Tax Tips Alert

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Cross-border transactions and investments: Key tax developments

As we wrap up 2016 and look forward to the New Year, we've outlined below a number of key international tax and transfer pricing developments to mull over this Christmas break in preparation for 2017

1. Inland Revenue recently released its updated **Multinational Enterprises Compliance Focus** document setting out its approach for managing the taxation of multinationals operating in New Zealand. The document does not contain any major surprises for taxpayers. It has been well written and is an easy read for both tax professionals and the broader business community. Inland Revenue seeks to be transparent about its expectations, how it will approach tax for multinationals and what it sees as the red flag compliance risks.

   As the global tax landscape continues to develop, multinational taxpayers can expect ongoing scrutiny of their cross-border transactions and that Inland Revenue will want to understand their tax affairs. Inland Revenue's annual risk reviews and international questionnaires will continue and the coverage of New Zealand companies will expand.

   Inland Revenue has also included a section on tax governance and recommends that companies adopt the BIAC Statement of Tax Principles for International Business (which is connected to the OECD). It will be more important than ever for boards and senior management teams to engage with tax issues and ensure appropriate corporate tax governance frameworks are in place.

   To see a copy of the compliance focus document, please *click here*.

2. The OECD released the **Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS** (the Multilateral Instrument) on 24 November 2016. This is a significant step forward in the OECD base erosion and profit shifting (BEPS) project and will allow certain BEPS measures to be integrated into more than 2,000 international tax treaties worldwide for those countries that sign up and ratify the process. These measures include changes to current treaty articles to provide against "treaty shopping" and updates the definition of "permanent establishment".

   Looking forward, the New Zealand Government has signalled it will look to sign the Multilateral Instrument in June 2017 and proceed with the ratification process shortly thereafter. It is likely the Multilateral Instrument will be integrated into New Zealand's tax treaties some time in 2018. A copy of the Minister of Revenue's media statement following the release is *available here*.

3. Inland Revenue has endorsed the revised OECD transfer pricing guidelines and, consequently, we observe that Inland Revenue has an **increasing focus on substance** (i.e. the alignment of transfer pricing outcomes with value creation) during risk review and audit activity. Common themes include validating the extent of local marketing and sales activities and the derivation of local marketing intangibles, as well as the commercial rationale behind restructuring activities. Taxpayers can expect more detailed information requests from Inland Revenue on transfer pricing, and it is crucial that transfer pricing policies accurately reflect the value contributed by the New Zealand taxpayer to the wider global supply chain.

4. As a result of implementing the revised OECD transfer pricing guidelines, effective as early as 2018, the mark-up applied under Inland Revenue's **administrative practice for low value service charges** will decrease from 7.5% to 5%. However, Inland Revenue's priority during risk review and audit activity of multinationals is not the mark-up. Consistent with an increasing focus on substance, Inland Revenue's focus is on validating the nature of the services provided and the calculation of the cost base. Access to this level of detailed information will require more transparency and cooperation from offshore related parties.

5. While Inland Revenue (so far) has elected not to legislate for mandatory transfer pricing documentation requirements in New Zealand, the OECD's themes of transparency and certainty are deeply reflected in Inland Revenue's expectations of New Zealand taxpayers and its approach to risk assessment. Inland Revenue endorses the **OECD's three tiered documentation approach** (including preparation of the country-by-country report, master file and local file) *(as previously discussed in our earlier Tax Tips publication)* and expects New Zealand taxpayers to prepare contemporaneous documentation consistent with this approach. Documentation provides a first line of defence during transfer pricing risk review and/or audit activity by Inland Revenue, and can aid in penalty protection in the event of a transfer pricing audit adjustment.

6. The OECD's themes of transparency and certainty are also reflected in Inland Revenue's move towards **greater international agreements and cooperation**. Taxpayer information, including country-by-country reports and unilateral advanced pricing agreement (APA) information, will become increasingly available to foreign tax authorities as a result of New Zealand's commitment to automatically exchanging information under the Multilateral Competent Authority Agreement. Transfer pricing policy validation and documentation should be prioritised if the transfer pricing position adopted in New Zealand deviates from that of entities with similar operating structures in the wider group.

7. The Finance and Expenditure Committee (FEC) recently reported back on the **Taxation (Annual Rates for 2016-2017, Closely Held Companies, and Remedial Matters) Bill**. A number of the recommendations are particularly relevant in an international tax context, including changes to the tax treatment of debt remission between related parties and the non-resident withholding tax (NRWT) and approved issuer levy (AIL) rules relating to interest paid by New Zealand borrowers to non-residents. The proposed "clarification" for the domestic anti-avoidance test to override New Zealand's tax treaties is also present. The key recommended changes from the FEC's review of the NRWT rules includes:
   - An intention test has been introduced to determine whether a back-to-back arrangement is in place and to ensure genuine indirect, associated funding arrangements are not caught, and
   - The previously proposed categories setting out requisite criteria for when AIL would be available has been removed.

8. Submissions for the Government Discussion Document, **Addressing hybrid mismatch arrangements**, closed 11 November 2016. The discussion document broadly looked to incorporate OECD recommendations into New Zealand domestic law. Given the complexity of the proposed measures to tackle hybrid arrangements and the limited worldwide responsive action taken outside of the United Kingdom and Australia to date, we do not believe New Zealand should be among the first wave of countries to introduce anti-hybrid rules.

   The scope of the hybrid mismatch proposals are wider than the name suggests. For example, domestic tax legislation is suggested to limit losses in New Zealand by foreign branches and to deal with companies that are tax resident in two countries. Many of these proposals could be far reaching, depending on the final scope of the rules.

   A second consultation paper is expected to be released in the first half of 2017. We suggest taxpayers take the opportunity to health-check their businesses for any potentially impacted arrangements before the proposed rules are enacted, likely to be 2018 at the earliest.

We understand consultation on the proposed strengthening of the current interest limitation rules is expected to take place in the first half of 2017.

9. **Thin capitalisation rules**: Action 4 of the OECD Action Plan on BEPS recommended 'interest limitation rules' to limit interest deductions to between 10%-30% of a taxpayer's EBITDA. To date, this recommendation has been implemented by a limited number of OECD countries. A rule like this would represent a substantive change to New Zealand's current thin capitalisation regime. We understand consultation on the proposed strengthening of the current interest limitation rules is expected to take place in the first half of 2017.

   While this proposal will be considered, we consider the current rules to be reasonably robust and an EBITDA test would be a very blunt tool with many disadvantages if the Government decided to proceed with it. The old adage rings true – "if it ain't broke, don't try to fix it!" However, we acknowledge there may be some areas in the current rules that the Government wants to tweak.

10. The Australian Government recently released draft legislation for the **Australian Diverted Profits Tax (DPT)**. The Australian DPT will apply to multinational groups with more than AUD$1 billion global turnover and, broadly, will impose a 40% penalty tax on any Australian income that is diverted to another jurisdiction where the foreign tax rate is less than 80% of the Australian corporate tax rate (i.e. less than 24%). While there are no immediate plans to introduce a similar regime in New Zealand, we understand the Government is closely watching the developments in Australia and the United Kingdom to consider whether a similar regime might be required to protect the New Zealand tax base.

    Please contact us if you would like to discuss any of these developments in more detail.

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