the discussion documents. Most of the submissions were from tax advisors to the affected businesses and raised concerns about uncertainty and compliance costs. We consider that these additional costs will mostly be borne by those who the measures are designed to address (taxpayers engaging in BEPS activities) and that the overall benefits to New Zealand of addressing BEPS outweigh these costs. We have used this feedback to refine the measures, so they are more certain for taxpayers and better targeted. These refinements should not reduce the overall effectiveness of the proposed measures. We consider the measures will address the BEPS issues we are concerned about.

11. The following are what we consider to be the most important matters coming out of consultation. This is not an exhaustive list. The individual Cabinet papers accompanying this paper also discuss other significant issues raised by submitters.

12. Finally we note the progress in relation to the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (also known as the multilateral instrument or MLI) signed by the Minister of Revenue on behalf of New Zealand in June. The MLI is intended to prevent our double tax agreements from being used to facilitate BEPS.

Main issues on BEPS – Strengthening our interest limitation rules

13. One of the easiest ways to shift profits out of New Zealand is for a foreign parent of a New Zealand subsidiary to fund the subsidiary with a loan rather than equity. This is because the interest paid to the parent is deductible to the subsidiary thereby reducing its taxable income. The specific problem we have identified is that transfer pricing rules are not effective in limiting the rate of interest that can be charged on that loan.

Proposal on pricing related-party debt

14. The discussion document proposed a hard rule to limit the interest rate on related-party debt to an amount close to the parent's cost of external borrowing - specifically an interest rate cap, based on the credit rating of the offshore parent plus a small margin. Submitters argued that this proposal could affect the interest rates of companies with only small amounts of debt (so not seen as a risk to the tax base) and could be difficult to apply if the parent has no credit rating. They were also concerned that it could produce results that were inconsistent with our tax treaties, leading to double taxation.

15. In light of these concerns we recommend using what we have termed a "restricted transfer pricing approach" for debt. We expect that this approach will generally result in the interest rate on related-party debt being in line with that facing the foreign parent. This is because the debt would be priced under a transfer pricing methodology but (i) be carried out with a rebuttable presumption that the borrower could be expected to be supported by its foreign parent; and (ii) disregard any commercially unattractive terms used to justify an excessive interest rate. We also intend that taxpayers be able to challenge the rate using the dispute resolution process in tax treaties. The Australian Taxation Office has recently released administrative guidelines which outline a similar approach for limiting related party interest rates (albeit Australia is implementing this approach as an operational policy, rather than a law change).

Proposal on allowable debt levels

16. The second interest limitation issue relates to allowable debt levels under our thin capitalisation rules. These rules limit the quantity of debt a foreign-owned subsidiary can have (generally to 60 percent of the subsidiary's assets). We propose to adjust what counts as "assets" by reducing them by "non-debt liabilities" (liabilities other than interest-bearing debt).

17. While there was some support for the broad proposal, submitters were very concerned about one aspect: that the proposed change would include what are known as "deferred tax liabilities." Accounting standards require deferred tax to be recognised in certain situations – broadly, where profits for tax and accounting purposes differ. This is a complicated issue, with some types of deferred tax liabilities having a stronger case for exclusion than others.

We recommend that officials consider this matter further as part of future consultation on the detailed design of the interest limitation proposals, with Cabinet delegating us the power to make a decision.

Main issues on BEPS – Transfer pricing and permanent establishment avoidance

18. The *BEPS – transfer pricing and permanent establishment avoidance* Cabinet paper contains measures to strengthen our transfer pricing rules, counter permanent establishment avoidance and help Inland Revenue deal with uncooperative multinationals.

Proposal on Transfer Pricing Time Bar

19. The discussion document proposed extending Inland Revenue's time bar for adjusting a taxpayer's transfer pricing position from four to seven years. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have shorter time bars for other tax disputes) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Proposal on permanent establishment avoidance

20. This proposal is aimed at preventing taxpayers from structuring their affairs to avoid a taxable presence in New Zealand where one exists in substance. The OECD has updated their model tax treaty to address this issue and New Zealand is adopting this into our tax treaties by signing the OECD's multilateral instrument. In addition to this, like Australia and the UK, we are also introducing a permanent establishment avoidance rule into our domestic law. The domestic law change is necessary to cover cases where the relevant tax treaty does not yet include the OECD's new recommendation. Submitters were of the view that the proposed rule was too broad and would catch ordinary commercial arrangements that were not its intended target. We agree that any rule should be more narrowly targeted at avoidance arrangements and therefore recommend that officials consult further with submitters to achieve this result.

Main Issues on BEPS – Addressing hybrid mismatch arrangements

21. The *BEPS – addressing hybrid mismatch arrangements* Cabinet paper proposes measures to remove the tax advantages of hybrid mismatch arrangements. Hybrid mismatch arrangements arise when countries classify transactions and entities differently from each other under their domestic tax laws. For example, fixed rate shares may be treated as debt in one country and shares in another, thus allowing the payment of an amount that is deductible in the payer's country but non-assessable in the payee's. Australia, the UK and EU member countries are taking similar actions to address BEPS from hybrid mismatches.

Scope of the rules

22. The hybrids proposals in the discussion document covered the full suite of OECD recommendations in this area, even though there is limited evidence of some of the structures being used in New Zealand. Submitters therefore suggested that our rules should concentrate on the known mischief. On balance, we recommend a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New

Zealand context. Tackling only the known structures might leave a loophole to use those that are not covered, encouraging taxpayers to move into different tax-efficient hybrids rather than converting to more conventional funding structures. A partial response also ignores the fact that some of the other structures might actually be in use, but have not been picked up by Inland Revenue audit.

Foreign Trusts

23. Foreign trusts are, simply put, trusts that have a New Zealand trustee, but are set up by a non-resident (the settlor) and generally derive only foreign-sourced income. Under current settings, foreign trusts are not taxed in New Zealand, except on any New Zealand sourced income. This was confirmed as appropriate by the 2016 Government Inquiry into Foreign Trust Disclosure Rules (the Shewan Inquiry). However, the Shewan Inquiry's conclusion was based on the existing tax settings and the hybrids project has the potential to change these settings in certain circumstances.

24. From a tax policy perspective, foreign trusts are treated as transparent in New Zealand. New Zealand takes the view that, to the extent the income is not paid to beneficiaries more or less as earned, it should be taxed to the settlor in their home jurisdiction. By contrast, the jurisdiction of the settlor may see the trust as a separate entity and not tax the income on the mistaken assumption that the trustee is being taxed in New Zealand. When the income of the trust is not taxed anywhere in the world because of the different tax treatment the relevant countries place on the trust structure, we recommend the New Zealand trustee be subject to tax. This measure would not result in double taxation of current year trust income.

25. We anticipate this meaning that most foreign trusts will be taxed in New Zealand on their foreign sourced income. However, it is important to note that this does not mean that they all will be. The relevant enquiry is "would the income be included in the tax calculation of the settlor in their own country if they had earned that income directly?" If the answer is "no" (and there might be numerous reasons why this would be the case, such as if the settlor is tax exempt, or in a country that does not tax residents on their worldwide income) then no New Zealand tax would be imposed. If the answer is "yes" then New Zealand tax should be imposed unless the income is included in the tax calculation of any person in the same control group (for example, the settlor or a beneficiary) in their own country in the corresponding income year.

26. Finally, we note that taxing foreign trusts in this way was signalled when the hybrids consultation paper was released in September 2016. However, because this rule has the potential to apply to both foreign trusts and limited partnerships, and because the foreign trust industry has very recently incurred significant compliance costs associated with the recommendations of the Shewan Inquiry, we are recommending a delayed effective date to give these structures time to assess their options.

Application dates and transitional measures

27. The measures should generally apply from income years beginning on or after 1 July 2018. Cabinet has already noted that the reforms are expected to apply from this date (CAB-17-MIN-0164 refers). This is based on the expectation that the legislation will be progressed to enactment before this date.

28. The new administrative powers for Inland Revenue to deal with uncooperative multinationals should apply from the date the legislation is enacted. We also propose different

application dates for two of the specific hybrid mismatch proposals. We recommend the unstructured imported mismatch rule (explained more fully in the attached BEPS – addressing hybrid mismatch arrangements Cabinet paper) apply from 1 January 2020 and the reverse hybrid measures (generally expected to apply to limited partnerships and foreign trusts) apply for income years beginning on or after 1 April 2019.

29. We do not recommend any additional transitional relief from the measures, except:

- relief from the hybrids measures for certain hybrid financial instruments issued to the public before 6 September 2016 (the date on which the hybrids discussion document was released); and

- relief from the transfer pricing and interest limitation measures for arrangements subject to an advance pricing agreement entered into before 1 July 2018. (An advance pricing agreement is a binding ruling from Inland Revenue that confirms that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years.)

Consultation

30. Officials consulted widely on the measures in the attached papers. Discussion documents were released for public feedback on the relevant topics (referred to in paragraph 8 above). For the hybrids proposals, given the earlier release of that discussion document, officials have undertaken a further round of consultation on the details of the proposals with interested stakeholders. Inland Revenue and Treasury officials have also consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment. In addition, officials have discussed some of the measures with their counterparts in the Australian Taxation Office, the Australian Treasury and the OECD secretariat.

General feedback on measures

31. Submitters generally acknowledged the importance of addressing BEPS risks facing New Zealand and agreed in principle that change is needed to strengthen the current rules. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more workable and better targeted. We have incorporated many of these suggestions into the measures on which we now seek Cabinet approval.

Feedback on economic impact

32. Some submitters argued that the proposals will have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. They also argued that the proposed measures were complex and onerous, and may induce foreign companies to remove their existing personnel from New Zealand.

33. It is true that there will be additional tax and compliance costs for some investors but these are necessary to address the issues. We 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 these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. At the same time, these

multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded partners throughout the OECD and the expected tax revenue increase is expected to be relatively small. 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.

Feedback on application date

34. The discussion documents did not indicate a likely application date. However, some submitters expected the Government to seek an early application date and argued that it would be better to allow taxpayers time to consider the proposals and rearrange their affairs if necessary.

35. We expect to receive more submissions on, and opposition to, the application date once affected parties become aware it is proposed to be 1 July 2018.

Further consultation

36. Following Cabinet decisions on these papers, we recommend Inland Revenue and Treasury officials engage in further targeted consultation on outstanding policy issues and technical design details relating to the measures. Due the timing constraints necessary for a 1 July 2018 application date, we are not proposing that submitters be consulted on an exposure draft of the entire bill before the bill is introduced to Parliament. However, we recommend targeted consultation of specific sections where additional consultation will provide the most value ahead of the bill's introduction.

Financial implications

37. Some of the revenue for these proposals has already been included in Budget 2017 forecasts. These are:

	$m – increase/(decrease)						
Vote Revenue	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Foreign hybrid entity double deductions	-	-	25.000	50.000	50.000	50.000	50.000
BEPS taxation bill	-	-	25.000	50.000	50.000	50.000	50.000
Total Revenue effect	-	-	50.000	100.000	100.000	100.000	100.000

38. If our recommendations in these Cabinet papers are agreed and adopted by the Government, then the forecasts would be adjusted upward by these additional amounts:

	$m – increase/(decrease)					
Vote Revenue Minister of Revenue	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Grand-parenting of certain hybrids issued to the public	-	19.000	19.000	19.000	14.000	-
Other BEPS measures	-	45.000	90.000	90.000	90.000	90.000
Total Revenue effect	-	64.000	109.000	109.000	104.000	90.000

39. The additional revenue from the hybrids measures results from our proposed grand-parenting approach for hybrid financial instruments issued to the public before 6 September 2016. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

40. We are recommending that officials continue to consult on details of how deferred tax liabilities and assets should be dealt with under the interest limitation measures - specifically, the measure to eliminate assets funded by non-debt liabilities from a taxpayer's total assets for thin capitalisation purposes. The above fiscal impact assumes deferred tax liabilities are included in the non-debt liabilities adjustments (as per the proposal in the discussion document). If these assets and liabilities were excluded from the adjustments the revenue forecast would be $10 million per year lower. In the attached paper on interest limitation we are asking Cabinet to delegate to us the authority to make a decision on this along with an authority to update the relevant revenue forecasts, if necessary.

41. The revenue in paragraph 37 was treated as a saving in Budget 2017. We propose the additional revenue in paragraph 38 be treated as a saving in Budget 2018.

Administrative impacts

42. The changes proposed in the BEPS discussion documents and recommended in these Cabinet papers are not expected to increase administrative costs or require any significant systems changes for Inland Revenue. This is because the reforms largely change the way some taxpayers self-assess the income and deductions that they report to Inland Revenue. Further, the administrative amendments we are recommending should make it easier for Inland Revenue to deal with uncooperative multinationals.

43. We note, however, that a common theme in submissions on all three discussion documents was that administration of the proposals would place a higher demand on Inland Revenue's audit and investigation functions. Our view is that any required increase in Inland Revenue's resourcing as a result of the BEPS package will be accommodated within existing baselines.

Human rights

44. There are no human rights implications arising from the measures.

Legislative implications

45. Legislative changes to the Income Tax Act 2007 and the Tax Administration Act 1994 will be required to implement the proposed measures. To achieve this, we intend to include the measures in a BEPS taxation bill introduced after the General Election. The BEPS bill will need to be introduced and have its first reading by 14 December 2017 in order to be enacted in time for the planned 1 July 2018 application date.

Impact Analysis Requirements

46. There are no regulatory implications arising directly from this Cabinet paper.

47. The regulatory impact analysis for each set of measures is set out in the Cabinet paper for those measures.

Publicity

48. We will arrange for an appropriate announcement of the policy decisions on these BEPS measures.

49. We also recommend that the Government proactively release the BEPS Cabinet papers, policy reports and submissions on the BEPS discussion documents and the issues paper on the multilateral instrument (including the pre-Budget 2017 policy report and Cabinet paper (T2017/949, IR2017/237)). This could be done when we announce the package. Given their inevitable release under the Official Information Act in any event, releasing these documents proactively will promote transparency around the policy process to the public, rather than just individual requestors. It would also be consistent with the approach taken for previous BEPS Cabinet papers.

Recommendations

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

1. **Note** we have developed and consulted on a package of measures to counter certain base erosion and profit shifting (BEPS) activities we are concerned about in New Zealand. In summary, the measures in the package:

    - prevent multinationals from using artificially high interest rates on loans from related parties (interest limitation);

    - prevent multinationals from using artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand;

    - prevent multinationals from using transfer pricing payments to shift profits to their offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore; and

    - remove the tax advantages of exploiting hybrid mismatches between different country's tax rules.

2. **Note** the attached three Cabinet papers seek Cabinet approval to introduce these BEPS measures.

3. **Agree** that work progresses along the indicative timeline, where we plan to introduce a BEPS taxation bill by the end of this year, and enact the bill by 1 July 2018.

4. **Agree** that the measures should apply from income years starting on or after 1 July 2018, apart from:

   - The new administrative powers for Inland Revenue to deal with uncooperative multinationals should apply from the date the legislation is enacted;

   - the hybrids unstructured imported mismatch measure, which should apply from 1 January 2020; and

   - the reverse hybrid measures (generally expected to apply in relation to limited partnerships and foreign trusts), which should apply for income years beginning on or after 1 April 2019.

5. **Agree** that there should be transitional relief from the measures:

   - in relation to the hybrid measures, relief for hybrid financial instruments issued to the public before 6 September 2016; and

   - in relation to the transfer pricing and interest limitation measures, relief for arrangements subject to an advance pricing agreement entered into before 1 July 2018.

6. **Note** the original BEPS revenue that was forecast in April:

	$m – increase/(decrease)						
Vote Revenue	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Foreign hybrid entity double deductions	-	-	25.000	50.000	50.000	50.000	50.000
BEPS taxation bill	-	-	25.000	50.000	50.000	50.000	50.000
Total Revenue effect	-	-	50.000	100.000	100.000	100.000	100.000

7. **Note** the following changes as a result of the decisions in recommendations 1 to 5 above, with a corresponding impact on the operating balance:

	$m – increase/(decrease)					
Vote Revenue Minister of Revenue	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Tax Revenue: BEPS taxation bill	-	64.000	109.000	109.000	104.000	90.000
Total Revenue effect	-	64.000	109.000	109.000	104.000	90.000

8. **Note** the attached paper on interest seeks delegated authority for the Minister of Finance and the Minister of Revenue to make a decision on the treatment of deferred tax liabilities which includes authority to reduce the revenue forecast by $10 million per year.

9. **Note** that forecast BEPS revenue in recommendation 6 above was treated as savings in Budget 2017.

10. **Agree** that the additional revenue in recommendation 7 be treated as savings in Budget 2018 (total to be confirmed after the decision on the treatment of deferred tax liabilities which could reduce the revenue forecast by $10 million per year).

11. **Agree** that Inland Revenue and the Treasury undertake further targeted consultation on outstanding policy issues, technical design details and selected parts of an exposure draft of the planned BEPS bill in relation to the measures.

12. **Agree** to proactively release the Cabinet papers, policy reports and submissions for the BEPS discussion documents and the issues paper for the multilateral instrument.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Appendix One: Comparison of Australia's and New Zealand's response to the OECD's BEPS Action Plan

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
1 – Address the tax challenges of the digital economy	Report identified issues raised by the digital economy and possible actions to address them. Did not generally recommend fundamental changes to international tax framework.	Generally robust and consistent with current international tax norms.	New Zealand imposed GST on online services. *GST imposed on supplies occurring on or after 1 October 2016.*	**Same response as New Zealand.** Australia to impose GST on online services. *GST imposed on supplies occurring on or after 1 July 2017.*
2 – Neutralise the effects of hybrid mismatch arrangements	Recommended domestic hybrid mismatch rules. Changes to the OECD Model Tax Convention and multilateral instrument (MLI) to address hybrid entities.	Domestic law and Double Tax Agreements (DTAs) already contain some targeted anti-hybrid mismatch rules.	New Zealand proposing comprehensive domestic hybrid mismatch rules based on OECD recommendations. *Public consultation in 2016/17. Legislation for domestic rules to be introduced late 2017/early 2018.* NZ has adopted MLI hybrid provisions to strengthen DTAs. *Consulted on the MLI in March 2017. NZ signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand.** Australia proposing comprehensive domestic hybrid mismatch rules based on OECD recommendations. However, we understand Australia is not adopting hybrids recommendation 5 (reverse hybrids) while we are proposing that New Zealand adopt this. *Public consultation in 2015/16. Domestic law changes to take effect from 1 January 2018 or six months after legislation is enacted. Draft legislation expected to be consulted on shortly.* Australia has also adopted MLI hybrid provisions to strengthen DTAs. *Consulted on MLI in December 2016. Australia signed the MLI on 7 June 2017. Ratification of the MLI will follow.*

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
3 – Strengthen Controlled Foreign Company (CFC) rules	Recommendations regarding the design of domestic rules	NZ and Australian CFC rules are already consistent with OECD recommendations.	No proposal to change CFC rules.	**Same response as New Zealand.** No proposal to change CFC rules.
4 – Limit base erosion via interest deductions and other financial payments	Recommended interest limitation using an EBITDA approach.	New Zealand and Australia both have an asset-based thin capitalisation test to control quantity of debt, which the OECD also recommends. Transfer pricing has limited ability to control high-priced debt.	New Zealand is improving its thin capitalisation rules by limiting interest rates on related party debt having particular regard to the interest rate of the foreign parent, and an adjustment for so-called "non-debt liabilities". *Consulted on interest limitation rules in March 2017. Legislation planned for 2017/18.*	**Similar response to New Zealand.** Australia has already tightened its transfer pricing rules. Since the New Zealand discussion document was published the ATO has released administrative guidelines (in draft) on what arrangements are considered low risk and close alignment with the interest rate of the foreign parent is an important factor. Both these changes will help it challenge high interest rates on related-party debt. **New Zealand is proposing the same rules as Australia in relation to the adjustment for non-debt liabilities.** Australia already requires an adjustment for non-debt liabilities.
5 – Counter harmful tax practices more effectively, taking into account transparency and substance	Finalise review of member country regimes. Expand participation to non-OECD members and revision of existing criteria.	NZ's and Australia's laws are already robust – no harmful tax practices identified.	NZ complies with requirements to exchange binding rulings and advanced pricing agreements as recommended by OECD.	**Same response as New Zealand.** Australia complies with requirements to exchange binding rulings and advanced pricing agreements as recommended by OECD.

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
6 – Prevent treaty abuse	Changes to the OECD Model Tax Convention and changes to DTAs through MLI to insert a general anti-avoidance provision called a "principal purpose test" (PPT).	NZ's and Australia's anti-avoidance law is generally strong, but MLI presents opportunity to further strengthen.	NZ to adopt PPT through signing the MLI. *Consulted on MLI in March 2017. NZ signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand**. Australia to adopt PPT through signing the MLI. *Consulted on MLI in December 2016. Australia signed the MLI on 7 June 2017. Ratification of the MLI will follow.*
7 – Prevent the artificial avoidance of Permanent Establishment (PE) status	Changes to the OECD Model Tax Convention and changes to DTAs through MLI to prevent PE avoidance.	NZ's and Australia's PE definition is generally based on the existing OECD and UN Models.	NZ to implement OECD best practice standards for majority of DTAs by signing the MLI. *Consulted on MLI in March and signed MLI on 7 June 2017. Ratification of the MLI will follow.* NZ also proposing a new anti-avoidance rule for large multinationals that structure to avoid having PE in NZ. *Consultation on PE anti-avoidance rule in March 2017. Legislation planned for 2017/18.*	**Similar response to New Zealand on some of the PE measures, but Australia has chosen not to implement changes to the DTA dependant agent PE provision through the MLI, but rather adopt them through bilateral negotiations.** *Consulted on MLI in December 2016. Australia signed the MLI on 7 June 2017. Ratification of the MLI will follow.* Australia's Multinational Anti-Avoidance Law (MAAL) targets PE avoidance. *Applies from 1 January 2016.*

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
Actions 8-10 – relate to transfer pricing to ensure transfer pricing reflects economic substance	Changes to the OECD Transfer Pricing Guidelines.	NZ and Australia currently apply the OECD Transfer Pricing Guidelines. Recent Australian law changes are consistent with the new OECD Transfer Pricing Guidelines. New Zealand law requires updating to reflect new OECD Transfer Pricing Guidelines.	New Zealand will follow the changes to the OECD Transfer Pricing Guidelines. This involves making changes to domestic legislation. *Consulted on transfer pricing in March 2017. Legislation planned for 2017/18.*	**Similar response to New Zealand** on transfer pricing, but generally goes further than New Zealand (and OECD recommendations), by applying a separate Diverted Profits Tax (DPT). Legislation for the separate DPT was introduced on 9 February 2017 and it will take effect in July 2017.
11 – Establish methodologies to collect and analyse data on BEPS and the actions to address it	Recommendations regarding data to be collected and methodologies to analyse them.	NZ and Australia collect and analyse certain data on BEPS as a matter of course.	Since 2015 Inland Revenue has conducted an annual International Questionnaire that collects key data to assess BEPS risks. The most recent survey covered almost 600 foreign owned corporates. Additional data collection from significant enterprises is being considered as part of the BT programme of work.	**Similar response to New Zealand.** ATO requires taxpayers to complete an international dealings schedule and has implemented an International Structuring and Profit Shifting (ISAPS) initiative. This initiative requested data from certain Australian companies at a level similar to the country-by-country (CbC) data requested under the OECD BEPS Action Plan.

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
12 – Require taxpayers to disclose their aggressive tax planning arrangements to revenue authorities	Recommendations regarding the design of domestic disclosure rules.	For both NZ and Australia, no requirement under current law to disclose aggressive tax planning arrangements, however the combination of our strong anti-avoidance laws and the binding rulings and penalties regimes incentivise disclosure.	No law reform planned but existing law incentivises disclosure. Taxpayers will often apply for binding rulings on potentially aggressive transactions to obtain certainty as to the tax treatment – especially in light of our strong anti-avoidance law. Penalties on aggressive transactions are reduced for early disclosure of the arrangement.	**Different to New Zealand.** While Australia has a rulings regime and reductions in penalties for voluntary disclosure, the Australian Treasury is also consulting on whether to adopt the OECD proposals for mandatory disclosure of tax information. Submissions closed on 15 July 2016. Australia also recently implemented transparency measures allowing the ATO to publish the taxable income and income tax liabilities of large companies.
13 – Re-examine transfer pricing documentation	Changes to OECD Transfer Pricing Guidelines and recommendations regarding the design of domestic rules, including country-by-country (CbC) reporting.	NZ and Australia currently apply the OECD Transfer Pricing Guidelines, but do not have a formal programme for automatic exchange of transfer pricing documentation.	Inland Revenue is implementing CbC reporting. NZ has signed the multilateral agreement on exchanging CbC reports with other tax authorities. NZ also recently entered into a bilateral arrangement with the US Internal Revenue Service to share CbC reports. *Where domestic legislation is required to support the changes to the Transfer Pricing Guidelines, this will be introduced in 2017/18.*	**Similar response as New Zealand**. Australia is implementing CbC reporting. It has enacted necessary domestic law and has signed the multilateral agreement on exchanging CbC reports with other tax authorities. In addition, Australia requires large multinationals to file their local and master file documentation with the ATO. *Applies from 1 January 2016.*

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
14 – Make dispute resolution mechanisms more effective	Recommendations on operational minimum standards and best practices for dispute resolution	NZ and Australia have strong dispute resolution systems, but do not currently allow taxpayers to approach the competent authority (CA)[1] of *either* DTA partner for resolution of dispute (taxpayer must approach home country CA) and do not generally offer arbitration of CA disputes.	NZ will implement OECD recommendations on dispute resolution by signing the MLI – in particular, NZ will allow taxpayers to approach the CA of either DTA partner in a treaty dispute and provide for arbitration of CA disputes. NZ also recently issued guidance on the mutual agreement procedure (MAP). *Consulted on the MLI in March 2017 and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand**. Australia will implement OECD recommendations on dispute resolution by signing the MLI – in particular, it will allow taxpayers to approach the CA of either DTA partner in a treaty dispute and provide for arbitration of CA disputes. *Consulted on the MLI in December and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*
15 – Develop the MLI to strengthen DTAs	The MLI implements substantive recommendations made in OECD's Action 2, 6, 7 and 14 reports. Report identified public international law and tax issues; and recommended an Ad-Hoc Group be set up to develop the MLI.	NZ has a network of 40 DTAs. Some of the MLI provisions are already included in a few DTAs.	NZ officials participated in the Ad Hoc Group to develop the MLI and New Zealand signed the MLI on 7 June 2017. NZ expects to ratify the MLI in 2018 and our DTAs are likely to begin to be modified in 2019. *Consulted on the MLI in March 2017 and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand**. Australian officials participated in the Ad Hoc Group to develop the MLI and Australia signed the MLI on 7 June 2017. *Australia consulted on the MLI in December and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*

[1] CA is a person authorised by a DTA to administer tax treaty provisions and resolve disputes.

POLICY AND STRATEGY

Tax policy report: BEPS Cabinet papers

Date:	13 July 2017	Priority:	Medium
Security level:	In Confidence	Report no:	T2017/1901 IR2017/429

Action sought

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

Contact for telephone discussion (if required)

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

13 July 2017

Minister of Finance
Minister of Revenue

Tax policy report: BEPS Cabinet papers

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

2. The three attached papers are:

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

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

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

Next steps

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

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

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

Recommended action

We recommend that you:

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

Noted Noted

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

Authorised Authorised

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

Steve Mack
Principal Advisor
Tax Strategy
The Treasury

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

In Confidence

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

Cabinet Economic Growth and Infrastructure Committee

BEPS – strengthening our interest limitation rules

Proposal

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

Executive summary

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

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

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

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

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

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

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

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

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

Background

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

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

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

Comment

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

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

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

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

- tightening the thin capitalisation rules, which set the debt levels allowed in New Zealand for taxpayers either with foreign parents (the inbound rules) or foreign subsidiaries (the outbound rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

Restricted transfer pricing

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

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

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

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

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

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

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

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

Private sector consultation

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

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

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

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

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

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating); and
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

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

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

Allowable debt levels in the thin capitalisation rules

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

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

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

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

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

Private sector consultation

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

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

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

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

Other changes

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

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

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

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

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

Rule for infrastructure projects

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

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

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

De minimis for the inbound rules

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

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

43. This proposal was generally supported by submitters.

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

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

- 60 percent; and

- 110 percent of its third party debt.

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

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

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

Asset valuations

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

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

Agency consultation

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

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

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

Impact Analysis Requirements

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

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

Recommendations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – strengthening our interest limitation rules

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

Summary: Problem and Proposed Approach

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

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

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

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

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

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

Section B: Summary Impacts: Benefits and costs

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

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

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

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

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

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

Section C: Evidence certainty and quality assurance

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

To be completed by quality assurers:

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

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

Impact Statement: BEPS – strengthening our interest limitation rules

Section 1: General information

Purpose

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

Key Limitations or Constraints on Analysis

Evidence of the problem

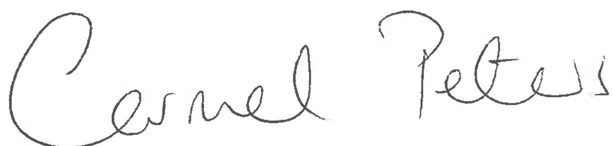
While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire.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

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

Consultation

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

Responsible Manager (signature and date):



Carmel Peters
Policy Manager, Policy and Strategy
Inland Revenue

13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

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

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

BEPS using interest deductions

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

New Zealand's BEPS work

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

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

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

New Zealand's tax system

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

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

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

have an indirect interest in the tax system.

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

Thin capitalisation rules

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

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

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

Transfer pricing rules

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

NRWT

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

2.3 What is the policy problem or opportunity?

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

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

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

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

This impact statement considers two related policy opportunities:

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

Scale of the problem

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

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

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

There are no constraints on scope.

2.5 What do stakeholders think?

Stakeholders

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

Consultation already undertaken

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

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

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

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

Interest limitation

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

General reaction

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

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

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

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

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

Allowable debt levels

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

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

General reaction

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

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

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

Deferred tax

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

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

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

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

Further consultation

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

Section 3: Options identification

3.1 What options are available to address the problem?

Related-party interest rates

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

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

Option 1: Interest rate cap (discussion document proposal)

As described in section 2.5.

Option 2: Restricted transfer pricing

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

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

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

parent.

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

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

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

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

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

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

Option 4: Administrative guidance

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

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

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

Option 5: Status quo (ordinary transfer pricing)

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

Relevant experience from other countries

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

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

Allowable debt levels

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

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

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

As described in section 2.5.

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

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

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

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

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

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

Relevant experience from other countries

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

---

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

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

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

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

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

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

No options were ruled out of scope.

Section 4: Impact Analysis

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

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

Key:

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

Allowable debt levels

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

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

Section 5: Conclusions

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

Interest limitation

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

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

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

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

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

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

Allowable debt levels

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

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

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

5.2 Summary table of costs and benefits of the preferred approach

Related-party interest rates

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

Allowable debt levels

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

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

5.3 What other impacts is this approach likely to have?

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

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

Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

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

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

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

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

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

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

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

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

6.2 What are the implementation risks?

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

Section 7: Monitoring, evaluation and review

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

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

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

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

7.2 When and how will the new arrangements be reviewed?

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

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

In Confidence

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

Cabinet Economic Growth and Infrastructure Committee

BEPS – transfer pricing and permanent establishment avoidance

Proposal

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

Executive summary

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

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

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

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

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

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

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

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

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

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

Background

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

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

- ***Tax structuring***: In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (a permanent establishment or "PE") in New Zealand. However, non-residents can structure their affairs to avoid such a taxable presence, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).

- ***Creating enforcement barriers:*** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.

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

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

- updated transfer pricing guidelines, to counter profit shifting.

Comment

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

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

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

- Stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities. We also

propose shifting the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length, and extending the time bar (the period of time which Inland Revenue has to reassess a taxpayer) from four years to seven years for transfer pricing.

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

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

Private sector consultation

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

General reaction

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

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

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

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

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

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

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

- Extending the time bar (the period of time which Inland Revenue has to adjust a taxpayer's transfer pricing position) from four years to seven years for transfer pricing. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have a special seven year time bar for transfer pricing) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Changes made as a result of consultation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Agency consultation

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

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

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

Impact Analysis Requirements

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

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

Recommendations

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

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

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

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

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

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

   - introducing an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source; and

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

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

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

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

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

- they refer to the latest OECD transfer pricing guidelines as guidance for how the rules are applied;
- the new legislation codifies the requirement for large multinationals to provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative;
- the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased to seven years (in line with Australia);
- the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters); and
- in addition to applying to transactions between related parties, the transfer pricing rules will also apply when non-resident investors "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.

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

   - more readily assess the multinational's tax position based on the information available to Inland Revenue at the time;
   - collect any tax owed by a member of a large multinational group from any wholly-owned group member, provided the non-resident fails to pay the tax itself;
   - use section 17 of the Tax Administration Act 1994 to request information that is held offshore by another group member of the large multinational group;
   - use section 21 of the Tax Administration Act 1994 to deem an amount of income to be allocated to a New Zealand group member or PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand sourced income (currently the existing power only applies in respect of deductible payments); and
   - impose a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty).

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

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

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

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – transfer pricing and permanent establishment avoidance rules

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

Summary: Problem and Proposed Approach

Problem Definition

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

There are international concerns about multinationals not paying their fair share of tax. This is because some multinationals use base erosion and profit shifting (BEPS) strategies to report low taxable profits in New Zealand and other countries in which they operate. These BEPS strategies include arrangements between related parties which shift profits out of New Zealand (usually into a lower taxed jurisdiction). They also include arrangements which are designed to ensure New Zealand is not able to tax any income from sales here despite there being a physical presence in New Zealand in relation to the sales. These particular BEPS strategies are known as transfer pricing and permanent establishment (PE) avoidance. Finally, Inland Revenue faces administrative difficulties in investigating large multinationals.

Proposed Approach

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

The proposed approach is to adopt the package of measures outlined in the Government discussion document *BEPS – transfer pricing and permanent establishment avoidance (March 2017),* with some changes resulting from consultation, as the measures will:

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

Section B: Summary Impacts: Benefits and costs

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

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

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

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

Section C: Evidence certainty and quality assurance

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

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

To be completed by quality assurers:

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

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

Section 1: General information

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

Key Limitations or Constraints on Analysis
Evidence of the problem
Our analysis has been limited somewhat by our inability to assess the exact size of the transfer pricing and PE avoidance structures in New Zealand. In common with BEPS activities generally, transfer pricing and PE avoidance is difficult to quantify as tax avoidance is often not directly observable. We consider that, while most multinationals are compliant, there is a minority that engage in transfer pricing and PE avoidance. Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not addressed. Furthermore, as New Zealand endorses the Organisation for Economic Co-operation and Development's (OECD) *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan), there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.
Range of options considered
Our analysis of options has been primarily constrained by New Zealand's double tax agreements (DTAs). Under its DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.
Assumptions underpinning impact analysis
The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of transfer pricing and PE avoidance arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs, and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

Responsible Manager (signature and date):
  Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

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

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

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

New Zealand's BEPS work

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

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

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

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

New Zealand's tax system

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

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

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

New Zealand's PE rules

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

In general, New Zealand can only tax a non-resident multinational group on its sales here if both of the following conditions are met:

- The multinational group has a sufficient taxable presence in New Zealand. This means the group must operate in New Zealand either through a New Zealand-resident subsidiary (in which case the subsidiary is taxable on its income) or through a PE of a non-resident group member. A PE is basically a place of business of the non-resident, but it also includes an agent acting for the non-resident.
- Where a multinational operates in New Zealand through a PE of a non-resident group member, some of the non-resident's net profits from its sales can be attributed to its taxable presence here. This involves determining:
  - The amount of the non-resident's gross sales income which can be attributed to its PE here; and
  - The amount of the expenses which can be deducted from that income to determine the net taxable profits in New Zealand.

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

New Zealand's transfer pricing rules

"Transfer pricing" refers to the use of cross-border payments between associated entities such as a parent and a subsidiary. Transfer pricing rules are therefore concerned with

determining the conditions, including the price (and therefore the tax liability), for transactions within a multinational group resulting in the allocation of profits to group companies in different jurisdictions.

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

General anti-avoidance rule (GAAR)

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

2.3 What is the policy problem or opportunity?

The problem of transfer pricing and PE avoidance

Some multinational companies operating in New Zealand exploit deficiencies in the current international tax system (both in New Zealand and abroad) by using transfer pricing and PE avoidance strategies to report low taxable profits in New Zealand despite carrying out significant economic activity here. Transfer pricing and PE avoidance can lead to unfairness and the substitution of low-taxed investors for tax-paying investors. This has the potential to reduce national income while doing little or nothing to reduce the overall pre-tax cost of capital to New Zealand or increase the overall level of investment. It also distorts the allocation of investment by favouring foreign investors who set out to game the system.

Transfer pricing avoidance

One of the major strategies used by multinationals to shift profits out of New Zealand and reduce their worldwide tax bills is transfer pricing. Related parties may agree to pay an artificially high or low price for goods, services, funding, or intangibles compared to the "arm's length" price or conditions that an unrelated third party would be willing to pay or accept under a similar transaction. By manipulating these transfer prices or conditions, profits can be shifted out of New Zealand and into a lower-taxed country or entity.

PE avoidance

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

Impacted population

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

Many of the proposed measures will apply only to multinational groups with over EUR €750 million of consolidated global revenue. While there are only 20 New Zealand-owned multinationals that earn this much, the EU has estimated that there may be up to 6,000

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

Transfer pricing and PE arrangements in New Zealand

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

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

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

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

2.5 What do stakeholders think?

Submissions on the discussion document

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

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

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

Further consultation

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

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

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

Section 3: Options identification

3.1 What options are available to address the problem?

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

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

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

Option 1: Status quo

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

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

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

Option 3: Diverted profits tax

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

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

This option involves adopting the package of measures proposed in the discussion document, with some changes resulting from consultation. The discussion document proposals have taken certain features of a DPT and combined them with the OECD's BEPS measures and some domestic law amendments to produce a package of measures that is tailored for the New Zealand environment. The intention is that this approach would be as effective as a DPT in addressing transfer pricing and PE avoidance in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. Under this option, we would introduce:

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

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

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

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

Consultation

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

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

Significant changes made as a result of consultation were:

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

The above changes are likely to be welcomed by submitters.

Evidence from Australia's reforms

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

to address PE avoidance and transfer pricing issues.

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

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

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

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

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

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

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

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

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

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

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

Section 4: Impact Analysis

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

Key:

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

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

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

Option 3 (Diverted profits tax)

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

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

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

Section 5: Conclusions

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

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

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

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

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

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

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

Option 2 (MLI and the OECD's transfer pricing guidelines) was the option suggested by many submitters. However, we consider that adopting the OECD's recommendations on their own (without corresponding domestic amendments) would not effectively address the issue of transfer pricing and PE avoidance. First, New Zealand's existing transfer pricing legislation does not contemplate an ability to apply some important aspects of the new OECD's transfer pricing guidelines. This means that Inland Revenue would only be able to

apply the guidelines to the extent that our current domestic rules allow. Domestic law changes would likely be needed to adequately address the issue. Second, while option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements. This is because the MLI will only apply where both countries choose to adopt it – and many of New Zealand's trading partners do not intend to adopt it. It is therefore important that New Zealand adopt its own PE avoidance measure to supplement the MLI, otherwise there would still be a gap for multinationals to exploit. Third, the OECD's BEPS measures do not address issues specific to New Zealand, such as issues with our current source rules and the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes).

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

5.2 Summary table of costs and benefits of the preferred approach

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

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

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

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

5.3 What other impacts is this approach likely to have?

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

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

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

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

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

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

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

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

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

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

6.2 What are the implementation risks?

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

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

Section 7: Monitoring, evaluation and review

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

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

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

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

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

7.2 When and how will the new arrangements be reviewed?

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

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

In confidence

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

Cabinet Economic Growth and Infrastructure Committee

BEPS – addressing hybrid mismatch arrangements

Proposal

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

Executive summary

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

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

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

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

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

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

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

Background

BEPS

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

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

Hybrid mismatch arrangements

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

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

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

The OECD's response

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

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

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

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

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

Other countries

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

Hybrids discussion document

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

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

---

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

Comment

Implementing the full OECD hybrids package

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

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

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

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

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

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

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

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

Significant issues

Foreign trusts

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

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

Application of hybrid rules to foreign branches

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

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

Imported mismatches

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

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

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

Over-taxation by reason of the imposition of NRWT

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

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

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

Grandparenting for certain instruments issued by banks to the public

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

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

Opaque election for foreign hybrid entities

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

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

Application of rules to branch mismatch arrangements

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

De minimis rule

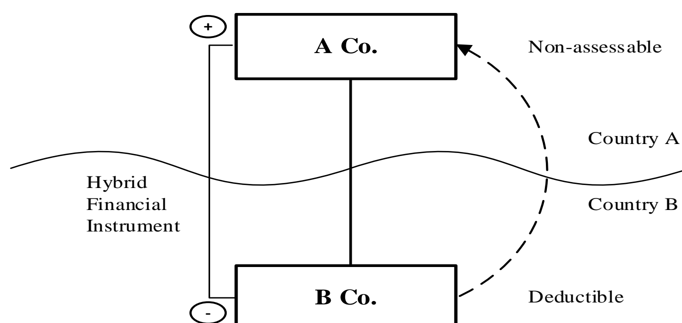
37. We recommend that there be no general de minimis for the hybrid rules. We believe that a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules. This means that any de minimis would likely be ineffective in practice because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

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

OECD recommendations

Hybrid financial instrument rules (Recommendations 1 and 2)

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



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

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

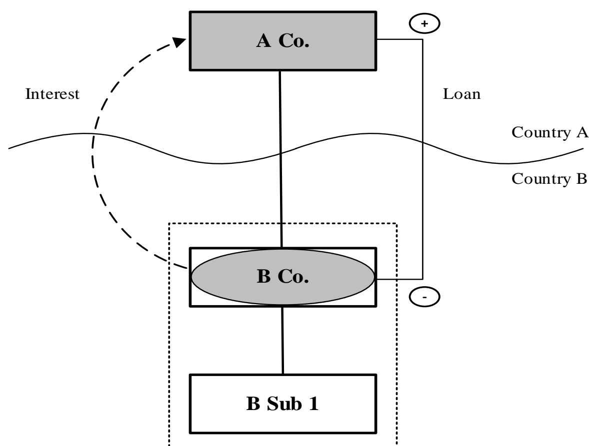
42. New Zealand already has a rule that switches off the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. We recommend that this rule be expanded to also apply if the foreign payer receives tax benefits similar in nature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

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

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

Disregarded hybrid payments rule (Recommendation 3)

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



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

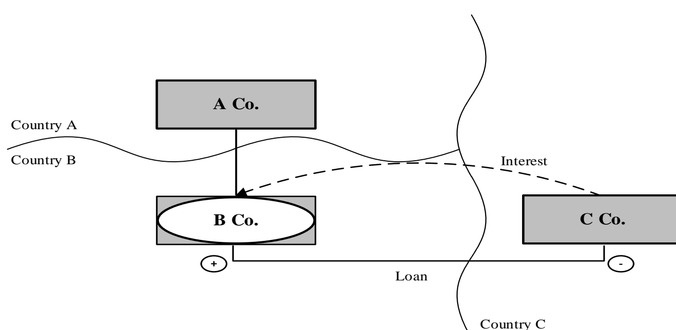
therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

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

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

Reverse hybrid rules (Recommendations 4 and 5)

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



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

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

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

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

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

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

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

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

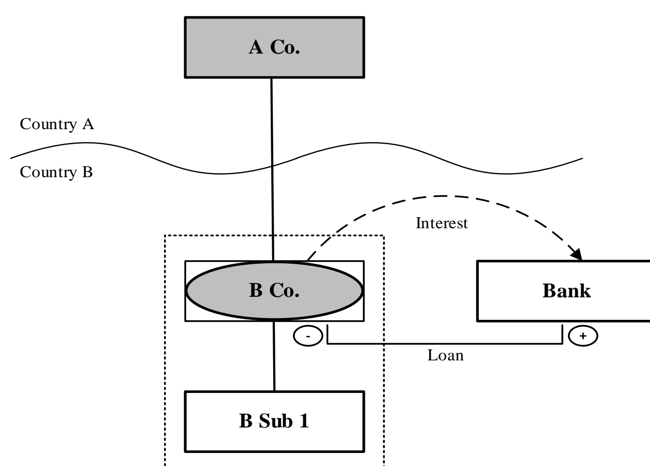
58. OECD recommendation 5.3 is that countries should consider improvements to record keeping and disclosure rules for tax transparent entities established in their country. Following the 2016 Government Inquiry into Foreign Trust Disclosure Rules, the disclosure rules for foreign trusts have been enhanced.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

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

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

Hybrid entities – double deductions (Recommendation 6)

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



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

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

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

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

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

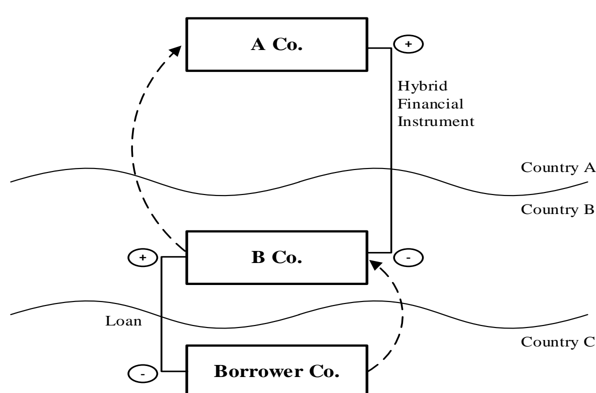
Dual resident entities (Recommendation 7)

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

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

Imported mismatches (Recommendation 8)

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



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

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

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

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

Agency consultation

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

Financial implications

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

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

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

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

Human rights, administrative impacts, legislative implications, publicity

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

Impact Analysis Requirements

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

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

Recommendations

79. We recommend that Cabinet:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Appendix

List of detailed design decisions

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

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

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

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

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

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

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

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

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

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

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

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

Coversheet: BEPS - Hybrid mismatch arrangements

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

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

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

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis. There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

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

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

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

Section C: Evidence certainty and quality assurance

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

To be completed by quality assurers:

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

Impact Statement: BEPS - Hybrid mismatch arrangements

Section 1: General information

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

Key Limitations or Constraints on Analysis

Evidence of the problem

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

Range of options considered

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

Assumptions underpinning impact analysis

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

Responsible Manager (signature and date):

Paul Kilford
Policy Manager, Policy and Strategy
Inland Revenue

12 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

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

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

Hybrid mismatch arrangements

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

New Zealand's BEPS work

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

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

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

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

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

New Zealand's tax system

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

Company tax and international rules

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

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

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

2.3 What is the policy problem or opportunity?

The problem of hybrid mismatch arrangements

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

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

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

Hybrid mismatch arrangements in New Zealand

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

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

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

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

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

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

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

2.5 What do stakeholders think?

Stakeholders

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

connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

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

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

Submissions to discussion document

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

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

Further and ongoing consultation

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

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

We have also consulted with the Reserve Bank.

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

Section 3: Options identification

3.1 What options are available to address the problem?

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

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

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

Status quo: No action

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

Option 1: Strict adoption of OECD recommendations

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

Option 2: Tailored adoption of OECD recommendations

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

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

Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid

enacting rules targeted at arrangements which are not currently seen in New Zealand.

Consultation

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

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

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

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

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

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

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

Section 4: Impact Analysis

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

Key:

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

Section 5: Conclusions

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

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

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

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

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

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

Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch

rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as "unstructured imported mismatches". This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

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

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

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

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

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

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

5.2 Summary table of costs and benefits of the preferred approach

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

costs	Administrative costs	Low	High

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

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

5.3 What other impacts is this approach likely to have?

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

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

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

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

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

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

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

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

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

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

6.2 What are the implementation risks?

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

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

Section 7: Monitoring, evaluation and review

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

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

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

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

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

7.2 When and how will the new arrangements be reviewed?

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

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

In Confidence

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

Cabinet Economic Growth and Infrastructure Committee

BEPS – strengthening our interest limitation rules

Proposal

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

Executive summary

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

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

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

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

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

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

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

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

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

Background

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

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

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

Comment

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

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

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

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

Restricted transfer pricing

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

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

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

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

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

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

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

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

Private sector consultation

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

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

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

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

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

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating); and
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

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

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

Allowable debt levels in the thin capitalisation rules

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

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

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

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

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

Private sector consultation

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

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

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

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

Other changes

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

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

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

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

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

Rule for infrastructure projects

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

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

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

De minimis for the inbound rules

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

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

43. This proposal was generally supported by submitters.

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

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

- 60 percent; and

- 110 percent of its third party debt.

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

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

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

Asset valuations

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

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

Agency consultation

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

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

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

Impact Analysis Requirements

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

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

Recommendations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – strengthening our interest limitation rules

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

Summary: Problem and Proposed Approach

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

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

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

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

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

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

Section B: Summary Impacts: Benefits and costs

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

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

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

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

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

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

Section C: Evidence certainty and quality assurance

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

To be completed by quality assurers:

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

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

Impact Statement: BEPS – strengthening our interest limitation rules

Section 1: General information

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

Key Limitations or Constraints on Analysis
Evidence of the problem While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire. This dataset includes debt levels, related-party debt levels, and related-party interest payments of large foreign-owned firms. However, there are still limitations to that data – for example, data on interest rates on related-party debt (and the interest rates facing a New Zealand subsidiary's parent company) is not captured in the Questionnaire. Where possible, this information was obtained from other sources (such as credit ratings of parent companies and disclosed related-party interest rates in financial statements) or estimated (for example, estimating interest rates based on related-party interest payments and related-party debt amounts). However, this other data is less comprehensive and accurate. **Consultation** The preferred option in relation to limiting interest rates on related-party interest rates has not been subject to consultation. This was because it was developed in response to submissions on the original proposals. However, it is similar in many respects to the original proposal, which was subject to consultation. In addition, to ensure the rule operates effectively and to mitigate the risk of unintended outcomes, it will be subject to consultation with submitters on the technical detail.

Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

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

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

BEPS using interest deductions

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

New Zealand's BEPS work

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

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

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

New Zealand's tax system

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

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

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

have an indirect interest in the tax system.

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

Thin capitalisation rules

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

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

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

Transfer pricing rules

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

NRWT

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

2.3 What is the policy problem or opportunity?

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

Example

Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.

Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.

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

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

This impact statement considers two related policy opportunities:

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

Scale of the problem

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

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

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

There are no constraints on scope.

2.5 What do stakeholders think?

Stakeholders

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

Consultation already undertaken

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

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

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

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

Interest limitation

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

General reaction

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

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

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

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

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

Allowable debt levels

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

The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest-bearing debts (a "non-debt liability adjustment"). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

General reaction

Several submitters indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

A number of other submitters argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

Stakeholders' views displayed no clear pattern. Two big accounting firms agreed with the proposal while two others disagreed. Similarly, of the three major stakeholder groups who submitted on the proposal, one supported and two opposed the change.

Deferred tax

To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future;
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

Further consultation

Following Cabinet decisions in July 2017, officials are planning to undertake further public consultation on outstanding policy issues, technical design details and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Related-party interest rates

We have identified five mutually exclusive options to the address the problem of excessive interest rates on related-party debts.

Option 4 (administrative guidance) is a non-regulatory option. The other options for change involve changing New Zealand's tax legislation.

Option 1: Interest rate cap (discussion document proposal)

As described in section 2.5.

Option 2: Restricted transfer pricing

Under a restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
    - That the loan has no exotic terms that are generally not seen with third-party lending
    - That the loan is not subordinated
    - That the loan duration is not excessive
    - That the debt level of the borrower is not excessive.

The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign

parent.

This restricted transfer pricing rule would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable.

This option was developed following consultation to address some of the concerns raised by submitters; however, it has not itself been subject to consultation.

Option 3: Adopt EBITDA-based rule (OECD recommended approach)

This option would involve limiting the amount of interest deductions a taxpayer is allowed with reference to their earnings (specifically, their profits before deductions for interest, depreciation and amortisation are taken into account, also known as their EBITDA). This new approach would completely replace the thin capitalisation rules, becoming the new method for limiting interest deductions for taxpayers with international connections.

This approach would constrain the tax effectiveness of highly priced debt, since it directly limits interest deductions rather than limiting the amount of debt; a taxpayer with highly priced debt would be more likely to exceed their EBITDA limit and face interest denial.

Almost all submitters did not support the adoption of an EBITDA-based rule.

Option 4: Administrative guidance

This option would involve Inland Revenue issuing administrative guidance on how it will assess the risk of related-party lending transactions – similar to what has recently been released by the Australian Taxation Office (ATO) (discussed below).

Under this option, related-party loans with certain features (such as having an interest rate in line with the interest rate facing the borrower's foreign parent) would be given a low risk rating and be unlikely to be challenged by Inland Revenue. Taxpayers with higher interest rates would be more likely to have their related-party loan investigated.

Several submitters suggested this option be adopted in place of the interest rate cap. They argued that it would provide certainty for taxpayers who desired it, but taxpayers who value certainty less would be free to breach the guidelines.

Option 5: Status quo (ordinary transfer pricing)

This option would involve continuing to price related-party debt under the transfer pricing rules. As discussed above, the Government proposed strengthening these rules in the discussion document *BEPS – transfer pricing and permanent establishment avoidance.* Many submitters argued that this should be sufficient to address any concerns over related-party interest rates.

Relevant experience from other countries

The ATO has released draft guidelines regarding the interest rates of cross-border related-party loans.[1] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

Allowable debt levels

We have identified three mutually exclusive options relating to setting the allowable debt level under the thin capitalisation rules.

The options (other than the status quo) involve changing New Zealand's tax legislation.

Option 1: Proceed with non-debt liabilities adjustment (as proposed in the discussion document)

As described in section 2.5.

Option 2: Proceed with non-debt liabilities proposal excluding deferred tax

Under this option, a taxpayer's deferred tax would be ignored for the purposes of the non-debt liability adjustment. That is, a taxpayer's allowable debt level would be set with reference to the result of the formula: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Of submitters who supported the proposed non-debt liability adjustment in principle, this was the preferred option.

Option 3: Status quo (do not proceed with non-debt liabilities adjustment)

Under this option, maximum deductible debt levels would continue to be calculated under the thin capitalisation rules with reference to assets, ignoring non-debt liabilities.

As mentioned in section 2.5, this was the preferred option of some submitters.

Relevant experience from other countries

Australia has thin capitalisation rules that are broadly similar to New Zealand's. Australia's rules currently require a non-debt liability adjustment, but deferred tax is carved-out. That is, Australia's rules are consistent with option 2.

---

[1] ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions, PCG 2017/D4.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible;
- *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way;
- *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible;
- *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible; and
- *Sustainability* – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

Efficiency, fairness and sustainability are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these three criteria.

3.3 What other options have been ruled out of scope, or not considered, and why?

No options were ruled out of scope.

Section 4: Impact Analysis

	Option 1 (interest rate cap)	Option 2 (restricted transfer pricing)	Option 3 (EBITDA-based rule)	Option 4 (administrative guidance)	Status quo
Efficiency and neutrality	+ Option 1 will provide a strong limit on related-party interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains. However, for some firms the interest rate allowed under the cap may be too low, which lowers the efficiency benefits.	++ Option 2 will provide a reasonably strong limit on related-party debt interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains.	0 Option 3 will provide an effective limit on all interest expenses (including related-party interest expenses). However, it also increases the uncertainty of returns on New Zealand investment, since whether or not interest is deductible turns on a taxpayer's EBITDA, which can be very variable.	+ Some taxpayers would benefit from the certainty provided by the administrative safe harbour. However, for taxpayers willing to exceed the safe harbour, this option is no different than the status quo – excessive interest rates on related-party debt would still be possible.	0
Fairness and equity	++ Option 1 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	++ Option 2 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	0 On the one hand, option 3 would be somewhat effective at preventing excessive interest rates. On the other hand, it could result in interest denial for firms with very conservative interest rates and debt positions (say, for example, if a taxpayer is in loss).	0 Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. For taxpayers willing to exceed the administrative safe, harbour this option is no different to the status quo.	0
Efficiency of compliance	++ Option 1 would reduce compliance costs for many taxpayers – the allowable interest rate on related-party debt would be set on a clear objective factor (the credit rating of the foreign parent). However, in some cases – where the non-resident parent has no credit rating – compliance costs will stay the same or could potentially increase.	+ Option 2 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo)	0 Compliance costs in some instances would reduce under option 3, as there would be fewer transfer pricing disputes about related-party debt. However, an EBITDA-based rule would be a fundamental shift in our interest limitation rules – taxpayers and agents would have to come to grips with an entirely new regime.	+ Option 4 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo).	0

Efficiency of administration	++ Option 1 would avoid the need for potentially complex and expensive disputes over whether the interest rate on related-party debt is set appropriate.	++ Option 2 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. For the remaining taxpayers, the restrictions (e.g. striking out exotic terms) would simplify the transfer pricing analysis.	+ Option 3 would reduce administration costs because there would be less need to review and challenge related-party loans under transfer pricing.	+ Option 4 would reduce the need to review the interest rates of taxpayers utilising the safe harbour.	**0**
Sustainability	+ Option 1 would apply to taxpayers that have structured their affairs to strip the maximum profits out of New Zealand; however, it could also affect the interest rates of less aggressive taxpayers.	++ Option 2 should generally only affect taxpayers with more aggressive debt structures.	**0** Option 3 could result in interest deduction denial even if a taxpayer has conservative debt levels.	+ Option 4 would not prevent firms from achieving excessive interest rates on related-party debt.	**0**
Overall assessment	+	++ **Recommended option**	**0**	+	**0**

Key:

++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Allowable debt levels

	Option 1 (non-debt liability adjustment)	Option 2 (adjustment with no deferred tax)	Status quo
Efficiency and neutrality	+ Option 1 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, submitters have argued that in some instances deferred tax (a type of non-debt liability) does not represent real liabilities; to the extent this is correct, reducing allowable debt levels in relation to these liabilities could hamper efficiency.	+ Option 2 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, this option carves out all types of deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option would allow some taxpayers to have too high a debt level.	**0**
Fairness and equity	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, submitters have argued that in some instances deferred tax does not represent a real liability. To the extent this is correct, including deferred tax in the non-debt liability adjustment could be seen as unfair.	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, this option excludes all deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option will not treat taxpayers in the same situation the same.	**0**
Efficiency of compliance	**0** Neither option will have a significant impact on compliance costs. The result of both options is just a change to how the existing thin capitalisation calculations are carried out. However, there may be some one-off compliance costs if the changes mean taxpayers breach their thin capitalisation limits and, as a result, decide to restructure their borrowing.		**0**
Efficiency of administration	**0** Neither option has a significant impact on administrative costs. Thin capitalisation calculations are carried out by taxpayers – this change has no substantive impact on Inland Revenue.		**0**
Sustainability	+ Both options similarly target firms with debt levels that are too high relative to their levels of equity and are therefore well targeted. Firms with low levels of debt, or with reasonable levels of debt relative to equity, will be largely unaffected by either option.		**0**
Overall assessment	+	+	**0**

Key: ++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Interest limitation

We consider that option 2 – developing a restricted transfer pricing approach – is the best option to limit interest expenses in relation to inbound related-party debt.

Following consultation and further analysis, we consider that if the Government pursued the interest rate cap (option 1), adjustments would be needed to the original discussion document proposal which would make it more complex. For example, to address some of the concerns expressed by submitters, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

The difficulty is, however, that simply relying on transfer pricing, as suggested by some submitters, will not achieve the desired policy outcomes. It is clear that the international consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. In addition, as noted in section 2.5, commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

Accordingly, we consider that the restricted transfer pricing rule is the best approach. Like the interest rate cap, it will ensure the policy objective – ensuring there is a robust mechanism for determining the interest rates for inbound related-party debt; however, since the restricted transfer pricing rule has more flexibility (compared to the interest rate cap – the other option that would most effectively achieve the policy objective) it is both more efficient and fairer.

Owing to the time available (and since it was developed subsequent to the initial consultation), this option has not been subject to consultation with stakeholders. This modification will address many, but not all of, submitters' concerns – it is still a departure from using ordinary transfer pricing. Nevertheless, we expect that it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur frequently because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

Allowable debt levels

At this stage, we do not have a preference between option 1 (non-debt liability adjustment as originally proposed) and option 2 (non-debt liability adjustment with deferred tax carve-out). Option 3 (status quo) is not preferred.

Both options 1 and 2 have similar impacts in terms of efficiency and fairness (and have no significant impacts in terms of compliance and administration costs). The non-debt liability adjustment in option 1 is potentially too extensive because of the inclusion of *all* types of deferred tax, but, on the other hand, the adjustment in option 2 is too narrow because of the exclusion of all deferred tax.

We consider that the best approach is to recommend neither options 1 or 2 at this stage, but instead consult further with stakeholders on whether there is another feasible option (since this is a minor technical detail, more consultation on this matter is feasible). For example, it might be possible to identify deferred tax liabilities that are the least likely to result in a future tax payment, and restrict the carve-out of deferred tax to just that identified group.

5.2 Summary table of costs and benefits of the preferred approach

Related-party interest rates

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40m per year	Medium
Regulators	Administration costs: There will be a one-off cost to Inland Revenue in developing guidance on how the new rules will operate.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40m per year	Medium
Non-monetised costs	Administration costs	Low	High
Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Reduction in compliance costs for firms that utilise safe harbour.	Medium	High
Regulators	Revenue: Tax collected will increase. Administration costs: Reduction in costs for ensuring related-party interest rates are appropriate.	Approximately $40m per year Medium	Medium High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40m per year	Medium
Non-monetised benefits	Compliance and administration cost reduction	Medium	High

Allowable debt levels

While a preferred option is not recommended, the costs and benefits of any option that is selected will be similar

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40–50m per year (depending on option)	High
Regulators			
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40–50m per year	High
Non-monetised costs			

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Tax collected will increase.	Approximately $40–50m per year (depending on option)	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40–50m per year	High
Non-monetised benefits			

5.3 What other impacts is this approach likely to have?

As discussed above, allowing BEPS through interest deductions is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take use interest deductions to reduce their New Zealand (and possibly worldwide) tax liability is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders. It is something that is fundamental to the tax system itself, which all of the stakeholders already discussed have an interest in preserving.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Implementation of both reforms (relating to related-party interest rates and allowable debt level) will be given effect through a combination of legislation and Inland Revenue administrative guidance. The legislative changes proposed will be progressed (subject to Cabinet approval) as part of a BEPS taxation bill to be introduced in late 2017. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin*.

In relation to the allowable debt level proposal, we will consult further with stakeholders on whether a preferred option can be identified. The Minister of Finance and Minister of Revenue will make the final decision on which option should be progressed (option 1, option 2, or a potential new option) following this consultation.

These reforms are expected to apply from income years beginning on or after 1 July 2018, subject to legislation progressing to enactment before this date.

Some submitters on the discussion document argued that transitional relief or grandparenting should be provided to give taxpayers sufficient lead-in time to restructure their affairs if necessary. We consider that the planned application date of 1 July 2018 is sufficiently prospective because:

- the interest rate proposal applies only to related-party transactions (which are more easily altered compared to transactions with third-parties); and
- in relation to the allowable debt level proposal, debt and asset levels under the thin capitalisation rules can be measured as at the end of the relevant income year, meaning taxpayers would have until at least 30 June 2019 to rearrange their affairs.

In addition, in response to consultation, we propose that advanced pricing agreements

(APAs) existing prior to the application date of these changes will be grandparented.

Once the proposals are implemented, Inland Revenue will be responsible for the ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

6.2 What are the implementation risks?

There is the risk that the relevant transfer pricing legislation could contain unintended errors or have unintended consequences. However, this risk can be efficiently managed by way of remedial amendments.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. Inland Revenue closely monitors the tax affairs of New Zealand's largest companies (which are, in general, the affected population of these proposals). For example, Inland Revenue currently collects data from these firms on their debt levels (including levels of related-party debt) through its International Questionnaire. This will allow how the proposals have impacted debt levels and related-party interest payments to be analysed.

More generally, Inland Revenue is considering the appropriate level of information that should be collected to support the proposed rules for all the BEPS measures being implemented. Any additional information may be collected via a disclosure statement that must be provided to Inland Revenue or it may be collected using existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTTP involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, following enactment, any changes identified as necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – transfer pricing and permanent establishment avoidance

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to prevent permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue investigate uncooperative multinationals. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Some large multinationals are currently using tax arrangements which allow them to report low taxable profits in New Zealand despite carrying on significant economic activity here.

3. In March this year, the Government released a discussion document called *BEPS – Transfer pricing and permanent establishment avoidance* to consult on proposals to combat these arrangements. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

4. Submissions and workshops with the private sector were used to refine the proposals and better target them at the BEPS activities we are concerned about, whilst reducing the compliance costs and other unintended impacts on taxpayers engaging in ordinary, commercial dealings.

5. We recommend that nearly all of the proposals in the discussion document proceed, subject to some changes following consultation. The most significant changes made to the original proposals as a result of consultation were:

- The proposed permanent establishment (PE) avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

- Clarification of the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

- The proposal to require disputed tax to be paid earlier should not proceed. This is because we consider it to be unnecessary in light of the current "use of money" interest rate regime.

6. These changes are likely to be welcomed by submitters and do not reduce the overall effectiveness of the proposed reforms.

7. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

8. The forecast tax revenue from implementing the transfer pricing and PE avoidance measures is $25m in 2018/19 and $50m per annum from 2019/20. Some of this revenue has already been included in the Budget 2017 forecasts.

Background

9. In February this year, Cabinet agreed to release the Government discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (CAB-17-MIN-0041 refers).

10. The discussion document, which was released in March 2017, consulted on proposals to combat aggressive tax strategies which allow some multinationals to report low taxable profits in New Zealand despite carrying on significant economic activity here. These strategies involve:

- ***Tax structuring***: In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (a permanent establishment or "PE") in New Zealand. However, non-residents can structure their affairs to avoid such a taxable presence, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).

- ***Creating enforcement barriers:*** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.

11. The OECD and the G20 are also concerned about these kinds of BEPS strategies, and have recommended measures to address them in their 15 point BEPS Action Plan. These include:

- a widened definition of "permanent establishment" for double tax agreements (DTAs), to counter PE avoidance (however this will only be included in a DTA if both countries agree); and

- updated transfer pricing guidelines, to counter profit shifting.

Comment

12. We have developed a package of proposed tax law changes to combat transfer pricing and PE avoidance. The main elements of the proposed reform package are:

- The introduction of a new PE avoidance rule that will prevent multinationals from structuring their operations to avoid having a PE in New Zealand where one exists in substance.

- Stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income.

- Stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities. We also

propose shifting the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length, and extending the time bar (the period of time which Inland Revenue has to reassess a taxpayer) from four years to seven years for transfer pricing.

- A range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues). These are similar to some of the administrative powers provided under the UK and Australia's Diverted Profit Taxes but New Zealand's administrative measures are more targeted at the practical barriers faced by tax investigators as they will only apply when a multinational does not cooperate with a tax investigation.

13. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment to address issues that Inland Revenue has identified when investigating multinationals.

Private sector consultation

14. 15 submitters provided written submissions on the discussion document. The Treasury and Inland Revenue also met with six of these submitters to discuss their submissions.

General reaction

15. Overall, most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more certain and better targeted.

16. Two of the 15 submitters welcomed the proposals as a positive step by the Government to ensure that all large multinationals are paying their fair share of tax.

17. The other 13 submitters were tax advisors or represent multinationals that could be negatively affected by the proposals. Their submissions were critical of some of the measures.

18. Some submitters argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. As noted in the accompanying covering Cabinet Paper (*Tax measures to prevent base erosion and profit shifting*), there will be additional tax and compliance costs for some investors but these additional costs will mostly be borne by taxpayers engaging in BEPS activities and the overall benefits to New Zealand of addressing BEPS outweigh these costs.

19. As expected, most of the submitters opposed the administrative proposals to increase Inland Revenue's powers to investigate multinationals. However, we consider these new powers are necessary to ensure Inland Revenue can effectively enforce the new rules. These new powers include:

- Expanding Inland Revenue's ability to request information that is held by a related group member offshore. Submitters considered this proposal could unfairly penalise a New Zealand entity that may not be able to get the information from their multinational group members. However, we consider it is unacceptable for Inland Revenue's investigations to be frustrated because a multinational group fails to provide information that is under its control.

- Shifting the burden of proof for transfer pricing onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length. Submitters considered Inland Revenue had information regarding comparable transactions and should bear the burden of proof. However, shifting the burden of proof is consistent with the fact that the taxpayer holds the relevant information on their own transfer pricing practices. The burden of proof is already on the taxpayer for other tax matters and is also on the taxpayer for transfer pricing matters in most other OECD and G20 countries, including Australia. Because most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries, the additional compliance costs from this change are not expected to be substantial.

- Extending the time bar (the period of time which Inland Revenue has to adjust a taxpayer's transfer pricing position) from four years to seven years for transfer pricing. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have a special seven year time bar for transfer pricing) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Changes made as a result of consultation

20. In response to submissions, we have updated the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

21. Many submissions focused on when the PE avoidance rule would apply. Submitters considered the proposal outlined in the discussion document applied too broadly and could have unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

22. We consider the PE avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

23. Submitters also pointed out that the OECD has updated their model DTA to address PE avoidance and New Zealand is currently in the process of adopting this into some of our tax treaties by signing the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* and through negotiating new tax treaties. We agree that the domestic law PE avoidance rule will only be necessary when the relevant tax treaty does not yet include the OECD's new recommendation and propose narrowing the application of rule accordingly.

24. The PE avoidance rule would apply notwithstanding the relevant DTAs (that don't yet include the OECD's new model PE rule). We consider that this is acceptable for two reasons:

- The OECD's commentary to their model DTA contemplates that countries can adopt anti-avoidance rules and states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. An existing example of this is New Zealand's General Anti-Avoidance Rule which explicitly overrides our DTAs to allow New Zealand to combat tax avoidance arrangements. The PE avoidance rule would be a specific anti-avoidance rule, which would also be consistent with the principle in the OECD's commentary.

- The UK and Australia have already implemented similar PE avoidance rules in their domestic laws which override their DTAs and their treaty partners have not challenged this.

25. Another major point raised by submitters was the need to clarify the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

26. Other significant changes made as a result of consultation were:

- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.

- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money" interest rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay tax that is in dispute.

27. The above changes will make the rules more certain and better targeted and are likely to be welcomed by submitters.

28. We also recommend widening the scope of the original proposal to deem an amount of income to have a New Zealand source under our domestic legislation if we have a right to tax the income under a DTA. The rule proposed in the discussion document was limited to income covered by the PE and royalty articles of our DTAs. We should extend the rule to all types of income that we can tax under a DTA – as Australia does. This ensures we can exercise a taxing right that we have negotiated under a DTA. We will consult further on this wider proposal in the next round of consultation.

29. These recommended changes will not affect the originally forecast revenue from implementing the transfer pricing and PE avoidance measures, which is $25m in 2018/19 and $50m per annum from 2019/20 (some of this revenue has already been included in the Budget 2017 forecasts).

30. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

Agency consultation

31. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, publicity

32. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

33. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

34. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

35. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing the overall effectiveness of the proposed reforms.

3. **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure their businesses to avoid having a PE (taxable presence) in New Zealand.

4. **Agree** to expand and strengthen the rules for taxing New Zealand-sourced income by:

   - deeming certain amounts of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA;

   - introducing an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source; and

   - addressing a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand, including where the income is not subject to New Zealand tax by operation of a DTA.

5. **Agree** to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. This involves amending New Zealand's transfer pricing rules so that:

   - they disregard legal form if it does not align with the actual economic substance of the transaction;

   - they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;

   - the legislation specifically refers to arm's length conditions;

- they refer to the latest OECD transfer pricing guidelines as guidance for how the rules are applied;

- the new legislation codifies the requirement for large multinationals to provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative;

- the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased to seven years (in line with Australia);

- the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters); and

- in addition to applying to transactions between related parties, the transfer pricing rules will also apply when non-resident investors "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.

6. **Agree** to strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation by amending the Tax Administration Act 1994 to allow Inland Revenue to:

   - more readily assess the multinational's tax position based on the information available to Inland Revenue at the time;

   - collect any tax owed by a member of a large multinational group from any wholly-owned group member, provided the non-resident fails to pay the tax itself;

   - use section 17 of the Tax Administration Act 1994 to request information that is held offshore by another group member of the large multinational group;

   - use section 21 of the Tax Administration Act 1994 to deem an amount of income to be allocated to a New Zealand group member or PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand sourced income (currently the existing power only applies in respect of deductible payments); and

   - impose a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty).

7. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

8. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

9. **Agree** that the results of the decisions in recommendations 3-6 and 8 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – transfer pricing and permanent establishment avoidance rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

There are international concerns about multinationals not paying their fair share of tax. This is because some multinationals use base erosion and profit shifting (BEPS) strategies to report low taxable profits in New Zealand and other countries in which they operate. These BEPS strategies include arrangements between related parties which shift profits out of New Zealand (usually into a lower taxed jurisdiction). They also include arrangements which are designed to ensure New Zealand is not able to tax any income from sales here despite there being a physical presence in New Zealand in relation to the sales. These particular BEPS strategies are known as transfer pricing and permanent establishment (PE) avoidance. Finally, Inland Revenue faces administrative difficulties in investigating large multinationals.

Proposed Approach

How will Government intervention work to bring about the desired change? How is this the best option?

The proposed approach is to adopt the package of measures outlined in the Government discussion document *BEPS – transfer pricing and permanent establishment avoidance (March 2017),* with some changes resulting from consultation, as the measures will:

- ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;
- stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and
- make it easier for Inland Revenue to investigate such multinationals.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit by receiving an additional $50 million of revenue per annum. Compliant businesses will benefit because the multinationals involved in transfer pricing and PE avoidance activities will no longer be able to achieve a competitive advantage. Also, the measures will support voluntary compliance by protecting the integrity of the tax system.

Where do the costs fall?
Multinationals which currently engage in BEPS activities will face a medium level of compliance costs. These taxpayers may choose to transition into more tax compliant agreements which will require restructuring costs; or they may apply for advance pricing agreements (APAs). However, the majority of multinationals are compliant and should not be materially affected by the proposals.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is a risk that foreign companies investing in New Zealand will view the proposals as complex and onerous, incentivising them to remove their existing personnel from New Zealand or to cease operating in New Zealand altogether. However, most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is limited certainty of evidence in relation to the problem of transfer pricing and PE avoidance arrangements. This is because such activities are often not directly observable in the absence of specific audit activity. However, Inland Revenue is aware of about 16 cases involved in these types of BEPS arrangements which are currently under audit. While there are only 20 New Zealand-owned multinationals that earn over the threshold for some of the main proposals (over EUR €750 million of consolidated global revenue), the European Union (EU) has estimated that there may be up to 6,000 multinationals globally

that do. However, we do not know how many of these global multinationals operate in New Zealand.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed *the BEPS – transfer pricing and permanent establishment avoidance rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – transfer pricing and permanent establishment avoidance rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem
Our analysis has been limited somewhat by our inability to assess the exact size of the transfer pricing and PE avoidance structures in New Zealand. In common with BEPS activities generally, transfer pricing and PE avoidance is difficult to quantify as tax avoidance is often not directly observable. We consider that, while most multinationals are compliant, there is a minority that engage in transfer pricing and PE avoidance. Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not addressed. Furthermore, as New Zealand endorses the Organisation for Economic Co-operation and Development's (OECD) *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan), there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.
Range of options considered
Our analysis of options has been primarily constrained by New Zealand's double tax agreements (DTAs). Under its DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.
Assumptions underpinning impact analysis
The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of transfer pricing and PE avoidance arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs, and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to the aggressive tax planning strategies used by some multinationals to pay little or no tax anywhere in the world. This outcome is achieved when multinationals exploit gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In 2013, the OECD published its BEPS Action Plan which identified actions needed to address BEPS (including transfer pricing and PE avoidance), set deadlines to implement these actions, and identified the resources needed and the methodology to implement these actions. In 2015, the OECD released its final package of recommended actions for countries to implement to counter BEPS.

If no action is taken to counter transfer pricing and PE avoidance arrangements, multinationals that are currently engaging in these types of arrangements will be able to continue, and the number of these types of avoidance cases will continue to increase.

New Zealand's BEPS work

New Zealand is a supporter of the OECD/G20 BEPS project to address international avoidance and is advancing a number of the OECD/G20 BEPS recommendations.

In September 2016, the Government released the BEPS discussion document *Addressing hybrid mismatch arrangements*. In March 2017, the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*; along with the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*.

The *BEPS – Transfer pricing and permanent establishment avoidance* discussion document consulted on the Government's proposal to introduce a new set of tax rules to counter BEPS activities involving transfer pricing and PE avoidance. Many of the proposals follow the OECD's BEPS Action Plan recommendations (such as updating our transfer pricing legislation to align with the OECD's new transfer pricing guidelines).

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework ensures the tax system is not generally used to deliver incentives or encourage particular behaviours.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge is to ensure that our tax rules are up to date and result in multinational firms paying a fair and efficient amount of tax in New Zealand. Base protection measures, such as transfer pricing and PE rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

New Zealand's PE rules

New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules in conjunction with our DTAs. Under our DTAs, New Zealand is generally prevented from taxing a non-resident's business income unless the non-resident has a PE in New Zealand. This is the case even if that income has a source in New Zealand under our domestic legislation.

In general, New Zealand can only tax a non-resident multinational group on its sales here if both of the following conditions are met:

- The multinational group has a sufficient taxable presence in New Zealand. This means the group must operate in New Zealand either through a New Zealand-resident subsidiary (in which case the subsidiary is taxable on its income) or through a PE of a non-resident group member. A PE is basically a place of business of the non-resident, but it also includes an agent acting for the non-resident.
- Where a multinational operates in New Zealand through a PE of a non-resident group member, some of the non-resident's net profits from its sales can be attributed to its taxable presence here. This involves determining:
    - The amount of the non-resident's gross sales income which can be attributed to its PE here; and
    - The amount of the expenses which can be deducted from that income to determine the net taxable profits in New Zealand.

The non-resident must also have a sufficient taxable presence in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

New Zealand's transfer pricing rules

"Transfer pricing" refers to the use of cross-border payments between associated entities such as a parent and a subsidiary. Transfer pricing rules are therefore concerned with

determining the conditions, including the price (and therefore the tax liability), for transactions within a multinational group resulting in the allocation of profits to group companies in different jurisdictions.

New Zealand's transfer pricing legislation was first introduced in 1995 and is largely focused on the legal form of the transaction and adjusting the consideration that is paid to an arm's length amount (which can be zero). Due to the increased complexity and tax planning of cross-border intra-group trade over the last 22 years, New Zealand's existing transfer pricing rules are unable to adequately address some types of profit shifting.

General anti-avoidance rule (GAAR)

New Zealand also has a general anti-avoidance rule (GAAR) which effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. However, the GAAR is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own.

2.3 What is the policy problem or opportunity?

The problem of transfer pricing and PE avoidance

Some multinational companies operating in New Zealand exploit deficiencies in the current international tax system (both in New Zealand and abroad) by using transfer pricing and PE avoidance strategies to report low taxable profits in New Zealand despite carrying out significant economic activity here. Transfer pricing and PE avoidance can lead to unfairness and the substitution of low-taxed investors for tax-paying investors. This has the potential to reduce national income while doing little or nothing to reduce the overall pre-tax cost of capital to New Zealand or increase the overall level of investment. It also distorts the allocation of investment by favouring foreign investors who set out to game the system.

Transfer pricing avoidance

One of the major strategies used by multinationals to shift profits out of New Zealand and reduce their worldwide tax bills is transfer pricing. Related parties may agree to pay an artificially high or low price for goods, services, funding, or intangibles compared to the "arm's length" price or conditions that an unrelated third party would be willing to pay or accept under a similar transaction. By manipulating these transfer prices or conditions, profits can be shifted out of New Zealand and into a lower-taxed country or entity.

PE avoidance

Some multinationals reduce their New Zealand tax liability by structuring their affairs to avoid a PE arising, despite carrying on significant activity here.

Impacted population

These rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Many of the proposed measures will apply only to multinational groups with over EUR €750 million of consolidated global revenue. While there are only 20 New Zealand-owned multinationals that earn this much, the EU has estimated that there may be up to 6,000

multinationals globally that do. However, we do not know how many of these global multinationals operate in New Zealand.

Transfer pricing and PE arrangements in New Zealand

Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not strengthened. Furthermore, as New Zealand endorses the OECD's BEPS Action Plan, there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Inland Revenue's judgement is that the transfer pricing and PE proposals can expect to add $50 million a year of revenue to the forecasts. This $50 million per year estimate relates to the fact that the proposals will make it more difficult to avoid tax under the transfer pricing and PE rules and easier to find and assess any remaining avoidance cases. This should reduce future avoidance arrangements and free up investigator resources. The changes will also result in more revenue being able to be assessed from any multinationals which continue to use transfer pricing or PE avoidance arrangements.

2.4 Are there any constraints on the scope for decision making?

Our analysis of options has been primarily constrained by New Zealand's DTAs. Under our DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. The OECD guidance permits departure from this only in respect of tax avoidance. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

2.5 What do stakeholders think?

Submissions on the discussion document

The Government received 16 submissions on the discussion document from key stakeholders.[1] We also met with six of the main submitters to discuss their submissions in more detail.

Many submitters strongly opposed the proposals that increased Inland Revenue's power to investigate large multinationals. Others argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented.

However, most submitters accepted the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. Some submitters even welcomed the proposals as a positive step by the Government to ensure multinationals pay their fair share of tax.

Further consultation

Following Cabinet decisions in July 2017, we are planning to undertake further public

[1] Most of the submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

consultation on outstanding policy issues, technical design details, and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Officials have identified four mutually exclusive options to address the problem:

- Option 1 – Status quo
- Option 2 – MLI and the OECD's transfer pricing guidelines
- Option 3 – Diverted profit tax
- Option 4 – Discussion document proposals (as amended through consultation)

Option 1 is the only non-regulatory option. The other options involve implementing an international agreement or changing New Zealand tax legislation.

Option 1: Status quo

This option would retain the existing tax rules for multinationals (as described in the sections above). Under this option, Inland Revenue would continue trying to enforce the existing rules and/or apply the GAAR to challenge tax avoidance arrangements.

Option 2: MLI and the OECD's transfer pricing guidelines

Option 2 is to rely on the combination of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI)[2] and the OECD's transfer pricing guidelines without amending our domestic law. Under this option, any PE avoidance issues would be addressed under the OECD's new PE definition in the MLI, and any transfer pricing issues would be addressed by applying the OECD's new transfer pricing guidelines.

Option 3: Diverted profits tax

Option 3 is to adopt a diverted profits tax (DPT). A DPT is a separate tax on the "diverted profits" that arise from transfer pricing and PE avoidance. It is levied at a penal rate, compared with income tax, and has greatly enhanced assessment and collection powers. Both the UK and Australia have already implemented a DPT to target multinationals engaging in BEPS strategies. DPTs are intended to incentivise taxpayers to pay the correct amount of income tax under the normal rules rather than to raise revenue by themselves.

Option 4: Discussion document proposals (as amended through consultation)

This option involves adopting the package of measures proposed in the discussion document, with some changes resulting from consultation. The discussion document proposals have taken certain features of a DPT and combined them with the OECD's BEPS measures and some domestic law amendments to produce a package of measures that is tailored for the New Zealand environment. The intention is that this approach would be as effective as a DPT in addressing transfer pricing and PE avoidance in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. Under this option, we would introduce:

- an anti-avoidance rule that will prevent multinationals from structuring their operations

[2] The MLI allows countries to quickly and efficiently implement a number of the OECD's BEPS Action Plan measures that can only be implemented through changes to DTAs, without having to bilaterally renegotiate their existing DTAs.

to avoid having a PE (a taxable presence) in New Zealand where one exists in substance;

- stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities; shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length; and extend the time bar for transfer pricing from four years to seven years;
- stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income; and
- a range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation (such as allowing Inland Revenue to request information that is held by an offshore group member).

Consultation

These four options were identified prior to consultation. The discussion document proposed the adoption of a package of reforms combining elements of a DPT with the OECD's recommendations and some domestic law amendments (option 4). The discussion document discussed the status quo (option 1) and the DPT (option 3). Some submitters proposed that the better approach would be to sign the MLI and apply the OECD's transfer pricing guidelines without amending our domestic law (option 2).

In response to consultation we have refined the proposals so they are better targeted at BEPS arrangements with less compliance costs and fewer unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

Significant changes made as a result of consultation were:

- More narrowly targeting the PE avoidance rule at avoidance arrangements (we will consult further on how best to achieve this).
- Clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.
- The PE avoidance rule will only apply where an applicable DTA does not include the OECD's widened PE definition (as in cases where the OECD's new PE definition is included, the proposed PE avoidance rule will be unnecessary).
- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money interest" rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay any tax which has been assessed.

The above changes are likely to be welcomed by submitters.

Evidence from Australia's reforms

Australia's recent experience updating their transfer pricing laws (in 2013) and introducing a new Multinational Anti-Avoidance Law (MAAL) demonstrates the effectiveness of tax reforms

to address PE avoidance and transfer pricing issues.

Australia's MAAL came into effect on 11 December 2015 and prevents multinationals from structuring their affairs to avoid having a PE in Australia. It is very similar to our proposed PE avoidance rule.

As of 4 June 2017, the Australian Tax Office (ATO) had identified 221 taxpayers they believed to be shifting profits to a non-resident group member resident in a low-tax jurisdiction. Of these 221 taxpayers, the ATO has cleared 102. Furthermore, since the MAAL was introduced, 18 companies with PE avoidance structures have restructured their affairs to bring their sales onshore – and a further 11 are currently working with the ATO to restructure.

According to the ATO, as a result of the introduction of the MAAL, an additional AUS$6.4 billion worth of assessable income will now be reported in Australia. This translates into $100 million a year in additional tax revenue for Australia.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible;
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible;
- Neutrality – the tax system should bias economic decisions as little as possible;
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way; and
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality, and fairness impacts without some increase in compliance costs and so there are some trade-offs that were, and continue to be, considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

Two options were ruled out of scope due to their radical nature, namely:

- cancel New Zealand's DTAs; and
- prevent multinationals from selling products in New Zealand if they were suspected of involvement in BEPS activities.

The former would harm New Zealand exporters and outbound investors. The latter would not only harm New Zealand consumers (as they would no longer be able to import certain goods), but it would also violate New Zealand's trade agreements.

Section 4: Impact Analysis

	Option 1: Status quo	Option 2: MLI and the OECD's transfer pricing guidelines	Option 3: Diverted profit tax	Option 4: Discussion document proposals (as amended through consultation)
Efficiency of compliance	**0**	- Option 2 imposes increased compliance costs on taxpayers as a result of applying the MLI and the new transfer pricing guidelines.	- - Option 3 imposes ongoing compliance costs on taxpayers as it requires them to provide information or concede transfer pricing outcomes in transfer pricing audits.	- Option 4 imposes increased compliance costs on taxpayers as they will be required to conform to the additional administrative measures. See below for further details.
Efficiency of administration	**0**	**0** We do not expect there will be increased administrative costs under this option as the reforms largely change the way some taxpayers self-assess the income and deductions they report to Inland Revenue.	- We expect there will be increased administrative costs under this option as a DPT is a separate tax from an income tax.	**0** We do not expect there will be increased administrative costs under this option. The proposed administrative measures should also make it easier for Inland Revenue to investigate uncooperative multinationals. See below for further details.
Neutrality	**0**	+ Option 2 will remove some of the tax benefit of currently observed transfer pricing and PE avoidance opportunities in New Zealand. See below for further details.	+ Option 3 will remove the tax benefit of currently observed transfer pricing and PE avoidance opportunities involving New Zealand. However, it may have a negative impact on investment certainty for taxpayers.	+ + Option 4 will remove the tax benefit of all currently observed transfer pricing and PE avoidance opportunities involving New Zealand. See below for further details.
Fairness and equity	**0**	+ Option 2 has some fairness benefits as it ensures that some taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	**0** Option 3 has some fairness benefits as it ensures that taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	+ Option 4 has the most fairness benefits as it ensures that all taxpayers able to use observed transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others.
Sustainability	**0**	+ Option 2 will remove some, but not all, of the current transfer pricing and PE establishment opportunities involving New Zealand.	+ Option 3 will remove current transfer pricing and PE establishment opportunities involving New Zealand. See below for further details.	+ + Option 4 will remove current transfer pricing and PE establishment opportunities involving New Zealand and is well-targeted at the problems that have been observed by Inland Revenue in New Zealand.
Overall assessment	Not recommended	Not recommended	Not recommended	**Recommended**

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Option 2 (MLI and the OECD's transfer pricing guidelines)

- **Neutrality:** The effect of this option will be limited as the MLI will not cover many of our DTAs and New Zealand's current transfer pricing legislation does not allow us to apply some of the new transfer pricing guidelines.
- **Fairness and equity:** While option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements.

Option 3 (Diverted profits tax)

- **Fairness and equity:** While option 2 has some fairness benefits, it also has some significant fairness detriments owing to its penal tax rate, reduced taxpayer rights, and wide scope. Further, a DPT could also impact on the perception of the fairness of New Zealand's tax system for multinationals investing into New Zealand.
- **Sustainability:** Compared to the other options it would provide less certainty for, and impose more compliance costs on, taxpayers.

Option 4 (Discussion document proposals (as amended through consultation))

- **Efficiency of compliance:** It is also highly likely that a number of taxpayers will choose to restructure their affairs and/or apply APAs.
- **Efficiency of administration:** The proposals may place a higher demand on Inland Revenue's transfer pricing team and more transfer pricing specialists may be required to deal with this.
- **Neutrality:** This option will ensure multinationals engaged in BEPS activities are not tax-advantaged over more compliant domestic and non-resident businesses. This will provide some efficiency gains.

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 4 (discussion document proposals (as amended through consultation)) is the best option to combat transfer pricing and PE avoidance.

Option 4 will improve the neutrality of New Zealand's tax system by eliminating the ability for multinationals to engage in aggressive transfer pricing and PE avoidance schemes to receive tax benefits. Option 4 will:

- ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;
- stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and
- make it easier for Inland Revenue to investigate such multinationals.

Option 4 will also improve the equity and fairness of New Zealand's tax system. Multinationals engaging in BEPS activities are currently able to structure their affairs to receive unintended tax benefits placing them at a competitive advantage over more compliant multinationals or domestic companies. As a result, these more compliant multinationals and domestic companies end up suffering a greater tax burden. Option 4 will therefore ensure that the tax burden is shared more equally among taxpayers.

While option 4 will impose additional tax and compliance costs on some taxpayers, it is important to note that some of the measures will only apply to large multinational groups with over EUR €750 million of consolidated group turnover. Submitters on the discussion document argued that the imposition of higher tax payments may make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, as a number of like-minded countries throughout the OECD are undertaking similar BEPS measures, we believe that any impacts on foreign direct investment into New Zealand will not be material and that implementing the proposals in option 4 remains in New Zealand's best economic interests (see further discussion in section 5.3 below).

Option 1 (status quo) was preferred by a number of submitters to the discussion document. However, retaining the current rules would mean that those multinationals engaging in aggressive transfer pricing and PE avoidance structures would be able to continue, and the number of these types of avoidance cases would continue to increase. While New Zealand has a GAAR (see above in section 2.2), it is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own. This is because applying the GAAR often leads to resource-intensive court cases and it may be difficult to show that certain avoidance structures fail the Parliamentary contemplation component of the GAAR.

Option 2 (MLI and the OECD's transfer pricing guidelines) was the option suggested by many submitters. However, we consider that adopting the OECD's recommendations on their own (without corresponding domestic amendments) would not effectively address the issue of transfer pricing and PE avoidance. First, New Zealand's existing transfer pricing legislation does not contemplate an ability to apply some important aspects of the new OECD's transfer pricing guidelines. This means that Inland Revenue would only be able to

apply the guidelines to the extent that our current domestic rules allow. Domestic law changes would likely be needed to adequately address the issue. Second, while option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements. This is because the MLI will only apply where both countries choose to adopt it – and many of New Zealand's trading partners do not intend to adopt it. It is therefore important that New Zealand adopt its own PE avoidance measure to supplement the MLI, otherwise there would still be a gap for multinationals to exploit. Third, the OECD's BEPS measures do not address issues specific to New Zealand, such as issues with our current source rules and the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes).

Option 3 (diverted profits tax) is not recommended. This option would provide less certainty for, and impose significant compliance costs on, taxpayers. This is because a DPT is a separate tax at a much higher rate than the standard company tax rate and includes stringent enforcement mechanisms. This means an investor may find themselves being charged a much higher rate of tax (plus interest and penalties) that can be difficult to challenge or credit against prior year losses or taxes charged by other countries. This increased risk and uncertainty may reduce their willingness to invest in New Zealand (compared to more certain investments elsewhere).

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: increased costs understanding the rules and applying them to transactions and structures for multinationals which currently engage in BEPS activities. Such taxpayers may choose to restructure which will involve compliance costs and the demand for APAs may increase.	Medium. However, they should only affect multinationals currently engaged in BEPS activities.	Medium
	Revenue	**$50 million per year**	Low*

Regulators	Administrative costs: Inland Revenue staff, particularly investigators and transfer pricing specialists, need to develop their knowledge of the proposals.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Revenue	**$50 million per year**	Low*
Non-monetised costs	Compliance costs Administrative costs	Medium Low	Medium High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Tax payable: we are confident of collecting a significant amount of revenue from the proposals. Reduced administrative costs: More powers to both request multinationals' offshore information and to investigate uncooperative multinationals should make investigating these types of BEPS arrangements easier.	**$50 million per year** Low	Low* High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	**$50 million per year**	Low*
Non-monetised benefits	Reduced administrative costs Improved voluntary compliance by supporting the integrity of the tax system in a high profile area.	Low Low	Low Low

*Note that the evidence for the $50 million figure is a conservative estimate made in light of the behavioural uncertainty associated with introducing transfer pricing and PE avoidance rules together with the fact that the full extent of these types of avoidance arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be significantly higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?

During consultation on the discussion document, some submitters raised concerns that adopting the proposed measures would have a detrimental impact on New Zealand being an attractive investment destination. In particular, these submitters were concerned that the proposed measures introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, thereby reducing GDP and lowering employment levels.

The higher tax payments and compliance obligations resulting from these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, at the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded countries throughout the OECD. Given this, we believe any impacts on foreign direct investment into New Zealand will not be material and implementing these measures remains in New Zealand's best economic interests. It is also highly unlikely that foreign companies will remove their existing personnel from New Zealand as a result of these proposals. Most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 4 (to adopt the package of measures in the discussion document) conforms to Government's 'Expectations for the design of regulatory systems'.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin* (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018.

One exception is a grandparenting rule that exempts from application of the rules all advance pricing agreements (APAs) existing prior to the application date.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider the planned application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we plan on meeting with taxpayers and preparing detailed guidance materials.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
In general, Inland Revenue monitoring, evaluation, and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. When the MAAL was introduced in Australia, 18 companies restructured their affairs to bring their sales onshore (and a further 11 are currently working with the ATO to restructure). We envisage a similar response to our proposals whereby a number of taxpayers will restructure their affairs to report their sales in New Zealand. We also expect more taxpayers to apply for APAs as a result of the new transfer pricing rules. However, it will be difficult to assess the true impact of the transfer pricing proposals. Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?
The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP. If it became apparent that an aspect of the proposed rules is significantly unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – addressing hybrid mismatch arrangements

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to address the problem of hybrid mismatch arrangements. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

3. The OECD, as part of its base erosion and profit shifting (BEPS) Action Plan, published in late 2015 its final report on hybrid mismatch arrangements. This report recommended that countries enact a comprehensive set of rules to neutralise the benefit of hybrid mismatch arrangements affecting their tax base.

4. The UK has legislated the OECD recommendations into their domestic law and Australia is committed to do the same. The EU has also issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

5. The OECD recommendations will not apply to the vast majority of taxpayers. They will not apply to purely domestic firms. They apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of the OECD recommendations is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

6. The Government released a discussion document in September 2016 called *Addressing Hybrid Mismatch Arrangements* which proposed that the OECD recommendations be adopted in New Zealand and asked for feedback on how that should best be done. Since receiving submissions to this document, officials have engaged stakeholders in targeted consultation on specific design issues relating to the proposal. Consultation has resulted in some of the proposals being modified, such as a proposed exclusion from the rules for New Zealand businesses that operate offshore only through a simple branch structure. Nevertheless, many taxpayers affected by these proposals will still oppose them. Some would prefer to see a targeted approach, which would only tackle hybrids that have already been observed in New Zealand.

7. However, in order to send the clear message that using hybrid mismatch arrangements should not produce a tax advantage, we are recommending that Cabinet agree to a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New Zealand context. To do otherwise may simply encourage the ongoing use of hybrids not covered by any targeted proposal. Other issues raised through the consultation process, and which are likely to attract the most comment (such as the application of the rules to foreign trusts) are set out in paragraphs 24-38 of this paper.

8. We are further recommending that hybrids rules be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Background

BEPS

9. New Zealand's BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan,. Its final package of reports was released in October 2015. The Action Plan is a multifaceted approach intending to encourage countries to close many (but not all) of the avenues multinational companies currently use to reduce their worldwide tax liability, and to improve the information available to governments when they deal with multinational companies, without changing the fundamental principles for the taxation of international trade and investment.

10. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

Hybrid mismatch arrangements

11. Hybrid mismatch arrangements are a significant base erosion and profit shifting (BEPS) strategy used by some multinational companies to pay little or no tax anywhere in the world on some or all of their income. They are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation.

12. One way in which this double non-taxation can arise is through a payment being deductible for a payer in one country but not included as taxable income for the payee in the other country. Another way double non-taxation can arise is by way of a single payment being deducted against different income streams in two countries.

13. Double non-taxation of this kind is difficult to deal with, because it can be achieved even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues. It is often difficult to determine which of the countries involved has lost tax revenue through the use of a hybrid mismatch arrangement, but there is undoubtedly a reduction of worldwide tax paid.

The OECD's response

14. The OECD has made a number of recommendations as to how countries can improve their domestic rules to prevent mismatches arising and neutralise their effect when they do arise. These recommendations relate to Action 2 of the OECD/G20 BEPS Action Plan: Neutralising the Effects of Hybrid Mismatch Arrangements.

15. The OECD recommends two kinds of rules. The first are rules specifically designed to reduce the likelihood of hybrid mismatches arising. The second are "linking rules", which apply to payments that give rise to a deduction in more than one country, or which give rise to a deduction in one country but are not taxed as income in another country due to a hybrid mismatch. These generally only apply to:

- arrangements between related parties (25% or more commonly owned) or control groups (50% or more commonly owned); or
- structured arrangements - generally, arrangements between non-associated parties which intentionally exploit such mismatches.

16. These linking rules are divided into "primary" and "secondary" responses. Primary responses have precedence, with secondary responses being used if the country that has the primary right does not have hybrid rules. This primary/secondary structure is important for ensuring that all hybrids with a connection to New Zealand are effectively countered irrespective of where the counterparty is based.

17. The OECD has also developed an additional BEPS Action 2 report that makes a number of recommendations as to how countries can deal with the problem of branch mismatch arrangements which is closely related to the hybrid mismatches issue.

Other countries

18. The UK has introduced into its domestic law rules that reflect a broad adoption of the OECD recommendations. Australia has proposed to do the same and, as part of its 2017 Budget, committed to introduce rules that are effective by 1 January 2018 or six months following Royal assent.[1] The EU has issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules by 1 January 2020. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

Hybrids discussion document

19. On 6 September 2016, the Government released a discussion document entitled "Addressing hybrid mismatch arrangements" seeking feedback on proposals to address hybrid mismatch arrangements in line with the OECD recommendations [CAB-16-MIN-0442].

20. 20 submissions were received on the discussion document. Most submitters accepted the need for some hybrid rules, with some submitters expressing support for New Zealand to take action in line with the OECD hybrids package, subject to various provisos, including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. The majority of submissions argued that we should only implement rules to counter hybrid mismatches actually observed in New Zealand, rather than the full suite of OECD recommendations.

---

[1] As set out in paragraph 59, Australia has indicated that it is unlikely to implement OECD recommendation 5 at this stage, but may do so in the future if integrity concerns arise.

Comment

Implementing the full OECD hybrids package

21. As set out in the cover Cabinet paper (*Tax measures to counter base erosion and profit shifting*), we are recommending that Cabinet agree to a comprehensive implementation of the OECD's proposed solutions to the hybrid and branch mismatch problem, , even though there was limited evidence of some of the structures being used in New Zealand. We are of the view that the OECD proposals are in New Zealand's best interests, as enacting these recommendations will improve fairness, reduce harmful distortions in investment patterns, increase tax revenue, and will also address the risk of taxpayers using new hybrid mismatch opportunities if only the more common techniques are addressed initially.

22. In making this recommendation, we recognise that these proposals involve considerable complexity, which will not generally be welcomed by those taxpayers affected. However, we are comfortable that there are a number of factors that outweigh these concerns:

- We are proposing to modify the OECD recommendations when it is appropriate to do so for the New Zealand context. Examples are ensuring New Zealand companies with simple foreign branch structures are not caught by the rules (see "application of hybrids rules to foreign branches" below), not applying the rules to purely domestic firms, and not introducing rules when an adequate New Zealand provision already exists.

- We are recommending that officials continue to consult on a few particular issues that have the potential to ease the compliance costs of the proposals before we make a final decision on them under Cabinet delegated authority. These consist of elective options which would in effect allow existing hybrids to be treated as simple equity investments.

- Despite the necessary complexity, the underlying principle is clear – using hybrid mismatches as a tax-efficient means of inbound, outbound or conduit investment is not appropriate.

- We are recommending that relevant parties be consulted on exposure drafts of key aspects of the legislation. This is intended to facilitate workable legislation that is understandable to those applying it.

- In almost all cases, the complexity will be optional. Taxpayers can avoid having to deal with these rules by undertaking simple debt or equity funding.

23. Some of the other more significant issues relating to this proposal are set out below. Those are followed by a brief explanation of each of the OECD recommendations and the principles behind them. The appendix contains a series of detailed aspects of the proposals that we are also seeking Cabinet's agreement to. These details have been consulted on with interested parties, and are consistent with the general recommendations set out below.

Significant issues

Foreign trusts

24. As set out in the cover Cabinet paper, we are recommending that foreign trusts be included within the scope of these rules in circumstances where their treatment outside of New Zealand means income of the trust is not included in a tax calculation anywhere in the world. This is not because they are foreign trusts, but because in those circumstances they are "reverse hybrids" according to the OECD recommendations (see the discussion on OECD Recommendation 5.2, below). The same rule would equally impose tax on New Zealand limited partnerships that fit within the reverse hybrids definition.

25. We are aware that foreign trusts have recently had a new set of disclosure rules apply to them following the 2016 Government Inquiry into Foreign Trust Disclosure Rules. In this respect, adding another regulatory regime to the industry now is unfortunate timing. To reflect the fact that these trusts have recently undergone significant compliance costs, and to give the foreign trust and limited partnership industries more time to understand the implications of the proposed rules, we are recommending a delayed effective date for New Zealand reverse hybrids of 1 April 2019.

Application of hybrid rules to foreign branches

26. The way in which the OECD recommendations are written would in some circumstances deny a New Zealand company the ability to offset a loss from its foreign branch against its New Zealand income. This is an issue that some submitters have been very concerned about.

27. We have made various modifications to the OECD recommendations to address this issue, including clarifying that taxpayers who have simple offshore branch structures do not present a hybrid mismatch problem and so are not covered by the rules.

Imported mismatches

28. OECD recommendation 8 suggests countries include an "imported mismatch" rule when implementing hybrid and branch mismatch rules. Imported mismatch rules apply when the New Zealand resident is not directly involved in the hybrid mismatch, but the benefit of a mismatch is "imported". Some submitters on the discussion document viewed this particular recommendation as over-reach, highly complex and impractical.

29. To address these concerns, we recommend that the introduction of the imported mismatch rule be different for "structured" and "unstructured" arrangements. Structured arrangements are deliberately entered into to obtain a tax advantage, so should be implemented at the same time as the rest of the hybrid rules. By contrast, unstructured arrangements are ones where the New Zealand benefit is not the primary reason for entering into the arrangement. We recommend that the unstructured rule has a delayed implementation date of 1 January 2020. By this date, we expect that the EU countries, the UK, and Australia will all have hybrid rules. Delaying the implementation of the unstructured rule until those countries have similar rules will reduce the costs involved in complying with the rule in New Zealand because, by that time, multinationals that are also operating in those countries should already be complying with their equivalent rules, and also because payments

to those countries will not be subject to the imported mismatch rule at all. More details regarding the imported mismatch rule are contained later in this paper.

Over-taxation by reason of the imposition of NRWT

30. The OECD recommends that countries apply the hybrid rules without regard to any withholding tax collected on the relevant payments. In situations where New Zealand imposes non-resident withholding tax (NRWT) on an interest payment that is also denied a deduction under the hybrid rules, there may be over-taxation.

31. As far as our officials are aware, Australia is not planning on departing from the OECD approach. An argument for this approach is that in the majority of cases taxpayers can simply switch to simpler structures and arrangements and be subject to only single taxation. The OECD approach is also less complicated. Nevertheless, there has been an argument from some submitters that the hybrid rules should be modified in New Zealand so as to remove this potential over-taxation for taxpayers that choose to remain in hybrid structures.

32. We recommend that in the case of a hybrid financial instrument, there needs to be further consideration of the possibility of letting taxpayers treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We recommend that Cabinet delegate the authority to determine the appropriateness of such an approach to us to decide after receiving further advice. For hybrid arrangements other than financial instruments, we are less concerned about the imposition of NRWT. Although there may be some over-taxation, in many cases this will simply be a timing issue.

Grandparenting for certain instruments issued by banks to the public

33. We recommend that there be an exception to the rules for certain hybrid instruments ("hybrid regulatory capital") issued by banks and insurance companies either directly or indirectly to third party investors, in partial satisfaction of the capital requirements imposed on those companies by regulators (such as the Reserve Bank and its Australian equivalent, APRA). We recommend that such instruments issued before the date of the discussion document release (6 September 2016) should not be subject to the hybrid rules until the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

34. This grandparenting date is different to the date proposed in Australia, which is 8 May 2017 (the day before their Federal Budget). We consider differing from Australia is justified in this case. The Australian Government had made public the fact that it was considering how such instruments should be taxed, and did not make an announcement until its 2017 Budget. In New Zealand the hybrids discussion document released on 6 September stated that such instruments would be subject to the hybrid rules. To grandparent instruments issued after the New Zealand discussion document may be seen as encouraging taxpayers to enter into aggressive structures after the government has stated an intention to change the rules but before that change is enacted. We are wary of creating an expectation that such arrangements will be grandparented.

Opaque election for foreign hybrid entities

35. The private sector has proposed that a New Zealand investor in a foreign hybrid entity be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand to remove the hybridity and put that entity outside the scope of the rules. Our initial view is that

excluding simple branch structures from the rules, and the ability of hybrid participants to restructure their arrangements, may make such an election redundant. Nevertheless, we have asked officials to continue their consideration of how such an election may work in practice, including whether the costs of administering it for what may be a relatively small group are justified. We recommend that Cabinet delegate to us the authority to decide on the appropriateness of an opaque election.

Application of rules to branch mismatch arrangements

36. Consultation on branch mismatches has taken place but has not been as comprehensive as that for the remainder of the hybrid proposals. In part this is because such mismatches are less significant for New Zealand, and in part because the OECD draft report on branches was released at around the same time as the New Zealand discussion document, and the proposal was therefore less well developed. Nevertheless, we recommend that New Zealand implement rules that are consistent with the OECD recommendations on branch mismatches (this is also consistent with the approach that has been taken by the UK and which we understand will be taken by Australia). Branch mismatches arising from foreign branch losses are a double non-taxation risk and to leave them out of these proposals would expose the tax base to future risk. The remainder of the branch mismatch concerns addressed are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

De minimis rule

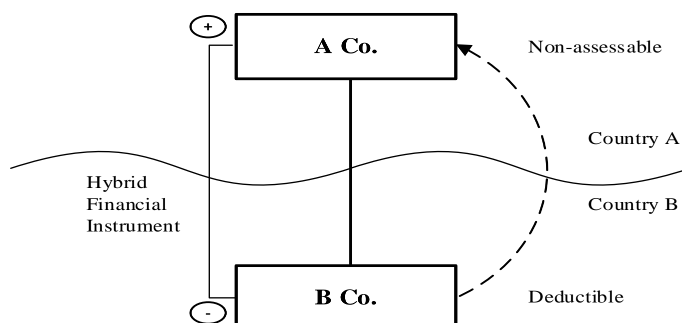
37. We recommend that there be no general de minimis for the hybrid rules. We believe that a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules. This means that any de minimis would likely be ineffective in practice because the other country would still counter the hybrid mismatch using their secondary response right. Also, our proposals will ensure that simple branch structures (the most likely beneficiaries of a de minimis) are not within the scope of the rules.

38. We do however recommend that there should be specific de minimis rules for reverse hybrid entities established in New Zealand (see paragraphs 55-57).

OECD recommendations

Hybrid financial instrument rules (Recommendations 1 and 2)

39. The following diagram illustrates a typical hybrid financial instrument issued between related parties A Co and B Co.



40. Double non-taxation arises in this situation because the payment on the hybrid financial instrument is deductible (as interest) in Country B but not taxable (because it is treated as an exempt dividend) in Country A.

41. OECD recommendation 2 is a specific recommendation that countries should amend their domestic law so that dividend payments that are deductible to the payer (B Co) should be treated as ordinary income for the payee (A Co).

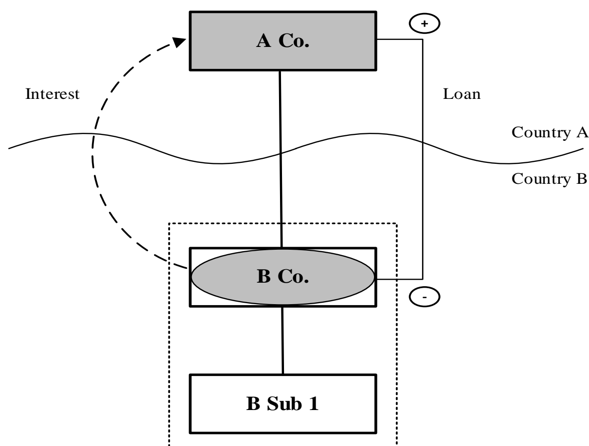
42. New Zealand already has a rule that switches off the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. We recommend that this rule be expanded to also apply if the foreign payer receives tax benefits similar in nature to a deduction.

43. We also recommend introducing rules in line with the general principles of OECD recommendation 1. This means that, in relation to hybrid financial instruments that are structured or between related parties, we should deny a New Zealand payer a deduction for the payment (when New Zealand is Country B) to the extent it is not taxed to a non-resident payee. It is in respect of this aspect of recommendation 1 that we are considering the election to treat interest payments as dividends. In addition, when New Zealand is Country A and Country B does not have hybrid rules, we should tax the New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit.

44. We also recommend that when there is a timing mismatch that allows a deduction to be claimed in one country in a period that is significantly earlier than the period in which income is included in the other country, the rules above should also apply.

Disregarded hybrid payments rule (Recommendation 3)

45. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor (Country A) but opaque for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the hybrid entity.



46. The interest payment by B Co is deductible in the hybrid entity country (Country B) but disregarded in the investor country (Country A) because Country A sees B Co as being part of A Co and therefore not capable of making a payment to itself. However, as the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can

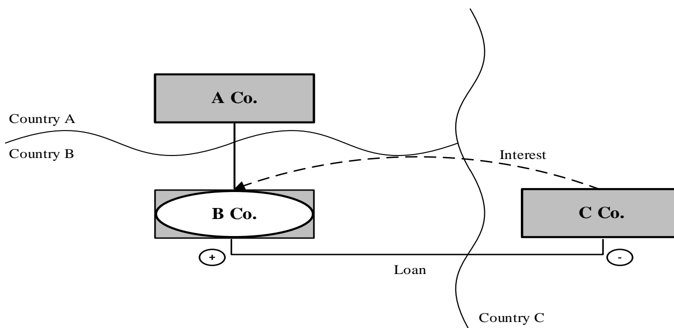
therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

47. We recommend introducing rules in line with the general principles of OECD recommendation 3 in order to prevent double non-taxation arising from a payment by a hybrid entity. We recommend that, when New Zealand is Country B and payments are deductible here but are disregarded for tax purposes in Country A (and the payments are part of a structured arrangement or made to a person in the same control group), we should deny a deduction for the payment. Similarly, if New Zealand is Country A and the non-resident payer in Country B has not been denied a deduction for the payment under similar rules, we should tax the receipt by the New Zealand payee as ordinary income.

48. We recommend that deductions denied and income included by the above rules should be reversible to the extent that the hybrid entity has earned “dual inclusion income”, being income taxed in both Country A and Country B. This is because this dual inclusion income is included as income in both countries so the corresponding deduction should also be allowed in both countries. The dual inclusion income can be earned in the same period as the payment is made, in an earlier period, or in a later period.

Reverse hybrid rules (Recommendations 4 and 5)

49. A reverse hybrid entity is an entity which is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the reverse hybrid.



50. If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co.

51. We recommend introducing rules in line with the general principles of OECD recommendation 4 to prevent double non-taxation arising from a payment to a reverse hybrid. We recommend that, when New Zealand is Country C, the New Zealand payer be denied a deduction for a payment to a reverse hybrid if the payment would have been taxed if paid directly to the investor (A Co). This rule would only apply when the payer, payee and investor are all in a control group or the payment is part of a structured arrangement.

52. OECD recommendation 5.1 is that countries should change their domestic law so that they tax residents on income not taxed in another country due to its being earned by a reverse hybrid. In other words, when New Zealand is Country A, we should tax A Co on the income of B Co if Country B does not tax it (because it treats B Co as transparent for tax purposes).

53. We recommend that New Zealand should have rules that are in line with the general principles of recommendation 5.1 and other international tax principles. New Zealand already has controlled foreign companies (CFC) rules that in most cases would prevent a reverse hybrid entity mismatch outcome from occurring when a New Zealand resident is the investor (A Co). We recommend that Cabinet delegate authority to us to determine whether our current CFC rules should be enhanced to deal with any forms of reverse hybrid income not currently dealt with, in line with the general principles of recommendation 5.1.

54. OECD recommendation 5.2 is that countries should change their domestic law so that they tax income which is earned by a reverse hybrid entity established in their country. So, when New Zealand is Country B, we recommend introducing rules in line with the general principles of this recommendation. As set out in the cover Cabinet paper and in paragraphs 24-25, this will require amendments to existing law regarding New Zealand limited partnerships and foreign trusts, which can be reverse hybrid entities depending on the tax treatment in the investor country.

55. In regards to limited partnerships, we recommend taxing the partnership income of a non-resident partner if they are in a control group with the partnership and not taxed on their share of the partnership income because their jurisdiction views the income as earned by the partnership as a separate taxpayer from the partner. This rule will only apply if the limited partnership has total foreign-sourced income of greater than $10,000 or 20% of its total income. This de minimis rule, and the corresponding one for foreign trusts in the following paragraphs, is consistent with the recently-enacted de minimis rule for foreign sourced income of look-through companies.

56. In regards to foreign trusts, we recommend taxing the foreign-source trustee income of the trust, provided that the non-resident settlor and trust are all in a control group. Many family trusts would meet this requirement. Foreign source trustee income will only be taxed if the non-resident settlor is not taxed on the trustee income in their residence country simply because the income is earned by the New Zealand trustee rather than the settlor directly. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income.

57. We also recommend taxing the foreign-source beneficiary income of a non-resident beneficiary of a foreign trust if they are not taxed on the income in their residence country because that country views the income as earned by the trustee and not the beneficiary. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income, and the non-resident beneficiary is part of a control group with the trust/trustee. In relation to both beneficiary and trustee income, tax would only be imposed if there was no-one else in the same control group required to include that income in their taxable income.

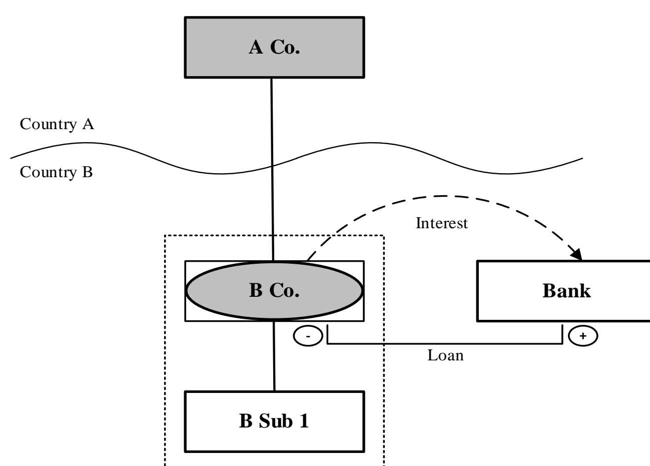
58. OECD recommendation 5.3 is that countries should consider improvements to record keeping and disclosure rules for tax transparent entities established in their country. Following the 2016 Government Inquiry into Foreign Trust Disclosure Rules, the disclosure rules for foreign trusts have been enhanced. New Zealand is regularly reviewed by the OECD to ensure that we are meeting international standards in this area. The Government will

continue to work with the OECD and make improvements to disclosure rules as necessary to ensure compliance with best practice.

59. We note that Australia has indicated that it is unlikely to implement any of recommendation 5 at this point – this is largely because they see their existing rules as adequate. However, they have reserved the right to do so in the future if integrity concerns arise. We are not as confident that our existing rules in relation to reverse hybrids are adequate to prevent mismatches from occurring. As set out above, we are concerned that leaving 'gaps' in our rules exposes our tax base to risks that can be mitigated by following all of the OECD's recommendations.

Hybrid entities – double deductions (Recommendation 6)

60. In addition to being capable of generating a deductible/non-inclusion hybrid mismatch, a hybrid entity can also be used to generate a double deduction mismatch. A diagram illustrating this possibility follows, where B Co is the hybrid entity.



61. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment can offset income earned by B Sub 1, which is in a tax consolidated group with B Co. This is a double non-taxation outcome because a single payment has been deducted against different income in two countries.

62. In Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand [CAB-17-MIN-0164]. This means that, when New Zealand is Country A, the deductions in B Co would not flow back to New Zealand if it is possible for that deduction to also offset Country B income that does not flow back to A Co (in this case, the income of B Sub 1).

63. Nothing in this paper is inconsistent with that specific decision. However, as mentioned in paragraph 26-27, we are recommending a slightly narrowed approach to the OECD recommendation 6, whereby simple structures involving a New Zealand company with only an offshore branch would not fall within the scope of the rules.

64. We also recommend implementing a rule that would, when New Zealand is Country B, disallow the losses of a foreign-owned New Zealand hybrid entity or branch when the country of the owner (Country A) has not denied the loss.

65. As with the recommendation 3 rule, denial of a deduction under the recommendation 6 rule should be reversed to the extent that the hybrid entity has dual inclusion income, whether in the current period, an earlier period, or a later period.

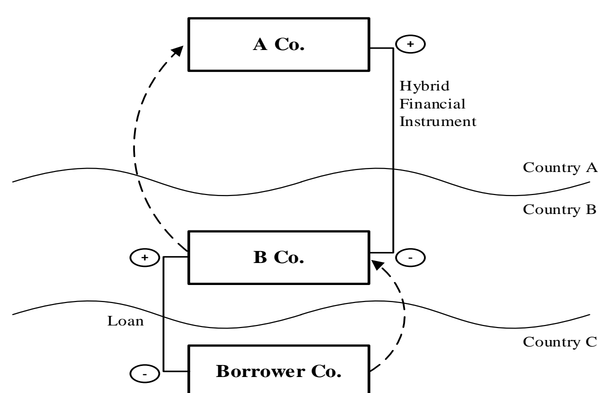
Dual resident entities (Recommendation 7)

66. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. Expenditure incurred by a company that is a resident of two different countries can potentially be used in each country to offset non-dual inclusion income, which is income taxed only in that country. This would achieve the same double deduction outcomes that hybrid entities can produce under recommendation 6 (above).

67. New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

Imported mismatches (Recommendation 8)

68. As set out in paragraphs 28-29, we recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment that funds another payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



69. In this example, New Zealand is Country C. The loan between A Co and B Co generates a deduction in Country B, with no corresponding income inclusion in Country A. This is a double non-taxation outcome. However, this tax mismatch is not counteracted because neither Country A nor Country B has hybrid rules. The tax benefit of the A/B mismatch helps fund the seemingly benign arrangement between B Co and the New Zealand entity (Borrower Co).

70. The imported mismatch rule would require New Zealand, as Country C, to deny a deduction for interest payments from Borrower Co to B Co to the extend they do not exceed the payments under the hybrid financial instrument between B Co and A Co. This is an integrity measure that prevents New Zealand's other hybrid rules from being circumvented.

Without this rule, businesses in Country A can simply avoid our proposed rules by going from A to C via B.

71. We recommend that the imported mismatch rule applies to both structured arrangements that are designed to produce an imported mismatch outcome, and unstructured arrangements within a control group. However, because unstructured arrangements may not be deliberately contemplated, we are recommending a delayed implementation for those arrangements until more countries, the EU countries in particular, have hybrids rules in place.

Agency consultation

72. The consultation on this project has been explained in the cover Cabinet paper. Briefly, there have been two rounds of consultation: one on the proposals in the discussion document; and a further round with selected submitters on branch mismatches and some of the detailed aspects set out in this paper.

Financial implications

73. The proposed hybrid rule denying double deductions for foreign hybrid entities is estimated to increase tax revenue by $50 million per year from the 2019-20 year onwards. These amounts are already included in the forecasts as per Budget 2017 (CAB-17-MIN-0164).

74. In addition, the proposed approach to grandparenting certain hybrid instruments as discussed at paragraphs 33-34 is expected to generate a total of $71 million over four years which is not currently included in the forecasts. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

75. The combined revenue impact of all proposals is estimated as:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions (already included in forecast)	0	0	25	50	50	50	50
Hybrid instruments – grandparenting (new adjustment to forecasts)	0	0	19	19	19	14	0
Total revenue effect	**0**	**0**	**44**	**69**	**69**	**64**	**50**

Human rights, administrative impacts, legislative implications, publicity

76. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

77. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

78. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

79. We recommend that Cabinet:

1. **Agree** that for payments under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:

    a. to deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (OECD recommendation 1 primary rule); and

    b. if a non-resident payer has not been denied a deduction for the payment under similar rules, to tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (OECD recommendation 1 defensive rule).

2. **Agree** to expand New Zealand's current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (OECD recommendation 2).

3. **Agree** that for payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognised under the tax law in the payee country because the payment is disregarded under that law:

    a. to deny a deduction for the payment if made by a New Zealand payer (OECD recommendation 3 primary rule);

    b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, to include the payment in ordinary income of the New Zealand resident (OECD recommendation 3 defensive rule);

    c. to allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against income that is included as income in both relevant countries ("dual inclusion income").

4. **Agree** to deny a New Zealand payer a deduction in relation to payments made to a reverse hybrid entity in the same control group as the payer or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid entity (OECD recommendation 4).

5. **Agree** that New Zealand should tax the income of a reverse hybrid established in New Zealand (such as a foreign trust or a limited partnership) to the extent that:

   a. the reverse hybrid income is not subject to tax in another jurisdiction (OECD recommendation 5.2); and
   b. the total foreign sourced income of the reverse hybrid exceeds the greater of $10,000 or 20% of the total income of the reverse hybrid.

6. **Agree** to the following in relation to double deduction outcomes produced by branches and hybrid entity structures:

   a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branch if there is another entity in that foreign country whose income is capable of being offset against the losses of the hybrid entity or branch and that income is not taxable in New Zealand (modified OECD recommendation 6 primary);
   b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (OECD recommendation 6 defensive); and
   c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

7. **Agree** to deny a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income (OECD recommendation 7).

8. **Agree** to deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, except to the extent that the payment is made to a country that has hybrid mismatch rules (OECD recommendation 8).

9. **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.

10. **Agree** that the effective date of the rule relating to unstructured imported mismatches (part of recommendation 8 above) should be delayed until 1 January 2020.

11. **Agree** that the application of the rule relating to New Zealand reverse hybrids (recommendation 5 above) should be for income years beginning on or after 1 April 2019.

12. **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:

    a. issued to satisfy the regulatory capital requirements imposed by New Zealand or Australian law;
    b. directly to, or are traceable to, issues to the public; and
    c. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

13. **Note** that the fiscal consequences of agreeing to recommendation 12 above is set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

14. **Agree** to the detailed design proposals set out in the appendix to this paper.

15. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on further detail of these proposals, or to amend the detail in the appendix, provided any such decisions are not contradictory with the principles set out in recommendations 1 to 12, without further reference to Cabinet.

16. **Agree** to delegate authority to the Minister of Finance and the Minister of Revenue to make final policy decisions on the following policy issues without further reference to Cabinet:

    a. whether New Zealand's controlled foreign company (CFC) rules should be modified to include as attributable foreign income all income of a reverse hybrid entity which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is treated as fiscally transparent in that country (OECD recommendation 5.1);
    b. whether New Zealand can and should include a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes; and
    c. whether, the payer under a hybrid financial arrangement for which a deduction is denied, should be allowed to treat the payment as a dividend for purposes of both (but not only one of) the non-resident withholding tax and the imputation credit rules.

17. **Agree** that the results of the decisions in recommendations 1-16 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Appendix

List of detailed design decisions

	OECD Recommendations 1 and 2
1.	A person who receives a payment which is deductible to the payer in another country will not be entitled to the benefit of any imputation credit attached to the payment.
2.	When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency, the deduction denied will take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes, and any net income from the instrument including any foreign currency fluctuations will be non-taxable.
3.	When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the taxpayer will not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.
4.	To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee entity under another country's controlled foreign company (CFC) regime, the payer will be allowed a deduction for the payment.
5.	If a person holds a FIF interest as part of a share repo arrangement, that person will be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest.
6.	If a person holds New Zealand shares as part of a share repo arrangement, where the borrower is a non-resident, the person is not entitled to the benefit of an imputation credit attached to any dividends on the shares.
7.	OECD recommendation 1 will only apply to timing mismatches if: • the mismatch arises on an instrument with a term of 3 years or more or on an instrument that has been extended to beyond 3 years; and • the lender is not accounting for the payment, for tax purposes, on a reasonable accrual basis; and • it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months

	of the end of the period in which the expenditure is incurred.
8.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.
9.	Interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.
10.	There will be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

	OECD Recommendation 3
11.	Any foreign currency fluctuations recognised for tax purposes in relation to a financial arrangement denominated in a foreign currency will be taken into account when denying a deduction to a New Zealand payer.
12.	Dual inclusion income will be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it will not include income which is protected from New Zealand tax by a foreign tax credit.
13.	For the purposes of denying a deduction for a New Zealand payer, full taxation of income under a CFC regime will prevent income being treated as not taxable to a payee and will qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.
14.	When an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that will be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible.
15.	The ability to claim a deduction in relation to a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.
16.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted.

17.	Denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules.
18.	A deduction would be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs.
19.	Where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income will be reversed in a later year when there is dual inclusion income earned through the hybrid entity.

	OECD Recommendation 4
20.	Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.
21.	Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.
22.	To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.
23.	Non-resident withholding tax will continue to be applied to payments, despite the denial of the deduction
24.	Interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

	OECD Recommendation 5.2
25.	Tax the partnership income of a non-resident partner of a New Zealand limited partnership if the non-resident partner is in a control group with the partnership and the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not by the partner.
26.	Tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that: • the beneficiary is in the same control group as the trustee; and • the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and • the income is not subject to tax as the income of any person other than

	the trustee (such as the beneficiary or settlor).
27.	Tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that: • the settlor is in the same control group as the trustee; • the settlor would be taxed on the trustee income if it held the trust assets directly; and • the income is not subject to tax as the income of any person other than the trustee.
28.	Include a de minimis so that none of the above recommendation 5.2 rules apply if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

	OECD Recommendation 6
29.	There will be a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity.
30.	A deduction will be allowed in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country
31.	Income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit.
32.	Double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch will be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
33.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.
34.	Amendments will be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are

	deducted.
35.	Denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	OECD Recommendation 7
36.	Amend existing consolidation and loss grouping rules for dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.
37.	Double deduction amounts and dual inclusion income amounts will be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
38.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred.
39.	Denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	OECD Recommendation 8
40.	When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied will ignore any foreign currency fluctuations on the instrument.
41.	Interest that is denied a deduction under recommendation 8 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules

	General design and definitional matters
42.	A coordination rule will be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.
43.	A specific anti-avoidance rule will be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.

Coversheet: BEPS - Hybrid mismatch arrangements

Advising agencies	*Inland Revenue, The Treasury*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
A tailored adoption of the OECD's BEPS Action 2 recommendations will comprehensively deal with the problem of hybrid mismatch arrangements while making modifications and variations to take into account what is appropriate for the New Zealand context. This tailored solution is sustainable and achieves gains to efficiency and fairness, while minimising compliance costs where possible. There will be a significant benefit in adopting a solution which is adopted by other countries and which will therefore be easier for multinational businesses to understand and comply with.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis. There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

Where do the costs fall?
Taxpayers that use hybrid mismatch arrangements will face a medium level of compliance costs. These may be up-front, in the form of restructuring costs to transition to more straightforward (non-hybrid) arrangements, or they may be ongoing in the case of taxpayers that keep their hybrid mismatch arrangements in place and must apply new tax rules in order to comply with the law.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is some risk of taxpayer noncompliance with the proposed rules. However, the risk of taxpayers being inadvertently caught by the proposed rules has been minimised due to the design of the preferred regulatory option which seeks to exclude the most simple offshore structures (foreign branches). More generally, the impacts have been reduced through the proposals taking into account the New Zealand context and adjusting the OECD-recommended rules as needed.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Not every type of hybrid arrangement that would be countered by the proposals has been observed in New Zealand. However, Inland Revenue is aware of some historic and current hybrid arrangements, and there is a very high likelihood there are others that relate to New Zealand and will be affected by this regulatory proposal.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the BEPS – hybrid mismatch arrangements Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS - Hybrid mismatch arrangements

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem Our analysis has been limited somewhat by our inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand. Inland Revenue is aware of some mismatch arrangements, but the full extent of the problem is unknown. This is because evidence of the problem primarily comes from Inland Revenue's investigations staff. Under current law these staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals. **Range of options considered** Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations. **Assumptions underpinning impact analysis** The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of hybrid mismatch arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.
Responsible Manager (signature and date):
Paul Kilford Policy Manager, Policy and Strategy Inland Revenue 12 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinational groups to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter base erosion and profit shifting (BEPS).

Hybrid mismatch arrangements

Hybrid mismatch arrangements arise when taxpayers exploit inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. The OECD's BEPS package includes Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. Hybrid mismatch arrangements are prevalent worldwide and are an important part of the base erosion and profit shifting strategies used by multinational companies. If no action is taken by the international community to counter these types of arrangements they are likely to continue to be used to avoid worldwide taxation and drive economic inefficiencies and unfairly distributed tax burdens.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations.

In September 2016 the Government released a BEPS discussion document: *Addressing hybrid mismatch arrangements* which proposed adoption of the OECD Action 2 recommendations in New Zealand and sought submissions on how that should be done. In March 2017 the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*.

As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand. This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions.

At the same time, Cabinet noted that the reforms proposed in the BEPS documents would be progressed, subject to modification in consultation, for implementation from 1 July 2018. Cabinet also noted that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later in 2017.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

Company tax and international rules

The company tax system is designed to be a backstop for taxing the personal income of domestic investors. Company tax is deducted at 28%, but New Zealand based investors can claim imputation credits for tax paid by the company when the income is taxed upon distribution at the personal level. At the same time, the company tax is designed as a final tax on New Zealand-sourced income of foreign investors and foreign-owned companies earning New Zealand-sourced income.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge in the area of international tax is to ensure that multinational firms pay a fair and efficient amount of tax in New Zealand. Anti-avoidance rules and base protection measures are important part of ensuring that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

2.3 What is the policy problem or opportunity?

The problem of hybrid mismatch arrangements

Businesses can use hybrid mismatch arrangements to create tax advantages through exploiting inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. For example, using a hybrid entity or a foreign branch, a single expense may be deducted in two different jurisdictions, potentially reducing the tax payable on two different streams of income. Another example is a payment that is tax-deductible in one jurisdiction with no corresponding taxable income in the jurisdiction where the payment is received. However it is achieved, the result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates when compared with a straightforward arrangement that is seen consistently by both relevant countries. Hybrid mismatch arrangements also have the effect of subsidising international investment relative to domestic investment, which distorts the efficiency of global markets.

Since releasing its final recommendations on hybrid mismatch arrangements, the OECD expanded the scope of BEPS Action 2 to include branch mismatches. Branch mismatch arrangements are a result of countries approaching the allocation of income and expenses between a branch and a head office in different ways. Branch mismatch arrangements can also result in a reduction in the overall taxation of a corporate group, so are similar in effect to hybrid mismatch arrangements.

It is important to note that the policy problem is limited to circumstances when global tax is reduced as a result of a hybrid mismatch. This project does not address other mechanisms that taxpayers may use to lower their global tax liability, such as the use of low-tax jurisdictions to trap income.

Hybrid mismatch arrangements in New Zealand

New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the effects of a hybrid mismatch arrangement. However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way. Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements.

New Zealand also has some specific rules in its domestic law that go some way to addressing particular recommendations made by the OECD in relation to hybrid mismatch arrangements.

Inland Revenue is aware of a significant volume of hybrid mismatch arrangements involving New Zealand. For example, the amount of tax at issue in recent litigation for a prominent type of hybrid financial instrument was approximately $300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to the most prominent hybrid entity structure results in approximately $50 million less tax revenue for New Zealand per year.

2.4 Are there any constraints on the scope for decision making?

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Consistent with the OECD approach, the analysis has been focused on arrangements between related parties or where a hybrid mismatch has been created through a structured arrangement between unrelated parties.

We have also chosen to restrict the policy thinking to cross-border activity. Purely domestic hybrid mismatches (some of which are contemplated by the OECD Action 2 final report) are outside the scope of this regulatory proposal.

2.5 What do stakeholders think?

Stakeholders

Stakeholders of this regulatory proposal are primarily taxpayers (typically multinational businesses that have hybrid mismatch arrangements) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules. The proposed rules affect only taxpayers with foreign

connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

Another stakeholder of this regulatory proposal is the OECD, which is aiming to eradicate hybrid mismatch arrangements to the extent possible. This goal can only be achieved through countries adopting hybrid mismatch rules of some kind and neutralising the mismatches that arise when different sets of rules apply to the same transaction or entity. In addition, other countries that have enacted or are proposing to enact hybrid mismatch rules (for example, Australia and the United Kingdom) will be interested in the interaction between their own hybrid mismatch rules and any rules that New Zealand introduce into law.

The Reserve Bank of New Zealand (RBNZ) is interested in the regulatory proposal to the extent that it affects bank regulatory capital.

Submissions to discussion document

There were 20 submissions made to the September 2016 Government discussion document. Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions of some variety. However, a greater number of submitters were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

Further and ongoing consultation

We have engaged in approximately a dozen workshops (with the Corporate Taxpayers Group and Chartered Accountants Australia and New Zealand) and attended various other meetings with private sector submitters (including the New Zealand Bankers' Association) in order to discuss specific design issues relating to hybrid mismatch arrangements.

We have also consulted with officials representing Australia and the United Kingdom, as well as the OECD secretariat, on an ongoing basis to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation.

We have also consulted with the Reserve Bank.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Section 3: Options identification

3.1 What options are available to address the problem?

Four options were considered in the development of this regulatory proposal. These options are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) New Zealand aligns itself with the OECD recommendations in dealing with hybrid mismatch arrangements.

None of the options (with the exception of the status quo option) are non-regulatory options. This is because our judgment is that the policy problem of hybrid mismatch arrangements cannot be addressed without changing tax rules, and that is something that can only be done through the use of legislation (as per section 22(a) of the Constitution Act 1986).

These options are what we consider other countries dealing with hybrid mismatch arrangements will consider in their policy development process. The United Kingdom and Australia can both be said to have chosen their own version of option 2. Some other countries have had rules to deal with hybrid mismatches that predate the OECD's work in this area.

Status quo: No action

This option relies on New Zealand's existing law (including the GAAR) to counter hybrid mismatch arrangements and avoids the increased compliance costs and administrative costs of the other options. The status quo option also contemplates that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to New Zealand.

Option 1: Strict adoption of OECD recommendations

The OECD recommendations as set out in its BEPS Action 2 report are a comprehensive set of principle-based rules to counteract all types of hybrid mismatch arrangements. Option 1 is to strictly adopt those recommendations as described by the OECD into New Zealand domestic law. This option would deal with the range of hybrid mismatch arrangements targeted by the OECD to the extent they are found in or affect New Zealand. It would have the advantage of interacting well with other countries that similarly adopt the OECD recommendations into their domestic law.

Option 2: Tailored adoption of OECD recommendations

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the New Zealand context. This option bears close relation to Option 1 as it involves introducing OECD-consistent hybrid rules unless there is a compelling reason to depart from the OECD approach. Thus, this option would solve the policy problem while ensuring that particular New Zealand issues are addressed.

Option 2 also recognises that there are some instances where New Zealand's existing tax laws are sufficient (or can be made sufficient with relatively minor amendment) to achieve the effect intended by an OECD recommendation.

Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid

enacting rules targeted at arrangements which are not currently seen in New Zealand.

Consultation

These four options were identified prior to consultation. The September 2016 discussion document proposed adoption of the OECD recommendations (options 1 and 2) and sought feedback on how that should be done. The document stated the Government's alternative options as option 3 and maintaining the status quo and concluded that they were not the best way forward. Consultation has affected the nature of option 2 in particular and has been helpful for options analysis generally.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible
- Neutrality – the tax system should bias economic decisions as little as possible
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality and fairness impacts without some increase in compliance costs and so there are some trade-offs that were and continue to be considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

We ruled out designing a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This is for reasons of international compatibility and to save compliance costs.

Section 4: Impact Analysis

	Status quo: No action	Option 1: Strict adoption	Option 2: Tailored adoption	Option 3: Targeted rules
Efficiency of compliance	**0**	- - Option 1 has a significant compliance burden because some of the OECD recommendations as drafted would not mesh well with New Zealand's existing tax laws.	- Option 2 imposes increased compliance costs on taxpayers and advisors, but is focused on reducing those costs where possible.	- Option 3 imposes increased compliance costs on taxpayers and advisors, but by its nature it reduces those costs in proposing rules that only address currently observed exploitation of hybrid mismatches.
Efficiency of administration	**0**	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.
Neutrality	**0**	++ Option 1 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	++ Option 2 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	+ Option 3 will remove the tax benefit of currently observed hybrid mismatch opportunities involving New Zealand. This will likely provide some efficiency gains. However, other hybrid mismatch arrangement opportunities will remain available. This means that, depending on the extent to which taxpayers respond to an option 3 approach by simply moving into "uncovered" tax-efficient hybrid structures, there will still be some inefficient allocations of investment due to ongoing hybrid mismatch arrangements.
Fairness and equity	**0**	+ Option 1 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 2 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 3 has fairness and equity benefits as it ensures that taxpayers able to use currently observed hybrid mismatch arrangements cannot reduce their tax liability. However, this option's fairness impact depends on the behavioural effects of introducing these rules to a greater extent than options 1 and 2.
Sustainability	**0**	++ Option 1 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	++ Option 2 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	+ Option 3 will remove currently known hybrid mismatch arrangement opportunities involving New Zealand. However, this option's sustainability is limited. It will leave some hybrid mismatches unaddressed, which may be exploited at a later date by opportunistic taxpayers.
Overall assessment	Not recommended	Not recommended	**Recommended**	Not recommended

Key:

++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 2 is the best option for addressing the problem of hybrid mismatch arrangements. It is an internationally consistent, proactive option which delivers net benefits to New Zealand greater than that of the other options considered.

Option 2 will improve the neutrality of New Zealand's tax system. Businesses that are able to exploit hybrid mismatch arrangements can currently operate at lower effective tax rates when compared with other businesses. This can result in a 'hybrid' business crowding out more productive investment and making international investment decisions based on whether a mismatch is available rather than commercial grounds. In addition, the imposition of higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrid mismatches is likely to be less efficient than imposing more moderate taxes across all economic actors. By eliminating the tax benefit of hybrid mismatch arrangements in a comprehensive way, these inefficiencies can be removed.

In a related sense, option 2 will help to improve the equity and fairness of the New Zealand tax system. Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally.

Option 2 will also have revenue collection benefits. The New Zealand tax revenue loss caused by the use of hybrid mismatch arrangements is difficult to estimate because the full extent of arrangements involving New Zealand is unknown and because the behavioural effects of introducing hybrid mismatch rules are difficult to ascertain. However, the tax revenue at stake is significant in the cases that Inland Revenue is aware of.

Importantly, the case for New Zealand to adopt the OECD recommendations is strengthened by the fact that other countries have enacted, or are proposing to enact, hybrid mismatch rules. This is because a hybrid mismatch arrangement involving a New Zealand counterparty may still be neutralised by the other country if they have a 'secondary' right to counteract under OECD principles. In that case, the tax benefit of the hybrid mismatch would be eliminated, but the tax collected would be by the counterparty country. In these circumstances, New Zealand would be better off having its own hybrid mismatch rules so that it can collect revenue when it has the priority to do so under the OECD recommendations. Whether New Zealand or the counterparty country collects any additional revenue as a result of implementing the rules depends on the actions taken by the affected business.

Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch

rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as "unstructured imported mismatches". This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

Accordingly, the compliance costs of the regulatory proposal are to be minimised to the extent possible, while still introducing a comprehensive set of rules to deal with the range of OECD-identified hybrid mismatches. This is where option 2 shows its advantage over option 1 which we view as having similar efficiency, fairness and revenue benefits. Option 1 would result in relatively higher compliance costs because the OECD recommendations are designed as a general set of best-practice rules and, in regards to their detail, are not necessarily optimal for individual countries such as New Zealand. When compared with option 1, option 2 ensures that the rules are workable and appropriate for the New Zealand tax environment.

It is also important to note that the ongoing compliance costs relating to this regulatory issue are expected to be optional in the majority of cases. The proposed rules will apply to taxpayers who use a hybrid mismatch arrangement after the rules become effective. Those taxpayers will generally have the option of incurring one-off costs to restructure into non-hybrid arrangements and remove themselves from the scope of the proposed rules.

Any higher tax payments resulting from the non-status quo options will make cross border investment less attractive for taxpayers using hybrid mismatch arrangements. However, these taxpayers should not be allowed to exploit hybrid mismatches to achieve a competitive advantage over taxpayers that do not use hybrid mismatch arrangements (such as purely domestic firms). Further, a significant number of New Zealand's major investment partners have introduced or will introduce hybrid mismatch rules. Other countries adopting these rules means that in many cases the tax efficiency of hybrid mismatch arrangements in New Zealand will be negated through the operation of the other country's rules on the counterparty, As a result, we believe that any impacts on inbound and outbound cross border investment from introducing hybrid mismatch rules in New Zealand will be low.

The status quo option would involve the least complexity and lowest compliance costs. However, similar to the cross-border investment discussion above, taxpayers whose groups deal with New Zealand's major trading partners that are adopting hybrid mismatch rules would have to understand the impact of those rules. The additional complexity of New Zealand having hybrid mismatch rules would therefore be lessened by the international momentum in this area.

Option 3 is an option that was preferred by many submitters to the Government discussion document on hybrid mismatch arrangements. Submitters pointed out that many of the structures considered by the OECD to be problematic have not been seen in New Zealand and therefore do not need to be counteracted. They also argued that the OECD recommendations are complex and have the potential for overreach. We do not think a targeted approach would serve New Zealand well when compared with option 2. The OECD recommendations are a coherent package intending to deal to the problem of hybrid mismatch arrangements exhaustively. Deliberately omitting aspects of the recommendations from New Zealand's response may cause taxpayers to exploit those remaining hybrid mismatch opportunities (which may even be seen as tacitly blessed). To the extent that happens, the efficiency, revenue, and fairness benefits of option 3 would be eroded. In

addition, other countries such as the United Kingdom and Australia have introduced or are intending to introduce a relatively comprehensive set of hybrid mismatch rules. If New Zealand does the same it will ensure our rules are internationally comparable and that they interact well with the rules of other countries without significant compliance issues. By favouring option 2, we also have consulted extensively on the OECD recommendations and how they should best be introduced into New Zealand law. This consultation has enabled us to design suitable modifications to the OECD recommendations to reduce complexity and compliance costs, limit overreach, and in some cases, increase the efficiency of the outcomes.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment***: nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Increased costs from understanding the rules and applying them to taxpayers' transactions and structures. Or, restructuring costs of transitioning to non-hybrid arrangements to fall outside the scope of the rules.	Medium	Medium
	Tax payable: Foreign hybrid entity double deduction structures are included in the rules and we are confident of collecting a significant amount of revenue from the disallowance of that type of hybrid mismatch arrangement.	Approximately $50 million per year on an ongoing basis	Low*
Regulators	Administrative costs: Inland Revenue staff, particularly investigations staff, need to develop their knowledge of the hybrid mismatch rules.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised	Compliance costs	Medium	Medium

costs	Administrative costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Revenue collected from tax payable item described above.	Approximately $50 million per year on an ongoing basis	Low*
	Reduced administrative costs: Less investigations and disputes resources spent on hybrid mismatch arrangements using the general anti-avoidance law (GAAR).	Low	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised benefits	Reduced administrative costs	Low	High

*Note that the evidence for the $50 million figure is strong, but it is a conservative estimate made in light of the behavioural uncertainty associated with introducing hybrid mismatch rules together with the fact that the full extent of hybrid mismatch arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?

As discussed above, allowing the use of hybrid mismatch arrangements is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders as it is something that is fundamental to the tax system itself.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 2 (tailored adoption of OECD recommendations) conforms to the expectations for the design of regulatory systems document.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its Tax Information Bulletin (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018. The major exceptions are:

- the proposed rule for "unstructured imported mismatch arrangements", which we recommend be delayed until income years starting on or after 1 January 2020; and
- the proposed rules applying to New Zealand "reverse hybrids", which we recommend be delayed until income years starting on or after 1 April 2019.

Another exception we recommend is a grandparenting rule that exempts from application of the rules (until the next call date) hybrid financial instruments issued by banks as regulatory capital (in Australian or New Zealand) to third party investors before the discussion document release date of September 2016.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider an application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. Audit staff will need to familiarise themselves with the proposed rules and how they operate in practice. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their hybrid mismatch arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we are minimising compliance costs where possible under our tailored adoption of the OECD recommendations. For example, and as mentioned above, we have delayed the application date of the unstructured imported mismatch rule contained in the OECD recommendations to acknowledge that it would be significantly more difficult and costly to comply with than the other rules if it applied at the outset.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

However, it may be difficult to assess the true impact of this regulatory proposal. This is because many taxpayers using hybrid mismatch arrangements may rearrange their affairs to fall outside the scope of the proposed rules. It will be difficult to measure the full extent of this behavioural effect.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.