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Base erosion and profit shifting – permanent establishment anti-avoidance rules

**Introduction**

This is the final version of the special report on permanent establishment anti-avoidance rules for base erosion and profit shifting (BEPS).

The rules were enacted on 27 June 2018 in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

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# Permanent establishment anti-avoidance rules

Sections BH 1(4), GB 54, YD 4(17C), YD 4B, YD 5(1BA), YD 5B and schedule 23 of the Income Tax Act 2007

The Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 inserts a new anti-avoidance rule into the Income Tax Act for large multinationals (with over €750m of consolidated global turnover) with a structure intended to avoid having a permanent establishment (PE) in New Zealand.

The rule deems a non-resident to have a PE in New Zealand if a related entity carries out sales-related activities for it here under an arrangement with a more than merely incidental purpose of tax avoidance (and the other requirements of the rule are met). This PE is deemed to exist for the purpose of any applicable double tax agreement (DTA), effectively overriding the DTA’s definition of a PE, unless the DTA incorporates the OECD’s latest PE article.[[1]](#footnote-1)

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

## Background

### PE anti-avoidance rule

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, like those for most other countries, 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.

A PE is basically a fixed place of business of the non-resident, but it also includes a dependent agent that habitually concludes contracts on behalf of the non-resident. If a PE exists, then under the DTA New Zealand may tax only the income attributable to that PE (unless that income is also subject to another DTA provision).

The non-resident must also have a PE in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax (NRWT) on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

The problem the new rule is trying to address is the ability of some multinationals to structure their affairs so they do not have a PE in New Zealand, despite having significant economic activity carried on for them here. This usually involves the non-resident entity establishing a New Zealand subsidiary to carry out local sales related activities (the transfer pricing rules discussed elsewhere in this special report will apply to transactions between the non-resident and the subsidiary in this case).

The OECD and the G20 are also concerned about PE avoidance, and have recommended measures to address it as part of their 15 point base erosion and profit shifting (BEPS) Action Plan. This includes a new, broader definition of a PE for DTAs. Under this new PE definition, a representative of the non-resident will only need to habitually play a *principal* *role* leading to the conclusion of contracts that are routinely concluded without material modification in order to give rise to a PE for the non-resident. This contrasts with the current PE definition in most DTAs, where the representative must habitually *conclude* contracts on behalf of the non-resident in order to give rise to a PE.

The OECD has prepared the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) to rapidly implement the treaty changes recommended as part of its BEPS Action Plan. New Zealand signed the MLI on 7 June 2017. Under the MLI, the OECD’s new widened PE definition will be included in New Zealand’s DTAs, but only if the other country signs the MLI and elects to adopt that new PE definition.

This new, widened definition should be effective in addressing the kinds of PE avoidance we have seen in New Zealand. However a majority of New Zealand’s trading partners have not elected to adopt the widened PE definition, including some countries from which significant investment into New Zealand is made. Therefore, the practical effectiveness of the OECD’s widened PE definition is curtailed by its failure to be incorporated into many DTAs, and so it will not be sufficient to address the issue of PE avoidance in New Zealand.

### Source rules

Under the current rules, there is a possibility that New Zealand may be entitled to tax a non-resident on its sales income under the PE article of a DTA, but cannot do so under our domestic source rules.

There is general international consensus that if income is derived through a PE in a country, then it is sufficiently connected with that country to be taxed there. Accordingly, any income that is attributable to a PE should also have a New Zealand source under our domestic rules.

In addition, in order to tax a non-resident on its New Zealand sales income, it is currently necessary to show that the income both has a New Zealand source and is attributable to a PE under a DTA. This increases the compliance and administrative burden of determining a non-resident’s tax liability for its sales to New Zealand customers.

## Key features

### PE anti-avoidance rule

The Act introduces a new PE anti-avoidance rule in section GB 54 of the Income Tax Act. The rule deems a PE to exist in New Zealand for a non-resident if all the following criteria are met:

* The non-resident is part of a large multinational group. The OECD has defined a “large multinational group” as a group with at least EUR €750m of consolidated global turnover for the purpose of filing Country-by-Country reports. The same revenue threshold is used for section GB 54.
* The non-resident makes a supply of goods or services to a person in New Zealand.
* A person (the “facilitator”) carries out an activity in New Zealand for the purpose of bringing about that particular supply.
* The facilitator is associated with the non-resident, is an employee of the non-resident, or is commercially dependent on the non-resident.
* The facilitator’s activities are more than preparatory or auxiliary to the non-resident’s supply.
* The non-resident’s income from the supply is subject to a DTA that does not include the OECD’s latest PE article.
* A more than merely incidental purpose or effect of the arrangement is to avoid New Zealand tax, or a combination of New Zealand tax and foreign tax.

Where a supply is subject to the rule, the non-resident is deemed to make that supply through the deemed PE. The activities of the facilitator in relation to the supply are also attributed to the PE. The deemed PE exists for all the purposes of both the Act and the applicable DTA, notwithstanding anything in that DTA.

The tax consequences of the deemed PE are determined by the other provisions of the Act and the DTA. For example, New Zealand will have a right to tax the profits attributable to the PE under the business profits article of an applicable DTA (unless that business profits article provides otherwise).

Section GB 54 may also apply in the context of a third-party channel provider arrangement. This is a single arrangement under which the non-resident supplies goods or services to a non-associated New Zealand resident and the New Zealand resident on-supplies the goods or services to identified New Zealand customers with the assistance of the facilitator. If the new rule applies in these circumstances, then the facilitator’s activities will give rise to a PE for the non-resident in respect of its supplies to the third-party channel provider.

### Source rule

The Act also introduces a new source rule for PEs. This rule provides that any income attributable to a PE in New Zealand has a source in New Zealand. The Act introduces the following definitions for a PE:

* Where a taxpayer is resident in a jurisdiction that has a DTA with New Zealand, the definition will be the same as the definition of a PE in that DTA. Any PE deemed to arise under section GB 54 will also be a PE under the definition (but only if the DTA does not include the OECD’s new PE definition).
* Where a taxpayer is resident in a jurisdiction that does not have a DTA with New Zealand, the definition of a PE will be that set out in the new schedule 23 to the Act (domestic PE definition). This definition is based on New Zealand’s model DTA article 5, which includes the OECD’s new PE definition.

The high-level application of all these new rules can be summarised as follows. In determining whether the non-resident has a deemed PE in New Zealand, the new PE anti-avoidance rule:

* **Applies** if the jurisdiction where the non-resident is resident has a DTA with New Zealand, but that DTA does *not* incorporate the OECD’s new PE definition.
* Does **not** apply if the non-resident’s jurisdiction has a DTA with New Zealand, and that DTA *does* incorporate the OECD’s new PE definition. Instead the OECD’s new PE definition in the DTA applies.
* Does **not** apply if the non-resident’s jurisdiction does *not* have a DTA with New Zealand. Instead the new domestic PE definition (which incorporates the OECD’s new PE definition) applies.

In all the above circumstances, if the non-resident has a PE in New Zealand then any income attributable to that PE will have a New Zealand source. Whether income is attributable to the PE will be determined under the standard PE profit attribution methodology applied by New Zealand.

The application of these rules is illustrated in the flowchart below (which assumes there is not already a PE in New Zealand in relation to the supplies).

Flow chart for application of new rules



## Application date(s)

The new rules apply for income years starting on or after 1 July 2018.

## Detailed analysis

### PE anti-avoidance rule

New section GB 54 deems a PE to exist in New Zealand for a non-resident if all the listed criteria in section GB 54(1) are met. These criteria are discussed below.

#### The non-resident is, or is part of, a large multinational group - paragraph (j)

A large multinational group is defined in section YA 1 of the Act to require a consolidated accounting group turnover of at least EUR €750m (being the threshold described in paragraph 5.53 of the OECD transfer pricing guidelines) for the previous period. This revenue threshold was agreed by the OECD as a way to define large multinational groups for the purpose of filing Country-by-Country reports. The multinational must also have a member in New Zealand (or income with a source in New Zealand) and a member overseas to be a “large multinational group” under the definition.

#### The non-resident makes a supply of goods or services to a person in New Zealand - paragraph (a)

The definition of “supply” from the Goods and Services Tax Act 1985 (GST Act) will apply for this purpose. The time of the supply should also be determined under the GST Act for the purposes of section GB 54. In addition the relevant supply may be made by the non-resident either:

* directly to a person in New Zealand; or
* to another person in New Zealand (the intermediary) under an arrangement that includes the intermediary on-supplying the goods to another person in New Zealand. The intermediary does not need to be associated or otherwise related to the non-resident.

The provision for intermediaries is intended to include third-party channel provider arrangements within the scope of the rule. Specifically, the provision is intended to ensure the rule can cover the supply by a non-resident to a third party where that supply is part of an arrangement under which those same goods or services are to be on-sold by the third party to an identified customer, and the non-resident’s facilitator deals with the end-customers to bring about the supply by the intermediary to the third party. Figure 4 illustrates this kind of arrangement (with the “Related party” in figure 4 being the facilitator).

Figure 4



The customer must be known to the facilitator at the time the non-resident makes its supply to the recipient for this rule to apply. This is to ensure that only arrangements involving an identifiable customer are caught by the rule.

Third-party channel provider arrangements should be within the potential scope of section GB 54. This is because under such an arrangement, the non-resident, the facilitator, and the third party are working together to sell the particular goods or services to the end customer. Further, the non-resident’s supply to the third party is wholly dependent on the customer agreeing to purchase the goods. This means that the facilitator’s activities are made in relation to the non-resident’s supply to the third party as well as the third party’s on-supply to the end customer (which makes sense given that the facilitator acts for the non-resident, not the third party). Therefore, the activities of the non-resident’s facilitator should still be able to give rise to a PE for the non-resident (provided the other requirements of section GB 54 are met).

Where section GB 54 does apply to deem a PE to exist in respect of a third-party channel provider arrangement, only the supply by the non-resident to the intermediary, and the facilitator’s activities, will be attributed to the deemed PE for the purposes of determining the profit attributable to that PE. The supply by the third-party channel provider to the customer, and the activities of the third-party channel provider, will not be attributed to the deemed PE.

#### A person (the “facilitator”) in New Zealand carries out in New Zealand an activity for the purposes of bringing about the supply - paragraph (b)

The facilitator must carry on an activity for the purpose of bringing about the supply to the recipient. Where there is an intermediary, the section will also apply if the facilitator carries on an activity for the purpose of bringing about the supply by the intermediary to the recipient. It is intended that only activities designed to bring about a particular supply to an identifiable person should potentially result in a deemed PE. Therefore activities that do not relate to a particular supply, such as advertising and marketing, would not be sufficient to trigger a possible PE under this requirement. After-sales activities, such as technical support, would also not be sufficient to meet this requirement, as they occur after the supply has been made.

The kinds of activities that are within the intended scope of this provision primarily include activities designed to convince a particular customer to acquire the supply (as opposed to general marketing and advertising, which are not carried on in relation to particular, identifiable, customers).

Paragraph GB 54(1)(b) specifies that the facilitator cannot also be the intermediary. This is to ensure that section GB 54(1)(b) does not cause section GB 54 to apply to an ordinary distributor arrangement. In an ordinary distributor arrangement, the distributor would be carrying out all the particular sales activities on its own behalf, rather than on the non-resident’s behalf (and the non-resident would not have a separate facilitator in New Zealand assisting with the sales of the kind found in 3rd party channel provider arrangements). Accordingly, in these circumstances the distributor’s activities should not give rise to a PE for the non-resident.

#### The facilitator is associated, an employee, or commercially dependent on the non-resident - paragraph (c)

Section GB 54 is aimed at circumstances where the facilitator is part of the same economic or control group as the non-resident. It is these circumstances which allow the multinational to avoid having a PE by splitting its activities between related companies (the non-resident supplier and the facilitator). Accordingly, for the section to apply, the facilitator must be associated with the non-resident under paragraph (c).

The same concern also arises where the non-resident’s sales activities are carried out by a New Zealand entity that is not associated with the non-resident, but is commercially dependent on it. In this case, the non-resident is also able to have sales activities carried out by a special purpose entity over which it has significant de-facto control (by virtue of its commercial dependency). Accordingly, paragraph (c) also applies in these circumstances.

The concept of “commercially dependent” is subjective. Therefore paragraph (c) instead uses the more precise test of whether the facilitator derives more than eighty percent of its assessable income from the non-resident or its associates in both the current and preceding income year. The requirement for the eighty percent test to be met for both years is to protect against the risk of a person unexpectedly falling within the definition for a year, which will give more certainty about when the test applies. It also ensures that a facilitator will not be commercially dependent in its first year of operation, when it is trying to build up its client base and may have a single customer only.

For the sake of clarity, paragraph (c) also states that a facilitator includes an employee of the non-resident. This means that section GB 54 could potentially apply to “fly-in/fly-out” arrangements, where a non-resident sends one of its employees to New Zealand to undertake sales related activities. The reason for this is that there is no black letter rule in DTAs providing that fly in, fly out employees or representatives cannot give rise to a PE for a non-resident (in particular, there is no requirement in our DTAs for a dependent agent’s activities to be connected with a fixed and permanent place in New Zealand in order for them to give rise to a PE). Whether a PE arises is always a question of fact and circumstance. There may be some circumstances in which a fly in, fly out employee or representative does give rise to a PE. Fly in, fly out employees and other representatives of the non-resident should therefore not be automatically excluded from section GB 54. Otherwise, a PE could still be avoided in a fly in and fly out arrangement.

However, the dependent agent provision in most DTAs requires that the non-resident’s representative (that is, the employee) *habitually* concludes contracts on behalf of the non-resident. This means that the employee’s activity in New Zealand must be regular to some degree before it can potentially result in the avoidance of any tax under section GB 54(1)(h). For example if an employee of the non-resident only made a short visit to New Zealand in order to promote or negotiate a single supply, we would not expect this to result in the avoidance of any tax under section GB 54(1)(h) (as the employee’s activity would not have given rise to a PE under the DTA even if the employee had executed the contract in New Zealand). Therefore, we would not expect section GB 54 to apply in this case.

However if the employee made regular trips each year to conclude contracts, then the employee potentially could be habitually concluding contracts in New Zealand, even if it only concluded a single contract on each trip[[2]](#footnote-2).

As a result of paragraph (c), any sales-related activity carried on by an unrelated independent agent will generally not give rise to a PE under section GB 54. This also reflects the current definition of a PE in New Zealand’s DTAs.

#### The activity is more than preparatory or auxiliary - paragraph (d)

As stated above, only activities that are designed to bring about a particular supply should be within the scope of section GB 54. To support this, paragraph (d) provides that any activities that are only preparatory or auxiliary to the non-resident’s supply of goods or services do not trigger the application of section GB 54. An example of preparatory or auxiliary activities is general marketing or advertising of a non-resident’s products. Warehousing and delivery of the supplied goods would also usually be preparatory or auxiliary. However, this would not be the case for example where the main business activity of the non-resident was delivering goods.

Paragraph (d) is also intended to incorporate the exception in most DTAs, which provides that preparatory and auxiliary activities do not give rise to a PE. Therefore in interpreting the meaning of “preparatory or auxiliary” in paragraph (d), it is intended that the OECD’s Commentary on the articles of the Model Tax Convention on Income and Capital (OECD Commentary) will be relevant.

The following table sets out examples of when paragraphs GB 54(1)(a) to GB 54(1)(d) (collectively referred to as the “sales test”) would apply. Even if the sales test is met for an example, section GB 54 would apply only if the section’s remaining requirements were met (in particular, the requirement that the relevant arrangement was carried out for a more than merely incidental purpose or effect of tax avoidance).

| New Zealand activity | Application of the sales test in paragraphs GB 54(1)(a)–(d) |
| --- | --- |
| There is no activity in New Zealand in relation to the supply. | The sales test is not satisfied. There is no “facilitator” under paragraph (b). |
| There is an online platform operated by a subsidiary of the non-resident through which New Zealand customers can order goods over the internet. The web-server for the platform is located in Australia and the platform is maintained and run by staff located in Australia. | The sales test is not satisfied. Although the platform can be accessed by customers located in New Zealand, all the activity in respect of the platform is carried on by the subsidiary’s employees and assets in Australia. Accordingly, paragraph (b) is not met as the subsidiary does not carry on any activity in New Zealand. |
| A non-resident operates a website through which customers worldwide can order goods and services. The website is located and maintained outside New Zealand. General advertising and marketing activity is undertaken in New Zealand by a subsidiary of the non-resident to make potential users of the website aware of its benefits and uses. The subsidiary does not deal directly with any particular customers. | In this case, there is an activity carried on in New Zealand, however the activity does not facilitate a particular supply to a customer. Accordingly paragraph (b) is not met. In addition the advertising and marketing activities are considered to be preparatory or auxiliary to making a supply. Consequently paragraph (d) also is not met. |
| A non-resident operates an off-shore website, through which it sells directly to customers in New Zealand. The non-resident also has a contract with an unrelated third party in New Zealand to store its goods at the third party’s warehouse. The third party has several similar arrangements with other, unrelated, suppliers. The non-resident does not have any particular part of the warehouse set aside for it, and it does not have the right to access the warehouse without prior arrangement. | The third party carries on an activity in New Zealand for the non-resident. However the third party is not associated with the non-resident, or commercially dependant on it. Accordingly section GB 54(1)(c) is not met, and so the sales test is also not satisfied. |
| A non-resident sells technical equipment to New Zealand customers. It has a subsidiary in New Zealand which undertakes technical demonstrations of the equipment to existing or potential customers to make them aware of the equipment’s capabilities. The subsidiary does not discuss any of the sales terms or customise orders for a particular customer. | The sales test is not satisfied. The subsidiary’s activity is in the nature of general advertising / marketing and does not relate to a particular supply to a customer. Accordingly paragraph (b) is not met. In addition, the subsidiary’s activities would also be preparatory or auxiliary, so paragraph (d) is not met either.  However, if the subsidiary went beyond demonstrating the equipment and instead worked with a particular customer to specify the equipment best suited to the customer’s needs, and/or directly persuade the particular customer to acquire the equipment, then the subsidiary’s activity would relate to any subsequent supply of that specified equipment to the customer, and so paragraph (b) would be met. Such an activity would also be more than preparatory or auxiliary, and so paragraph (d) would be met. Accordingly the sales test would be met in these circumstances. |
| A non-resident company offers an online platform, under which owners of horses in New Zealand can contract to supply their horses to riders for a fixed period. The platform is accessed via a smartphone app, with the server and all staff responsible for maintaining it located outside New Zealand. The non-resident company does have a subsidiary in New Zealand, which assists horse-owners in meeting the requirements to list their horses on the platform. However the subsidiary does not liaise with any horse riders. | The sales test is not satisfied. The activity of the subsidiary is essentially technical support for horse owners that have already decided they want to join the platform. Accordingly it is preparatory or auxiliary to the supply of platform services by the non-resident.  However, if the subsidiary instead persuaded individual horse-owners to sign up to the platform, then the sales test would be met in respect of the platform’s recurring supply of services to the horse owner. |
| A non-resident supplies photocopiers to New Zealand businesses. Its sale team is located offshore. However the non-resident has a subsidiary in New Zealand which provides technical support to existing customers. The subsidiary repairs malfunctioning photocopiers as part of the non-resident’s warranty programme and trains new purchasers on how to use the photocopiers. | The sales test is not satisfied. The subsidiary’s activity of providing repairs and training is made after the non-resident’s supply has occurred, and therefore is not made for the purpose of bringing about the supply. This is the case even though the promise to provide such repairs and training may have encouraged the New Zealand businesses to acquire the photocopiers. |
| A non-resident has a subsidiary in New Zealand. The non-resident sells cars to the subsidiary. The subsidiary then markets and sells the cars to customers in New Zealand. Sometimes a customer requests a car with specifications that the subsidiary does not stock. In this case, the subsidiary enters into a contract to sell the car to the customer, and then buys that car from the non-resident for on-supply to the customer. | The sales test is not met. The subsidiary is a normal distributor, rather than a facilitator for the sale of cars by the non-resident to New Zealand customers. In particular the subsidiary is not acting as an intermediary for the sale of the cars by the non-resident. This is because there is not a single arrangement under which the non-resident supplies the cars to the subsidiary and the subsidiary on-supplies the cars to the customer. Instead there are two arrangements – one for the sale of the cars to the subsidiary, and another for the sale of the cars by the subsidiary to the customer. It does not matter in this regard whether the subsidiary acquires the car before or after it agrees to sell that car to the customer. |
| A multinational has a New Zealand subsidiary, whose staff have initial and on-going contact with customers. The subsidiary negotiates the contractual terms for the first sale to the customer. However orders after the first are placed directly with the offshore sales representative. | The sales test will be met for the first order. Whether the sales test is met for subsequent orders will depend on whether the subsequent sales are part of the same arrangement as the sale that was facilitated by the subsidiary. For example, if the subsidiary negotiated an arrangement under which the New Zealand customer could make repeat orders of paper from the non-resident, then the sales test would be met in respect of any repeat orders even if the customer sent the order directly to the offshore sales representative. However if for example the subsidiary facilitated an order for one product sold by the non-resident, but then the New Zealand customer ordered a completely different product and negotiated the terms of sale for that product with the offshore sales representative directly, then the sales test would not be met for that different product. |
| A non-resident has a subsidiary in New Zealand that discusses a potential sale by the non-resident with targeted customers and ensures that the non-resident’s contractual terms for the sale are acceptable to the customer. | The sales test is met. The subsidiary is carrying out an activity in respect of a particular supply and the activity is undertaken for the purpose of bringing that supply about. In this case the subsidiary does not need to actually negotiate the contracts with the customers, as its activities are still made for the purpose of bringing a particular supply about.  For example if the subsidiary initiated and arranged the sale in all other respects, but left any disagreement over the non-resident’s contractual terms to be negotiated directly between the non-resident and the customers, then the sales test would still be met. This is because the subsidiary would still be carrying on an activity for the purpose of bringing about a particular supply, even though it did not carry on all the activities necessary to bring about that supply. |
| A non-resident does not have a subsidiary in New Zealand. Instead the non-resident sends one of its employees to New Zealand for 4 weeks every year to meet with potential customers. The employee markets the non-resident’s products to potential customers and answers any questions they may have about the operation of the products. However the employee does not discuss contractual terms and does not help customise particular orders for customers. | The employee in this case is a facilitator for the non-resident under paragraph (c)(i). However, the employee’s activity does not relate to a particular supply by the non-resident, so paragraph (b) is not met. In addition, the employee’s activities are preparatory or auxiliary, so paragraph (d) also is not met.  However if the employee instead worked with a particular customer to specify the products best suited to the customer’s needs and/or negotiated contractual terms for the supply of those products, then the employee’s activity would relate to the subsequent supply of those products to the customer, and so paragraph (b) would be met. Such an activity would also be more than preparatory or auxiliary, and so paragraph (d) would also be met. Accordingly, the sales test would be met. |
| A non-resident supplies home theatre components to custom installers in New Zealand. The custom installers work with customers to design their home theatres, and on-sell the home theatre components to the customers as part of the installation of the agreed design. The non-resident also has a subsidiary in New Zealand. For large projects, the non-resident’s subsidiary works with both the custom installer and the customer to determine the customer’s needs, select the products best suited to those needs, and provide expert technical oversight on their installation. The non-resident still supplies the home-theatre components to the custom-installer, who on-supplies them to the customer. | The sales test will be met for large projects (but not for smaller projects that do not involve the subsidiary working with the customer installer and the customer). The non-resident’s subsidiary is the facilitator in this example. The non-resident makes a supply to an intermediary in New Zealand (the custom installer) who in turn on-sells the products to another person in New Zealand (the customer). The facilitator (the subsidiary) carries out an activity for the purpose of bringing about the sale to the recipient (the customer). Finally, the supply by the non-resident to the custom installer, and the supply by the custom installer to the customer, are both part of the same arrangement. |

#### The non-resident is relying on a DTA that does not include the OECD’s new PE definition – paragraph (e)

As discussed above, the OECD has introduced a new PE definition to counter PE avoidance. This new PE definition has been included in its Model Tax Convention on Income and Capital (Model Treaty), and will also be inserted into the DTAs of participating countries under the MLI (provided both jurisdictions elect to include it).

The OECD’s new PE definition has several components. The relevant component here is that contained in article 12(1) of the MLI. In particular, the part of article 12(1) providing that a dependent agent PE will arise for a non-resident where a person habitually plays the principal role leading to the conclusion of contracts by the non-resident that are routinely concluded without material modification. The Government’s view is that this amended definition should be sufficient to prevent the kind of PE avoidance we have seen in New Zealand. It is also expected that section GB 54 and the OECD’s new PE definition will apply in broadly similar circumstances.

For this reason, paragraph (e) provides that section GB 54 will not apply where the non-resident’s income from its supplies to New Zealand customers is covered by a DTA which incorporates the OECD’s new PE rule. It does not matter for this purpose whether the OECD’s new PE rule is inserted into the DTA by the MLI, or is subsequently agreed by New Zealand and the other party in bilateral treaty negotiations. The new PE rule does not apply automatically to a DTA once the participating countries sign the MLI. Instead each country must first elect to include the new PE rule, then ratify the MLI. The OECD’s new PE rule will then apply to the DTA with effect from the date specified in articles 34 and 35 of the MLI.

While article 12(1) of the MLI and section GB 54 are expected to apply in broadly similar circumstances, there may be differences in their application due to their different formulations. In particular paragraphs GB 54(1)(a) to GB 54(1)(d) (referred to in the examples above as “the sales test”) will collectively apply more broadly than the requirement under article 12(1) that a person habitually plays the principal role leading to the conclusion of contracts by the non-resident. On the other hand, section GB 54 also requires the arrangement to have a more than merely incidental purpose of tax avoidance (under paragraphs GB 54(1)(h) and (i)), which article 12(1) does not. Therefore section GB 54 might apply to some circumstances which article 12(1) does not, and vice versa

#### The domestic law definition of a PE does not apply to a non-resident – paragraph (f)

New section YD 4B(3) inserts a definition of a PE into the Act for non-residents to whom no DTA with New Zealand applies. This domestic definition includes the OECD’s new PE definition. Accordingly, paragraph (f) provides that section GB 54 does not apply if the non-resident is subject to the domestic definition of a PE under section YD 4B(3).

#### The income from the supply is not already attributable to a PE – paragraph (g)

This is a mechanical provision. If the non-resident’s income is already attributable to a PE, then there should not be any PE avoidance occurring in respect of that income. Accordingly, paragraph (g) provides that section GB 54 will not apply in these circumstances.

#### The arrangement does not have a more than merely incidental purpose or effect of tax avoidance – paragraphs (h) and (i)

In order for section GB 54 to apply, the relevant arrangement must have a more than merely incidental purpose or effect of avoiding tax under paragraphs (h) and (i). This requirement has been inserted for two reasons:

* to target the rule’s application at BEPS activities, rather than more ordinary commercial arrangements; and
* to make the rule consistent with New Zealand’s DTA obligations. The OECD Commentary states that, as a general rule, there will be no conflict between anti-avoidance provisions and the provisions of a DTA (as discussed further below under “other matters”).

Tax for this purpose means both New Zealand income tax, and a combination of New Zealand income tax and foreign income tax. This is to prevent any argument that an arrangement’s avoidance of New Zealand tax was only incidental to its avoidance of foreign tax. For income years starting on or after the enactment date of the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill, sections (h) and (i) will also apply to arrangements that have a purpose or effect of avoiding other types of tax (as specified by section YA 2(3)), such as NRWT.

The general anti-avoidance rule (GAAR) in section BG 1 also requires that an arrangement has a more than merely incidental purpose of tax avoidance. However, in applying the GAAR, the courts have imposed a further requirement that the arrangement uses the relevant provisions in a manner not contemplated by Parliament (see *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115). This further requirement arises out of the need to reconcile Parliament’s purpose for the specific tax provisions (which may have been intended to confer a benefit in the circumstances) with its purpose for section BG 1 (see *Ben Nevis* at [102]). This further requirement is usually referred to as the ‘Parliamentary contemplation test’.

Section GB 54 is a specific anti-avoidance provision, rather than a GAAR. Further, the scope of section GB 54 has been carefully circumscribed. For these reasons, there is no need to reconcile the application of section GB 54 with the intended application of any other provisions. Instead, the intention is for only the more than merely incidental purpose test to be used in determining whether section GB 54 applies. It is not intended for the Parliamentary contemplation test (or the earlier scheme and purpose test) to also apply.

Subparagraphs (h) and (i) have been drafted to achieve this. It would not be appropriate to refer directly to the Parliamentary contemplation test in the legislation, as this is a judicial rather than a statutory requirement (and so might change in the future). Instead, the subparagraph has been drafted without reference to the definitions of “tax avoidance arrangement” or “tax avoidance” used by section BG 1. This is to make it clear that the test under subparagraphs (h) and (i) does not import the Parliamentary contemplation test (or the earlier scheme and purpose test) associated with those definitions.

Only the case law relevant to whether there is a more than merely incidental purpose or effect of tax avoidance should apply (for example, excluding any Parliamentary contemplation or scheme and purpose component of the test under the GAAR) in determining whether the more than merely incidental purpose test in subparagraphs (h) and (i) is met.

There is a significant body of case law on the more than merely incidental test. This case-law has generally required a degree of artificiality or contrivance before the test can apply (see the decision of Woodhouse P in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA)). In particular, the test has been held not to apply to ordinary commercial arrangements (i.e. arrangements undertaken for commercial purposes only). More information on the application of the merely incidental test is set out in the Commissioner’s Interpretation Statement IS 13/01 *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007*, paragraphs 395–438.

An example of the application of section GB 54 is set out below. The facts of this example are loosely based on the French *Valueclick* tax case, in which the non-resident was held not to have a PE under the French/Irish DTA (Sté Valueclick Ltd., n° 17PA01538 (CAA Paris, 9e ch., 1 March 2018)). France does not have an equivalent to section GB 54.

Example

A non-resident (Parent) operates a business of personalised digital marketing, allowing brands to connect with consumers individually. Parent is part of a large multinational group, with consolidated global revenues well in excess of €750 million. Parent is resident in a country with which New Zealand has a DTA, but that DTA does not incorporate the OECD’s new PE article.

Parent has a subsidiary in New Zealand (Subsidiary), whose purpose is to promote Parent’s services in the New Zealand market.

Subsidiary contractually agrees to provide the following services to Parent:

* marketing and sales support, which includes the identification and prospection of potential customers;
* ongoing management services and back office support services; and
* administrative assistance, including accounting, human resources management, information technology and treasury.

Subsidiary’s employees in practice negotiate the terms of the sales agreements and draft certain key terms with the customers. In addition, Subsidiary’s employees behave towards customers as if they were representatives of the Parent.

Subsidiary’s employees legally cannot bind or otherwise act in the name of Parent. The acceptance of the customer contract always requires Parent to sign the contract offshore. In practice however, the signature is an automatic validation of the contracts negotiated and developed by the employees of Subsidiary.

Applying section GB 54 to this case:

* There is a non-resident (Parent) making supplies to a person in New Zealand (the customers). Consequently, paragraph GB 54 (1)(a) is met.
* A facilitator (Subsidiary) carries on an activity in New Zealand for the purpose of bringing about those supplies under an arrangement with the non-resident (Parent). Consequently, paragraph GB 54(1)(b) is met.
* The facilitator (Subsidiary) is associated with the non-resident (Parent), as it is a wholly owned subsidiary of Parent. Consequently, paragraph GB 54(1)(c) is met.
* Subsidiary carries out significant sales activities for Parent. Accordingly, Subsidiary’s activities are more than preparatory for, or auxiliary to, Parent’s supplies. Consequently, paragraph GB 54(1)(d) is met.
* Parent’s income from the supply is subject to a DTA, but that DTA does not incorporate the OECD’s latest PE definition (as set out in article 12(1) of the MLI). Consequently, paragraph GB 54(1)(e) is met.
* Section YD 4B(3) incorporates a definition of a PE into domestic law, but only for non-residents that are not subject to a DTA. In this case, Parent’s income from the supply is subject to a DTA, and so section YD 4B(3) does not apply to Parent. Consequently, paragraph GB 54(1)(f) is met.
* The non-resident does not already have a PE in New Zealand. Consequently, paragraph GB 54(1)(g) is met.
* The arrangement results in the non-resident paying less tax in New Zealand compared to if the non-resident had a PE in New Zealand. Consequently, paragraph GB 54(1)(h) is met. Since section GB 54(2) deems a PE to exist, the relevant counterfactual for this purpose is the non-resident having a PE in New Zealand. However if the existence of a PE would not affect the non-resident’s tax liability, then paragraph GB 54(1)(h) would not be met.
* The non-resident is part of a large multinational group, as that term is defined in section YA 1. This is because Parent’s consolidated accounting group has:

– over EUR €750 million of revenue for the preceding income year;

– a member resident in New Zealand (Subsidiary); and

– a member resident overseas (Parent).

Therefore, section GB 54(1)(j) is met.

As a result, section GB 54 will apply if the reduction in tax for the Parent is a more than merely incidental purpose or effect of the arrangement between Parent and Subsidiary. In determining whether this test is met, previous case law on the more than merely incidental component of the general anti-avoidance rule in section BG 1 will be applicable. The Commissioner’s interpretation of this case law is set out in her Interpretation Statement IS 13/01 *Tax Avoidance and the Interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (particularly paragraphs 395–438). However, the Parliamentary contemplation component of the general anti-avoidance rule will not apply.

In applying the more than merely incidental test to the arrangement, it is significant that all the sales activity is carried out by Subsidiary in New Zealand. Parent’s only role is the pro-forma execution of the contracts negotiated by Subsidiary. There is no convincing commercial purpose for the non-resident to formally execute the contracts offshore when it was not involved in negotiating the contracts. In addition, the legal form of the arrangement does not reflect its substance. This is because in reality Subsidiary creates the customer contracts in New Zealand. The formal execution of the customer contracts by Parent offshore is thus artificial. It is also this feature that also allows Parent to avoid having a PE in New Zealand, and so allows the non-resident to avoid tax in New Zealand. Accordingly it can be objectively concluded that Parent’s execution of the contracts offshore was inserted into the arrangement for the purpose of avoiding New Zealand tax. Consequently this tax avoidance purpose is not merely incidental to another purpose of the arrangement.

Therefore, the arrangement has a more than merely incidental purpose or effect of tax avoidance, and so paragraph GB 54(1)(i) is met. As a result, section GB 54 will apply to the arrangement.

#### Consequences of application (sections GB 54(2), BH 1(4))

If section GB 54 applies, then under section GB 54(2) the non-resident is treated as having a PE in New Zealand. Supplies made by the non-resident are then treated as being made though that PE – but only if section GB 54(2) applies to those particular supplies. So for example, if the non-resident made some supplies in New Zealand in respect of which a related entity in New Zealand carried out sales activities (and the other requirements of the rule were met), then those supplies would be treated as made through the PE. However, if the non-resident also made other supplies in New Zealand and no related entity in New Zealand carried out any sales related activities in respect of those supplies, then those supplies would not be treated as made through the deemed PE for tax purposes.

The activities of the facilitator in relation to the supplies will also be attributed to the PE for the purposes of determining the profit attributable to it (and so the taxable income in New Zealand). Other activities of the facilitator (for example activities in relation to another taxpayer’s supplies) will not be attributed to the PE

The normal PE profit attribution rules apply to determine the amount of profits attributable to the deemed PE under section GB 54. In this regard, New Zealand follows an earlier version of the OECD’s latest PE profit attribution rules (and not the latest version, which is known as the “authorised OECD approach”, or AOA). This is for two reasons:

1. The AOA only applies to DTAs which incorporate the latest version of Article 7 (business profits) of the Model Treaty. None of New Zealand’s DTAs incorporate this version of Article 7, so the AOA is not relevant to New Zealand’s DTAs.
2. New Zealand does not agree with some aspects of the AOA and has made an explicit reservation against it.

DTAs, as international agreements, do not have any legislative effect except to the extent provided for in domestic legislation. DTAs are given legislative effect for tax purposes by section BH 1(4) of the Income Tax Act. This provides that DTAs have effect, despite anything else in the Act (subject to a list of exceptions). To make it clear that section GB 54 overrides any applicable DTA, an amendment to section BH 1(4) adds GB 54 to the list of sections which a DTA cannot override. This means that section GB 54 will deem a PE to exist for all the purposes of the Income Tax Act notwithstanding anything in that DTA.

The PE under section GB 54 will also be deemed to exist for the purposes of the other articles of the DTA. This is because those articles only have legal effect as provided for in the Income Tax Act, and section GB 54 of the Income Tax Act provides that the taxpayer has a PE in New Zealand. Therefore the Income Tax Act will give legal effect to the other articles of a DTA on the basis that the taxpayer has a PE in New Zealand.

It is important to note that section GB 54 on its own simply deems a PE to exist. It does not directly impose any tax or deem any assessable income to arise. Instead, the tax consequences of a deemed PE will be determined under the other provisions of the Income Tax Act and any applicable DTA.

Example

Section GB 54 applies to a non-resident subject to the New Zealand-Australia DTA. Consequently:

* The taxpayer is deemed to have a PE for the purposes of New Zealand law. This also means it has a PE for the purposes of giving legal effect to a DTA.
* The business profits article of the DTA (Article 7) applies to allow New Zealand to tax the profits attributable to that PE.
* The ordinary tax rules apply on the basis that the taxpayer has a PE in New Zealand. In particular, new section YD 4(17C) deems the income attributable to the PE to have a New Zealand source.
* The PE under section GB 54 exists for the purposes of any other provision of the DTA. For example, it is deemed to exist for the purposes of Article 12(5) of the DTA. This means that New Zealand could impose NRWT on any royalties paid by the non-resident that are borne by or deductible in calculating the profits of the PE. In this regard the Act also inserts new section YD 4(17D), which provides that income has a source in New Zealand if New Zealand has a right to tax it under an applicable DTA. Accordingly if New Zealand was entitled to impose NRWT on royalties under Article 12(5) in respect of the deemed PE, then those royalties would also have a New Zealand source under article YD 4(17D). This means that the royalties would also be subject to NRWT under the Income Tax Act.
* Items of income that are dealt with by other articles of a DTA will continue to be taxed in accordance with those other articles. This is because any conflicts between the tax treatment under a specific article (assuming the existence of a PE) and the tax treatment under Article 7 are dealt with under Article 7(5) of the DTA. Article 7(5) provides that the provisions of the other articles are not affected by the provisions of Article 7. For example, an Australian resident’s profits from shipping and air transport would continue to be dealt with under Article 8 of the DTA (rather than Article 7), even if section GB 54 applied to deem the non-resident to have a PE in New Zealand in respect of that activity.

#### Other matters

The Government anticipates that some multinationals may wish to restructure their New Zealand operations in response to section GB 54. One of the policy goals of section GB 54 is to encourage taxpayers to move away from PE avoidance structures. Therefore, the Government is happy for taxpayers to restructure their New Zealand operations in response to section GB 54 by either adopting a formal PE, or by moving to a standard distributor model (where the goods or services are sold by the non-resident to an associated party in New Zealand, who then on-sells the goods to unrelated customers).

Section GB 54 applies for income years starting on or after 1 July 2018. The standard income year for taxpayers starts on 1 April (see the definition of “income year” and “tax year” in section YA 1 of the Income Tax Act 2007). This means that non-residents to whom section GB 54 applies will also have income years starting on 1 April (meaning section GB 54 will apply to them from 1 April 2019), unless they have applied to the Commissioner for a different balance date under section 38 of the Tax Administration Act 1994.

Non-residents to whom section GB 54 applies may wish to change their New Zealand income year to align it with their financial reporting period. The Commissioner’s policy on requests to change balance dates for income years is set out in standard practice statement SPS 18/02 *Requests to change a Balance Date*. The statement notes that the Commissioner will accept retrospective requests to change balance dates provided certain criteria are met.

While section GB 54 will override DTAs, it should not conflict with New Zealand’s obligations under those DTAs. This is because New Zealand’s DTAs are based on the OECD’s Model Treaty. The OECD Commentary is an important part of the context in which these DTAs are internationally understood. Section GB 54 is an anti-avoidance provision, as it only applies to an arrangement with a more than merely incidental purpose of tax avoidance. The OECD Commentary states that, as a general rule, there will be no conflict between such 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).

However, it is important that section GB 54 applies notwithstanding anything in a DTA. This is to simplify the application of the rule. Otherwise it would be necessary to show that the application of section GB 54 was consistent with a DTA in each particular case. This would be a time-consuming and resource intensive exercise. The Government also considers that taxpayers should not be able to rely on DTAs to protect their tax avoidance arrangements. This is the same position that the UK and Australia have taken in respect of their PE anti-avoidance rules. As a result of this, the effect of section GB 54 on a taxpayer will not be reversed under a DTA’s mutual agreement procedure.

Several provisions of the Income Tax Act refer to a “fixed establishment”. A “fixed establishment” is conceptually similar to a PE, but they are not the same – for example a fixed establishment does not include a dependant agent of a non-resident. Section GB 54 only apples to deem a PE to exist – it does not also deem a fixed establishment to exist. Therefore provisions referring to the existence of a fixed establishment will not be affected by section GB 54.

Finally, the Government expects section GB 54 to apply in broadly similar circumstances to the OECD’s new PE definition. However, there will be differences in the application of the two rules, due to their different formulations.

### PE source rule

#### Section YD 4(17C)

Under the new source rule in section YD 4(17C), income of a non-resident will have a New Zealand source if it is attributable to a PE in New Zealand. This is subject to exceptions for certain dividends and income already subject to a specific source rule.

Dividends are excluded from section YD 4(17C), provided they are paid on a share in a foreign company that is not revenue account property. The reason for this exclusion is so that income earned overseas by a subsidiary of a non-resident does not become subject to New Zealand tax just because the shareholding of the subsidiary is managed by the New Zealand PE. However where the shares are held for the purpose of resale (or are otherwise on revenue account), then the dividends will be attributable to the New Zealand PE. This is because such shares will be investment property of the PE (rather than part of its operating structure), and so any returns in respect of them should be assessable.

Officials plan to consider whether this exclusion for dividends should be limited to active income earned by the foreign company (as determined under the CFC rules). This is to address a concern that non-residents could avoid New Zealand tax by shifting passive income out of the New Zealand PE and into an overseas subsidiary that is still managed by the PE. Officials were aware of this concern when the Act was passed, however there was insufficient time to consult on the fairly complex legislation that would be needed to include an active/passive distinction. Officials will consult on proposals to introduce an active/passive distinction before any further legislative action is taken.

Income with a source under section YD 4(17C) has its own apportionment rule under new section YD 5B. However the Income Tax Act currently has specific source apportionment rules for income from sea transport (sections YD 4(15) and YD 6), non-resident general insurers (sections YD 4(16) and YD 8(2)) and non-resident life insurers (sections YD 4(17) and EY 48). The intention is for these specific apportionment rules to still apply to income from these sources, rather than the PE income apportionment rule in section YD 5B. To allow for this, the new source rule in section YD 4(17C) is stated to be subject to sections YD 4(15) to YD 4(17).

#### Section YD 4B

Section YD 4(17C) only applies if a taxpayer has a PE in New Zealand. New section YD 4B inserts a definition of a PE into the Act for this purpose. Under section YD 4B:

* If a New Zealand DTA applies in respect of the taxpayer, then:
* The definition of a PE in that particular DTA will be used (section YD 4B(2)). The effect of this will be that where income is attributable to a PE in New Zealand under an applicable DTA, that income will automatically have a New Zealand source under section YD 4(17C).
* Any PE arising under section GB 54 will also be a PE, as defined under section YD 4B(2). However section GB 54 only applies if the relevant DTA does not incorporate the OECD’s new PE definition (section GB 54(1)(e)).
* If no New Zealand DTA applies to the taxpayer, then the new definition of a PE in schedule 23 of the Income Tax Act will apply. The PE definition in schedule 23 is based on New Zealand’s model PE article, and incorporates the OECD’s new PE definition.

New section YD 4B(4) has been inserted to clarify that the OECD Commentary should be used as a guide in interpreting the definition of a PE in schedule 23. However, the OECD Commentary does not itself have legislative effect. Therefore, the guidance in the OECD Commentary should not be applied in contradiction to the words of schedule 23.

In particular, the OECD Commentary applies in respect of the OECD’s model PE definition, which the definition in schedule 23 departs from in some areas. In addition, New Zealand has made reservations and observations on the Commentary to the PE definition (Article 5). The OECD Commentary should therefore be used as a guide subject to these differences, reservations and observations.

It is the OECD Commentary, as amended at the start of the relevant income year, which is to be used as a guide in interpreting schedule 23. This version of the OECD Commentary may be later than the version applying at the commencement of the Act.

#### Section YD 5B

Under section YD 4(17C), it is only income attributable to the New Zealand PE that has a New Zealand source. New section YD 5B sets out how both the income and the expenses attributable to a PE are to be determined. This section has been drafted to replicate the wording of the business profits articles of most of New Zealand’s DTAs (adjusted to reflect differences in terminology between the Income Tax Act and DTAs). Accordingly, whether income and expenditure are attributable to a PE for the purposes of section YD 5B should be determined under the normal PE profit attribution principles (as applied by New Zealand).

As noted above, New Zealand does not follow the AOA for PE profit attribution. The AOA also only applies in respect of the latest version of the business profits article in the OECD’s Model Treaty. Section YD 5B has been deliberately worded to follow the earlier version of the business profits article, and not the latest version in respect of which the AOA applies. Accordingly the AOA should not apply to determine the profit attributable to a PE under section YD 5B. Instead, the earlier version of the OECD’s profit attribution method currently followed by New Zealand should be used.

It is important to note that sections YD 4(17C) and YD 5B determine the amount of income and expenditure attributed to the PE. They do not determine whether such income and expenditure are assessable or deductible. This will be determined under the Income Tax Act’s usual assessability and deductibility rules. This is the same tax treatment as for a PE under the DTA. In particular, the deductibility of expenses attributed to a PE under the DTA is also determined under the Income Tax Act’s general deductibility rules (see paragraphs 30–34 of the OECD Commentary to Article 7).

#### Section YD 5(1BA)

The Income Tax Act 2007 already contains a source apportionment rule in section YD 5 for income from carrying on business in New Zealand (section YD 4(2)) or making or performing a contract in New Zealand (section YD 4(3)). A PE in New Zealand will also usually derive income from carrying on business in New Zealand or making or performing contracts in New Zealand. Accordingly without amendment, section YD 5 would also apply to apportion the income attributable to a PE.

Consequently, section YD 5(1BA) has been inserted to confirm that, where there is a PE, the PE attribution rules in new section YD 5B should be used, rather than the existing apportionment rules in section YD 5.

It is not expected that there would be material differences in the amount of income apportioned to New Zealand under section YD 5B and section YD 5. However, one of the purposes of section YD 4(17C) is to simplify the taxation of income attributable to a PE, by not requiring taxpayers and Inland Revenue to apply two sets of rules (the DTA rules and the domestic source rules). Consequently, section YD 5B has been inserted to remove any doubt that the PE profit attribution methodology which applies under the DTA should also be used in the domestic source rules.

Example

S Co is a company resident in Panama. It carries on a shipping business and has an office in New Zealand through which it enters into contracts to ship goods from New Zealand around the world. It also imports its own goods into New Zealand on its ships and sells them through a retail shop located under its offices.

Whether S Co has a PE in New Zealand is determined under section YD 4B. Because Panama and New Zealand do not have a double tax agreement, the permanent establishment definition in schedule 23 will apply (under section YD 4B(3)). S Co should use the OECD Commentary on article 5 as a guide in determining whether S Co has a PE under the definition in schedule 23, as the OECD Commentary was at the beginning of that income year. For S Co’s 2017–18 income year, this means that it should ignore the amendments made to article 5 of the OECD Commentary part way through 2017.

It is clear that S Co has two PEs in New Zealand under the schedule 23 definition, as it has two fixed places of business in New Zealand through which it carries on its shipping and its retail businesses. Therefore S Co has a separate PE for each of those separate businesses.

Under section YD 5B, S Co should determine the amount of profit attributable to its retail PE using New Zealand’s standard (non-AOA) approach to PE profit attribution. S Co can use the relevant parts of the OECD’s guidance on PE profit attribution for this purpose. In particular, since section YD 5B does not incorporate the wording needed to implement the authorised OCED approach (AOA) to profit attribution, none of the OECD guidance relating to the AOA will be applicable. Inland Revenue will shortly issue guidance on what parts of the OECD’s profit attribution guidance are relevant for New Zealand.

Once S Co has determined the profit attributable to the retail PE, the amount of income and expenditure comprising that profit will automatically have a New Zealand source under sections YD 4(17C) and YD 5B. S Co will then need to apply the ordinary tax rules in the Income Tax Act 2007 for assessability, deductibility, and timing to that income and expenditure in order to calculate its taxable income for the year.

In respect of S Co’s income from its shipping PE, the source of this income is specifically dealt with under section YD 4(15) and YD 6. Income with a source under section YD 4(15) is specifically excluded from the application of section YD 4(17C). Therefore section YD 4(17C) will not apply to S Co’s shipping income (with section YD 4(15) applying instead).

If S Co was resident in a country with which New Zealand had a DTA, then the tax treatment would be the same as above, except that:

– whether S Co had a PE would be determined under the DTA itself (and section GB 54), rather than schedule 23 (see section YD 4B(2));

– S Co’s ability to tax the shipping PE’s income would be restricted by the terms of the DTA. For example, if the New Zealand/Australia DTA applied, article 8 of that DTA would prevent New Zealand from taxing S Co’s shipping activity.

# Deemed source rule

YD 4(17D)

The Act inserts new section YD 4(17D) into the Income Tax Act 2007. The new subsection will deem an item of income to have a New Zealand source under our domestic legislation if New Zealand has a right to tax that item of income under a DTA. There is an exclusion from this rule for dividends from shares in foreign companies that are not revenue account property. The new rules aim to both simplify the test for determining whether an item of income has a source in New Zealand, and ensure that all items of income that New Zealand is entitled to tax under a DTA will be taxable under domestic law.

## Background

Under our domestic law, New Zealand can only tax income if it has a source in New Zealand. Section YD 4 of the Income Tax Act 2007 sets out the types of income that are treated as having a source in New Zealand for income tax purposes.

New Zealand has also entered into DTAs, which set out when New Zealand has a right to tax the income of a taxpayer resident in the counterparty to the DTA. These rules override anything in our source rules. This gives rise to two issues:

* The DTA may give New Zealand a right to tax income of the non-resident. However that income may not have a New Zealand source under section YD 4. This means that New Zealand is unable to tax the income, despite the other country having agreed in the DTA that New Zealand may tax that income.
* It is necessary to apply 2 sets of rules – one in the DTA and one in section YD 4, to determine whether New Zealand may tax an item of income.

Australia has a rule deeming income which Australia may tax under its DTAs to have a source in Australia for domestic law purposes.

## Detailed analysis

The Act inserts new subsection (17D) into section YD 4. The subsection deems an item of income to have a source in New Zealand if we have a right to tax the item of income under a DTA. There is an exclusion from this rule for dividends from shares in foreign companies that are not revenue account property. This is to preserve the exclusion from dividends under section YD 4(17C), discussed above.

Section YD 4(17D) also provides that the apportionment rules for shipping in YD 6, non-resident general insurers in section YD 8(2)) and non-resident life insurers in EY 48 will continue to apply in respect of income from those sources rather than new subsection (17D).

## Application date

The amendment applies for income years starting on or after 1 July 2018.

# Hybrid mismatch rule for NRWT

Sections BH 1(4), RF 11C

New section RF 11C inserts a new hybrid mismatch rule allowing New Zealand to charge non-resident withholding tax (NRWT) on payments under certain cross border hybrid financing instruments if New Zealand treats the payment as interest. This rule overrides our double tax agreements (DTAs).

## Background

The Government has identified a further hybrid mismatch issue that arises in the following circumstances.

The New Zealand PE of a non-resident company borrows money from another non-resident in the same overseas jurisdiction as the corporate headquarters of the PE. This occurs under a hybrid instrument which New Zealand treats as debt, but the other country treats as shares.

Under our DTAs, New Zealand is able to charge NRWT on interest payments made by a non-resident’s New Zealand PE to another non-resident. However, New Zealand is not able to charge NRWT on dividends paid by one non-resident company to another (regardless of whether the dividends are connected with a PE in New Zealand). This means that whether New Zealand can charge NRWT on payments under a hybrid financial instrument in these circumstances depends on whether the payments are classified as interest or dividends for DTA purposes.

Inland Revenue’s view has been that New Zealand can charge NRWT on the payments on the basis that the source state’s (that is, New Zealand’s) classification of the payment determines its tax treatment under the DTA. However, a question has recently been raised as to whether this view is correct.

If this view is not correct, then the PE would be entitled to an interest deduction in New Zealand for the payments (as the payments are characterised as “interest” under New Zealand domestic law), but the payments would not be subject to NRWT (as the payments are characterised as “dividends” under the DTA). This is contrary to the intent of the relevant DTA provisions, as outbound interest, which is deductible in determining the profits of a PE, should always have NRWT withheld unless there is a specific exemption providing otherwise (for example, some of our DTAs provide specific exemptions to the sovereign wealth funds of the other country).

The hybrid mismatch measures in the Act ensure that payments made under such hybrids cannot be both deductible in New Zealand and non-assessable overseas. This removes the incentive to use these types of hybrids in most, but not all cases. In particular the existing hybrid measures still permit payments under a hybrid financial instrument to be deductible in New Zealand, but not subject to NRWT in some cases. This tax treatment differs from that applying to either ordinary interest (which is deductible and subject to NRWT) or dividends (which are non-deductible), and could be attractive to some taxpayers.

Australia already has a rule effectively providing that outgoing payments are not dividends for DTA purposes (and so are subject to Australian NRWT) if they are treated as interest under Australia’s domestic law.[[3]](#footnote-3)

## Application date(s)

New section RF 11C applies retrospectively from 1 April 2008. A savings provision is available for payments where taxpayers have already adopted the position that NRWT or AIL is not payable in respect of such cross-border interest payments made prior to the introduction of the Bill (on 6 December 2017).

## Key features

The Act inserts new section RF 11C. Section RF 11C(1) provides that the section applies to a payment of interest (as defined in section YA 1) by a company that is resident outside New Zealand under an applicable DTA to another person who is also resident outside New Zealand under that DTA. Section RF 11C(2) then provides that the payment is treated as interest under the NRWT rules and the DTA, notwithstanding anything to the contrary in the DTA. The Act also amends section BH 1(4) to clarify that section RF 11C overrides the applicable DTA.

The combined effect of the legislation is that New Zealand may withhold NRWT from a cross border payment that is interest under section YA 1, regardless of whether it is treated as a dividend under the applicable DTA.

1. This is contained in Article 12(1) of the *Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting* (MLI) [↑](#footnote-ref-1)
2. See paragraphs 98 and 29 of the OECD Commentary to Article 5 [↑](#footnote-ref-2)
3. Section 3(2A) of Australia’s International Tax Agreements Act 1953 [↑](#footnote-ref-3)