BEPS tax bill — Significant tax change with widespread impact fast becoming reality in New Zealand

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In brief

The anticipated changes to New Zealand's tax regime for cross-border relationships and transactions are fast becoming a reality. New Zealand's new Government recently introduced a tax bill to Parliament proposing to:

- tighten the transfer pricing regime;
- move the way that related-party debt is priced away from normal arm's-length principles;
- make it more likely that groups with a physical presence in New Zealand will be taxable here on sales revenue;
- eliminate tax advantages arising from hybrid mismatches;
- further restrict interest deductibility under the thin capitalisation regime; and
- give Inland Revenue more power to investigate large multinationals.

If enacted as proposed, most of the new rules could take effect as early as of July 1, 2018 or, in the case of the new deemed permanent establishment rules, from the enactment date, which could be earlier.

All New Zealand businesses that operate overseas, and all business groups based overseas that operate in New Zealand, are likely to be affected in some way by the new rules.

It is critical for all businesses operating in New Zealand to consider carefully the potential cumulative effect that the proposed rules would have, and to do this as soon as possible given the short lead time. Taxpayers will need to be confident their business strategies still have the expected tax outcomes, and detailed and contemporaneous New Zealand-specific transfer pricing documentation following closely the OECD's new guidelines will be critical moving forward.

In detail

The way related-party debt must be priced for New Zealand tax purposes is proposed to change significantly

If you have borrowed funds from an offshore related party, the way those borrowings must be priced for New Zealand tax purposes is changing significantly. The Government intends to proceed with the proposed 'restricted transfer pricing rule,' under which, unless borrowings do not exceed $10m, they must be priced by:

- using a credit rating that is one notch below the ultimate parent's credit rating, or if you have no identifiable parent, a credit rating of BBB-, unless you can demonstrate you are not in a 'BEPS risk' category (which is proposed to be based on prescribed criteria, namely, your interest coverage ratio, your leverage ratio, and the tax rate applicable to the recipient of the interest); and
- ignoring what the Government views to be 'exotic' features not typically found in third-party debt, for example, subordination, a loan term of more than five years, and convertibility, unless you can demonstrate that your group has a significant amount of third-party debt with those features.

PwC comment: We strongly recommend taxpayers start considering now the potential impact of these proposed rules for related-party debt pricing. We anticipate that many taxpayers will find it difficult to demonstrate that they are not a 'BEPS risk' on the restrictive criteria currently proposed, and therefore will be forced to price debt for New Zealand tax purposes effectively on the basis of their parent's credit rating (minus a notch), whether or not this is commercially rational or appropriate.

PwC comment: In our view, the proposed rule is very complicated and will lead to (a) high compliance costs for taxpayers, and (b) cross-border interest rate mismatches (and potentially double tax) where the offshore lender is required to price the loan for its own tax purposes using normal arm's-length principles. Although the proposed rule was expected following the consultation process, it is disappointing that there are not more 'exceptions' to the rule to allow for normal transfer pricing principles where taxpayers can prove that the pricing of the loan is consistent with third-party borrowing.

The transfer pricing rules are getting tougher

The reach of the transfer pricing regime is being extended – New Zealand companies owned by investors in the same 'control group' (a new BEPS-related concept that includes acting together/acting in concert to effectively control a taxpayer) will become subject to the regime following enactment.

If you are currently subject to the transfer pricing regime, or will be in future, you need to check that your current arrangements can comply with the new transfer pricing rules. If the transfer pricing proposals are enacted:

- your legal arrangements will be required to be commercially rational and consistent with their economic substance, or Inland Revenue will be able to disregard or replace them for transfer pricing purposes;
- the onus of proof will shift so that you (the taxpayer) will have to prove that your arrangements are on arm's-length terms (rather than Inland Revenue having to disprove it); and
- the time bar for making transfer pricing adjustments will be extended from four years to seven years.

PwC comment: The proposed transfer pricing changes have been foreshadowed for some time. Taken together, the changes will enable Inland Revenue to adopt a stricter approach to transfer pricing compliance, in line with the approach currently adopted by the Australian Tax Office. Taxpayers will need to meet a much higher standard to be eligible for penalty protection if they are audited. Detailed and contemporaneous New Zealand-specific transfer pricing documentation in line with the new legislation and following closely the analysis as set out in the new OECD guidelines will be critical moving forward.

Rules are changing around when a physical presence in New Zealand is taxable

If you, or your group, have a physical presence in New Zealand but are not currently subject to New Zealand tax on New Zealand sales revenue, or if the group pays royalties attributable to New Zealand sales that are not currently subject to New Zealand withholding tax, this may change if the deemed PE proposals are enacted. You should review your business processes and contractual arrangements to analyze whether the new rules apply to you. Similar rules are being adopted in other countries, so if you are New Zealand-based and operating overseas you need to consider whether foreign equivalent rules apply to you.

The proposed measures address the Government's concerns around the avoidance of permanent

establishments (PEs), and include both domestic measures and changes to New Zealand's double tax treaties, to be incorporated by the OECD's multilateral instrument (MLI) (see August 2017 Tax Tips Alert). Each new measure is broadly intended to have a similar scope; however there are subtle differences between them.

One of the domestic tax law measures — the deemed PE anti-avoidance rule — is intended to override New Zealand's double tax treaties, although it will not apply where a nonresident benefits from a double tax treaty that incorporates the OECD's new PE definition under the MLI. New Zealand also will have a new domestic law definition of a PE under the proposals, which will apply if there is not an applicable double tax treaty or at least a relevant double tax treaty PE definition (the new PE definition reflects the OECD's revised definition of PEs). Which new PE measure applies therefore will be determined by the jurisdiction of residence of the non-resident concerned. Once the existence of a PE is established in New Zealand, income attributed to the PE automatically will be deemed to have a New Zealand source (including royalties paid between nonresidents that relate to that New Zealand deemed PE).

The deemed PE anti-avoidance rule is targeted at large multinationals (with consolidated global turnover of more than EUR 750 million), where a related or commercially dependent entity carries out activities for the purpose of bringing about a supply by the non-resident and there is a tax avoidance purpose that is more than incidental. An exception will apply if the activities are preparatory or auxiliary in nature (e.g., general marketing and advertising of a nonresident's products).

PwC comment: The proposals as introduced generally are as previously discussed with Policy Officials, with some helpful clarifications in relation to issues we raised during the targeted consultation process. We welcome that the Bill Commentary gives useful guidance as to the scope of activities that the proposed deemed PE anti-avoidance rule is intended to capture; however, in our view the proposed statutory language itself is far from clear and needs to be more targeted. We expect that there will be uncertainty around which new rule could apply, and there will be situations where a domestic rule could seem to apply for a transitional period until a relevant double tax treaty changes due to the MLI or bilateral negotiations.

If a nonresident has a deemed PE in New Zealand, the next important question is: what profits should be attributed to it? The calculation of the resulting tax outcome for New Zealand is a contentious issue globally (see our March 2017 Tax Tips). Detailed guidance from Inland Revenue is urgently needed to help taxpayers assess tax outcomes if they would be affected by the rules.

Tax benefits arising from hybrid and branch mismatches are being eliminated

If you benefit in any way from a tax advantage that arises due to an entity or arrangement being treated differently for tax purposes by different countries, whether in New Zealand or elsewhere, this benefit is likely to be counteracted under the proposed (and complicated) 'hybrid mismatch' New Zealand tax rules. If enacted as expected, the rules may apply to deny deductions or to tax income that currently is not taxed, with limited exceptions to the proposed application date of income years starting on or after July 1, 2018. Any business with related-party cross-border transactions or an offshore presence should consider as soon as possible the potential impact of these proposals and to engage quickly if restructuring might need to be considered.

Common examples of hybrid mismatches include (see our September 2016 and August 2017 Tax Tips Alert for more detail):

- a payment that is interest in one jurisdiction (therefore deductible) but a receipt of a dividend in another (potentially exempt);
- a limited partnership that is treated as transparent in its country of formation but not in a partner's country (or vice versa);
- a trust that is not taxed on income anywhere due to how the trust is treated in the country of the settlor, trustee, and beneficiary respectively; or
- a branch or a dual resident company that is currently allowed deductions for expenditure in two countries.

The proposals largely follow the OECD recommendations in relation to hybrid and branch mismatches, with some modifications for the New Zealand context. One such modification is that some taxpayers may be required to use the comparative value method to calculate 'foreign investment fund' (FIF) income if the FIF entity pays distributions that are deductible to it.

Proposals to simplify the impact of the anti-hybrid/branch proposals

Following extensive consultation, some measures have been proposed to help taxpayers deal with the potential application of the rules. The key ones are summarised below:

- *Dividend election* – A person who pays interest that is non-deductible as a result of the hybrid rules can elect to treat the hybrid instrument

on which the interest is paid as a share for New Zealand tax and the payment as a dividend (non-deductible). This could eliminate any potential double taxation arising as the payment may be able to be made without nonresident withholding tax if imputation credits are attached etc.

- *Opaque election* – A New Zealand resident may elect to treat a wholly owned foreign hybrid entity (e.g., a foreign partnership) as a company for New Zealand tax purposes, so that there is no hybrid mismatch and the hybrid rules do not apply.
- *Foreign branches* – The rules applying to branches have been limited in scope in an effort to ensure that they do not apply to New Zealand companies with simple branch structures (which are not viewed as a BEPS hybrid risk).

PwC comment: These rules are by far the most complex of the proposed measures. They are difficult to navigate and will apply in many unexpected circumstances. We expect that in many cases it will be hard to ascertain with certainty whether the rules apply. While these rules have been foreshadowed for some time, and are being proposed as a result of the OECD's recommendations, New Zealand would be only the second globally after the UK to adopt them. The Australian government has recently released similar proposals, which are likely to take effect after New Zealand's rules are expected to apply.

PwC comment: Given the nature of the rules, we believe that the implementation date should be delayed until more countries where hybrid mismatches are prevalent adopt the OECD recommendations. If enacted as expected, there will be many difficult transitional cases where the New Zealand rules only apply until the other country has enacted rules. It also may be difficult in some cases to determine whether the other country's rules are 'hybrid rules' – for example, there are some aspects to the current US tax reform proposals that could be viewed as hybrid rules. Will these rules qualify to mean the New Zealand rules do not apply?

The thin capitalisation regime is to be tightened (again!)

The thin capitalisation regime will 'bite' harder (again) for almost all businesses subject to the thin capitalisation rules if the proposed changes to the regime are enacted. The Government intends those changes to apply soon — i.e., for income years starting on/after July 1, 2018.

The calculation of thin capitalisation ratios is proposed to change significantly. If you are currently subject to the thin capitalisation regime, or will be in future, you need to analyze how the new rules will change your position. If the proposals are enacted as drafted:

- You will be required to calculate the value of your assets, net of your non-debt liabilities – there are some exceptions to this for liabilities that are 'equity-like,' such as interest-free loans from shareholders, some shares that are classified as debt instruments for accounting, and provisions for the payment of dividends;
- Deferred tax liabilities will count as a non-debt liability, unless the crystallisation of the liability would not actually result in a tax cost (for example, on a notional liquidation);
- If you calculate your thin capitalisation ratio using net current values rather than financial statement values for certain assets, you will need to obtain a valuation from either an independent expert or a suitably experienced person using a methodology approved by an expert;
- If you enter into transactions that change your thin capitalisation ratio near a measurement date, you need to make sure those transactions are not entered into with the purpose or effect of manipulating the ratio; and
- If the New Zealand companies are in the thin capitalisation regime (because of the measures introduced in 2014), where a group of nonresident shareholders who act together and hold more than 50 percent (under the current test) and/or act in concert with other shareholders (under the new extension), the safe harbour debt-to-net asset thresholds now will be 60 percent (or 100 percent for worldwide debt), subject to grandparenting for five years in relation to the existing 110-percent worldwide debt threshold.

Limited relaxations of the current thin capitalisation regime also are proposed:

- You may be able to take advantage of the extension of a new $1 million interest *de minimis* threshold if you are subject to the inbound thin capitalisation rules, but only if you have only third-party debt;
- If you are engaged in projects that meet certain public infrastructure project criteria, you may be able to claim a full interest deduction on third-party debt even if your debt to asset ratio exceeds 60 percent for the relevant project.

PwC comment: The proposals as introduced largely are what was signalled following targeted consultation over the last six months. We are disappointed with some aspects of the proposals. For example, while the exclusion of deferred tax liabilities from being a non-debt liability has been welcomed, the limited nature of the exclusion as proposed will make it difficult for taxpayers to apply and should be relaxed. Other aspects of the new rules will need more clarification than currently given. For almost all taxpayer groups subject to thin capitalisation, these rules likely will have a significant negative effect on the thin capitalisation gearing ratios – some industries much more than others. Taxpayer groups need to be modelling the impact of the proposed changes as soon as possible, as restructuring may be needed if the ratios are expected to exceed the safe harbour thresholds in future.

Inland Revenue will have more power to investigate multinationals

If you are a member of a large multinational group (with consolidated turnover in excess of EUR750m), Inland Revenue will have greater powers to investigate your group's tax affairs and collect New Zealand tax payments if the proposals are enacted. Under the new measures, intended to be mostly focused on matters around transfer pricing and deemed New Zealand permanent establishments:

- A local subsidiary could be required to provide information held by any member of the group;
- A local subsidiary may not be able to use information that it failed to produce when formally requested by Inland Revenue in dispute resolution or challenge proceedings;
- The Commissioner may impose a civil penalty of up to $100,000 for the failure to produce information when formally requested;
- Criminal penalties may apply in situations where information held by other members of a multinational group is not provided when formally requested; and
- The Commissioner may collect unpaid tax from any local subsidiary of a multinational group.

PwC comment: These proposals were foreshadowed in previous policy announcements, but the scope of the proposals as introduced is much clearer than what was originally announced.

The takeaway

The cumulative effect of the changes in many cases will be significant. With short lead times to effective dates, and draft legislation now available, the potential impact of these proposals needs to be considered now.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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