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New Zealand releases BEPS guidance to provide clarity

Global Transfer Pricing Alert 2018-024

The New Zealand government's taxation bill to address base erosion and profit shifting (BEPS) concerns received Royal Assent on 27 June 2018, finally bringing the BEPS proposals into New Zealand's domestic legislation. The majority of the proposals apply to income years starting on or after 1 July 2018.

While Royal Assent would normally signal the end of the road, the breadth and complexity of the BEPS changes has seen Inland Revenue release draft guidance material, in the form of five special reports, to ensure the changes are as clear and understandable to the public as possible. This is an ambitious task, but a necessary one, and feedback is requested on the usefulness of the draft guidance (which is to be finalized and published in early 2019).

The key areas covered by the guidance are outlined below. Some areas of the guidance will need to be clarified and refined, and other areas could benefit from further examples and direction. You can read a summary of the BEPS bill as it was reported back from Parliament and our December Tax Alert on the changes as originally proposed.

Interest limitation rules

This special report covers the new restricted transfer pricing approach, thin capitalization changes, and infrastructure project finance changes. In particular, the report covers:

- The new rules requiring related-party loans between a nonresident lender and a New Zealand-resident borrower to be priced using a restricted transfer pricing approach. The report includes a flowchart outlining the process for determining a New Zealand borrower's credit rating (i.e., whether transfer pricing rules apply, a credit rating adjustment is required, or no credit rating adjustment is required), with each step explained in detail.

- If a credit rating adjustment is required, the process for determining the rating is set out in another flowchart. The concepts of "high BEPS risk," implicit parental support, group borrower's credit rating, and long-term senior unsecured debt are also explained further.

- The new economic substance and reconstruction provisions that disregard legal form when it does not align with the actual economic substance of the transaction, or to allow transactions to be reconstructed or disregarded when the arrangements are commercially irrational and would not be entered into by third parties operating at arm's length. A flowchart is included to illustrate the overall process to be followed in determining the interest rate on a particular instrument.

- The approach required for financial institutions ("insuring or lending persons") when they are generally required to use their parent's credit rating rather than the default credit rating, restricted credit rating, or group credit rating (including a flowchart determining whether a feature can be included in pricing).

- The changes to the thin capitalization rules so that debt percentages will now be based on an entity's assets net of its "non-debt liabilities," explaining what is and what isn't a non-debt liability with examples.

- Other changes made to strengthen the thin capitalization rules, including a de minimis rule for the inbound thin capitalization rules, reducing the ability for companies owned by a group of nonresidents to use related-party debt, new rules around asset valuation, and an anti-avoidance rule for when a loan is substantially repaid just before year end.

- Amendments that have been made to provide entities carrying out eligible infrastructure projects with a limited exception from the thin capitalization rules by allowing them to claim deductions on debt that exceeds the thresholds set out in the legislation.

Transfer pricing

This special report covers the strengthening of New Zealand's transfer pricing rules, providing for closer alignment with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. These changes include:

- Extending the application of the transfer pricing rules to circumstances when there are transactions between members of nonresident owning bodies and companies and to specifically refer to cross-border related borrowings.

- Adding a reference to using the 2017 OECD transfer pricing guidelines as guidance for how the transfer pricing rules are applied, noting that any changes to the OECD guidelines will be considered with a view to updating the section YA 1 definition of the OECD guidelines to refer to the most recent version.

- Giving the economic substance of a transaction and actual conduct of the parties to the transaction priority over the terms of the legal contract, and requiring the arm's length amount of consideration to be determined using arm's length conditions. When a transfer pricing arrangement is not commercially rational because it includes unrealistic terms that unrelated parties would not be willing to agree to, the approach in the new OECD transfer pricing guidelines may apply to disregard and, if appropriate, replace the transaction.

- Placing the onus of proof on the taxpayer for providing evidence that its transfer pricing positions are correct, acknowledging that there may be a range of conditions that can be considered to be arm's length conditions. The special report endorses the three-tiered approach to transfer pricing documentation, whereby a master file, a local file, and a country-by-country report are prepared, and links to supplementary Inland Revenue guidance on what is required (in addition to the OECD transfer pricing guidelines).

- Increasing the time bar for transfer pricing positions to seven years when the Commissioner of Inland Revenue has notified the taxpayer that a tax audit or investigation has commenced within the usual four-year time bar. The example provided applies the four years from the date of filing the tax return, so the actual position will need to be clarified with officials, because the legislation and guidance are not consistent.

Permanent establishment avoidance

This special report covers the new anti-avoidance rule for large multinationals (those with over EUR 750 million turnover) that structure to avoid having a permanent establishment (PE) in New Zealand, as well as the broadening of the source rules. In particular:

- The special report explains the new PE avoidance rule that deems a nonresident to have a PE in New Zealand if a related entity carries out sales-related activities for it under an arrangement with more than a merely incidental purpose of tax avoidance (and other requirements are met). This moves away from the previous test of habitually concluding contracts and instead places the focus on whether the representative of the nonresident habitually plays a *principal role* leading to the conclusion of contracts.

- The report includes an analysis of the criteria that, if met, deems a PE to exist in New Zealand, as well as a table of examples that illustrate when the criteria are met. Also included are analysis and examples regarding whether there is a more than merely incidental purpose of tax avoidance and the consequences of this.

- The new source rules are covered, whereby if income is attributable to a PE in a country, then it will be deemed to have a New Zealand source under New Zealand's domestic rules. This is contrary to the current position, whereby to tax a nonresident on its New Zealand sales income, it is necessary to show that the income both has a New Zealand source and is attributable to a PE under an income tax treaty.

Administrative measures

This special report covers a number of the administrative changes made in relation to "large multinational groups," as newly defined in the Income Tax Act 2007 (ITA). These include:

- The increased ability of Inland Revenue to request information from large multinational groups, including the ability to impose a civil penalty of up to NZD 100,000 on multinationals that fail to respond to requests for documents. An example sets out the process by which Inland Revenue will request information held by nonresident members of large multinational groups, and the consequences of the failure to provide this information.

- The ability of Inland Revenue to collect tax owed by a nonresident member of a large multinational group from another wholly owned group member that is a New Zealand resident or that has a PE in New Zealand, and the requirement to file country-by-country reports.

Hybrid mismatch arrangements

The longest of the special reports covers the changes to introduce the OECD hybrid and branch mismatch arrangements recommendations into New Zealand domestic legislation, with modifications for the New Zealand context. As noted in the report, while the new rules are relatively complex, they will have no impact on the vast majority of taxpayers. This report covers:

- The rules in subpart FH addressing the hybrid and branch mismatches arising from hybrid financial instruments, disregarded hybrid payments and deemed branch payments, reverse hybrid and branch payee mismatches, deductible hybrid and branch payments resulting in double deductions, dual resident payers, and imported mismatches.

- The ability for taxpayers with inbound hybrid financial instruments to elect to treat the instrument as a share for New Zealand income tax purposes and the ability to irrevocably elect to treat a wholly owned outbound foreign hybrid entity existing on 6 December 2017 as a company for New Zealand income tax purposes. Taxpayers must send these elections to the following email address: hybridelections@ird.govt.nz.

- The consequential changes to the foreign investment fund (FIF) rules, nonresident withholding tax, and thin capitalization as a result of the introduction of the hybrid mismatch arrangement rules.

Deloitte comment

Taxpayers should keep in mind that we have yet to really see this legislation and guidance in force. For those entities that are affected by these rules (which is the majority of multinational taxpayers), these changes add another level of complexity and consideration to their operations. Further, even with refinement and the inclusion of more examples, the effect of these rules and their compliance burden will depend on the operational approach taken by Inland Revenue.

The majority of the new rules will become law for income years beginning on or after 1 July 2018. For companies with June balance dates, this means they effectively apply from 1 July 2018, despite the fact that the guidance on applying the rules is not likely to be finalized until early 2019.

If all that isn't enough to consider, the government has indicated that this may not be the end of the BEPS journey, and we may yet see further changes to New Zealand's international tax rules.

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- 2016 Global Transfer Pricing Country Guide
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