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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: **Taxing International Business Income**

Position Paper for Session 5 of the Tax Working Group
March 2018

Purpose of discussion

This paper outlines some recent developments in international taxation, and seeks the Group's preferences regarding the focus of subsequent work on this subject.

Key points for discussion

- To what extent should the digital economy and equalisation taxes be a focus of the interim report?
- Are there concerns about the effect of BEPS initiatives on foreign investment into New Zealand?
- What further analysis would be useful to assist the Group's deliberations on these subjects?

Recommended actions

We recommend that you:

a **note** that a discussion on the level of the company tax rate and its effect on inbound investment is currently scheduled for April;

b **indicate** the extent to which the Group would like to consider the digital economy in its interim report;

c **note** that the Secretariat will provide further advice on developments at the OECD level as they become available;

d **indicate** whether, apart from OECD updates, there is any other information or analysis that the Group would like in this area.

International Issues in Taxing Business Income

Discussion Paper for Session 5
of the Tax Working Group

This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

March 2018

Prepared by the Inland Revenue Department and the Treasury

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1. Executive Summary

This paper provides a brief introduction to the basic concepts underlying New Zealand's taxation of business income arising from cross-border investment and transactions. These concepts provide background for a more detailed discussion of two related topics in international taxation that the Group has indicated an interest in.

The issues raised in this paper have important implications for securing government revenues and achieving the Government's objectives related to financial/physical and social capital.

The first topic is Base Erosion and Profit Shifting (BEPS). While the terms of reference of the Group exclude discussion of the technical aspects of BEPS, the information is included because of the implications BEPS can have for achieving the Government's financial/physical and social capital. BEPS can be described as artificial arrangements that result in the shifting of income from taxing jurisdictions in a way that lowers or eliminates worldwide taxation of that income. The paper outlines some of the techniques that are used and how New Zealand's tax rules have responded to prevent loss of tax revenue. The OECD has examined this area and has issued a report recommending provisions to deter BEPS. Major anti-BEPS measures are currently contained in the Taxation (Neutralising Base Erosion and Profit Shifting) Bill now being examined by the Finance and Expenditure Committee. The policy issues section examines the impact of BEPS measures on the incentive of non-resident companies to invest in New Zealand.

Is there further information or analysis that the Group would like in this area?

The paper also outlines the issues of taxing the digital economy. There is ongoing work at the OECD on this issue and an interim report is expected in April 2018. A number of countries have implemented, or are examining, measures to respond to these problems, which could be implemented outside of the OECD initiative. These include diverted profits taxes and equalisation taxes. The policy issues section examines these measures. Officials plan to provide the Group with updates of international developments as they occur. An Inland Revenue official is attending and OECD meeting on the digital economy this week. We hope to provide a written and/or verbal update to the Group to consider at its meeting.

Officials suggest that the Group agree this is an important issue because of its potential impact on the NZ revenue base and note that:

- There is ongoing work at the OECD on this topic;
- Other countries may be acting unilaterally but there are hazards in this approach, so we would caution against unilateral action ahead of international consensus; and,
- We consider that this is a subject that the Group is likely to want to comment on as part of its interim report, so we will update them on OECD developments as they occur.

2. Introduction

1. International transactions and business arrangements introduce a variety of issues and concepts that do not arise in the taxation of domestic activities. For purely domestic taxpayers, all income is, in principle, available for taxation. But once transactions and arrangements cross borders, different questions arise. Obviously, not all income in the world should sensibly be subject to New Zealand taxation. So rules must be devised to determine what income is properly subject to New Zealand taxation, and what belongs to other countries. But all countries face the same dilemma. So an international network of agreements has been devised to divvy up the pie.

2. The result is a framework that attempts to resolve complex theoretical issues and the interests of different countries in a manner that is practical in application and reasonably fair in outcome. In particular there is a goal to provide certainty to taxpayers in planning their affairs while protecting the rights of countries to get their fair share of tax from income arising from cross-border business activity. This framework is introduced in Section 3 of the paper and a brief outline of New Zealand's international taxation of business income is outlined in Appendix A.

3. In recent years, this framework has been put under strain by two developments (among others). First, international tax bases have been eroded as companies have arranged their affairs to allow some income to escape tax. This is the so-called Base-Erosion and Profit Shifting (BEPS) problem, (background given in Section 5). Second, even if there are no BEPS issues, new business arrangements are straining traditional frameworks for allocating income among countries. This issue is particularly acute for the so-called digital economy, but is not limited to it (background given in Section 6).

4. These developments have important implications for achieving the Government's objectives for raising revenues and developing New Zealand's financial/physical and social capital. An indication of revenue risks is given in Section 4. BEPS can undermine financial physical capital by causing unintended variations in the effective tax rates on activities depending upon their structures, countries of origin and tax planning. Both issues can undermine social capital by giving the impression that multinational companies do not pay their fair share of tax, leading to reduced voluntary compliance with the tax system and resentment against otherwise productive cross border activity.

5. These issues are difficult to resolve by unilateral action without undermining the multilateral framework of taxation. Accordingly, there has been considerable multilateral work, principally through the OECD. New Zealand has been active in that work and is currently implementing measures consistent with it. The BEPS work is particularly advanced. The work on new business arrangements (digital economy) is also underway, but presents particular challenges as it involves possible revisions of some longstanding fundamental concepts in the allocation of taxing rights among countries. Some policy issues are outlined in Section 7.

6. Effectively countering international tax avoidance and evasion depends crucially on having the information necessary to identify such situations. Appendix B outlines a number of important initiatives in this area.

3. Basic concepts

7. When the activities of a business span international borders, rules are required to allocate income across different jurisdictions. If two or more countries tax the same income (double taxation), cross border activity will be discouraged, with a consequent loss of well-being. Rules and conventions have therefore been developed to reduce double taxation. There is also a risk that the income might not be taxed by any of the countries involved, or might be channelled into a very low tax rate country. The resulting non-taxation or under-taxation is the kind of issue that the BEPS project is designed to address.

8. The OECD Model Tax Treaty and associated conventions have been developed over many years to provide a framework for allocating the right to tax income among countries. Countries generally use the Model as a basis for negotiating bilateral tax treaties between countries. The rules are intended to provide a balance among the interests of different countries and are intended to be a practical compromise to yield a workable system. There is probably is no single administratively-feasible right answer here. Any system will necessarily involve compromise and approximation.

9. Income can potentially be allocated to:

   - the country of the owner of the business (residence country);
   - the country, or countries, where the activity giving rise to the income takes place (source country); or,
   - the country of the consumer (market country).

10. Currently, primary taxing rights on business income are allocated to the source country, that is, the country where the income arises. Typically the source country only taxes income arising in its jurisdiction. The residence country on the other hand, will typically have taxing rights on the worldwide income of the taxpayer. However, for business income, these rights are subordinated to the source country's rights. That is, the residence country will grant a tax credit for any taxes paid to the source country when taxing its residents. Or, as has become more commonly the case, it will provide an outright exemption for foreign source business income, so that only the source country taxation applies[1].

11. Source taxation can be seen as an application of the benefit rule of taxation. Businesses operating within a country are able to earn income because they can take advantage of a great many public goods provided by that country in terms of education, infrastructure, contract law, protection of property etc.

12. There are more practical reasons in favour of source taxation. Residence-based taxation of business income would be subject to manipulation. The residence of a company is typically the jurisdiction in which it is incorporated. This is a very manipulable characteristic. Companies can be incorporated anywhere[2].

[1] At the moment issue of differences between branch and subsidiary taxation are being disregarded.

[2] Incorporation tests can be bolstered by common law tests of management and control, but the point of residence shifting risks remains.

Economic source, on the other hand, often relates to real activities, bricks and mortar, people, resources, etc.; and so provides a more certain basis for taxation of business profits, as well as often having assets that act as a form of collateral for the payment of tax debts. The major difficulties arise when the location of the source becomes more amorphous, as with the digital economy; or with intangible property that is not fixed in place. In that case, source-based taxation shares similar problems with a pure residence-based system.

13. While the source country is given first right of taxation; that source must be identified. The primary rule for determining whether has taxing rights to a source of business profits in the country is whether there is a Permanent Establishment (PE). The basic concept of a PE is that of a fixed place of business. There are numerous add-ons to these rules that are intended to extend the basic concepts to cover particular situations that might otherwise not fit within the rules.

14. There is also the problem of measurement of income, that is, how much profit is attributable to a given source. The "transfer pricing" rules are important here. The intended effect of these rules is that firms operating within a worldwide group should transact with other group members on an "arm's length" basis. This prevents group members paying artificially high prices for goods or services received from other group members as a way of reducing its taxable profits in any particular country. Without effective transfer pricing rules, firms can over-ride the primary allocation of taxation rights to the source country. Sourced based taxation can effectively be replaced by residence-based-taxation.

15. Different mechanical methods in the transfer pricing rules can also have profound implications for the effective allocation of the underlying sources of profits.

16. Consumption, per se, does not give rise to any taxing rights on business profits[3]. This treatment reflects conceptual and practical considerations. With the PE concept, taxation is limited to businesses with sufficient presence in country. Simply exporting goods or services to a country does not give rise to an income tax liability in the market country for the exporting business. This means that there is no taxation of underlying profits of imported goods by the market country. Further, there is not a PE arising from a simple sale and purchase, and so there is no taxation of any income associated with the production and sale in the market country. These provisions remove potential barriers to international trade. They also make it more likely that the taxing country will be able to enforce compliance, since there will be the presence of assets associated with the PE in the jurisdiction.

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[3] For clarity, these points are relevant for taxing the <u>income</u> of <u>non-resident</u> sellers of products. Consuming countries have full rights to tax the <u>consumption</u> of their <u>residents</u>.

4. Revenue risks

17. Since late 2012, there has been significant global media and political concern about evidence suggesting that some multinationals pay little or no tax anywhere in the world. These concerns were reflected in commentary in New Zealand as well.

18. Some very high estimates were produced publically of potential BEPS losses in New Zealand. Any results on the size of BEPS erosion for a particular country are quite speculative. Simple one-size-fits all methodologies are likely to be highly inaccurate across countries. BEPS vulnerabilities depend upon:

- The statutory tax rate;
- The degree of cross-border ownership;
- The sectoral distribution of business activity;
- The nature of activities in the country (i.e. manufacturing or distribution);
- Structural features of the tax base, including the robustness or otherwise of any general anti-avoidance rules; and,
- Any specific anti-BEPS measures in the tax system.

19. Accordingly, the Inland Revenue has suggested that external estimates be treated with caution. To the extent that New Zealand has unique institutional and economic circumstances, it is not appropriate to simply import methodologies that might be used for making estimates in other jurisdictions. Given the lack of data on BEPS, Inland Revenue’s approach to date has been to identify specific BEPS concerns and calculate the possible revenue leakage associated with them.

20. Regardless of the methodology used, there is little doubt that BEPS issues can put considerable revenues at risk. BEPS-like arrangements involving New Zealand banks in the early 2000s had revenue losses of up to $350 million per annum. The BEPS provisions contained in the current Bill that is before the Finance and Expenditure Committee are estimated to raise some $200 million annually.

21. BEPS issues are often associated with inbound investment, but they are not limited to that situation. The New Zealand tax base can be eroded by arrangements with outbound investment as well. And even purely domestic companies can be affected by international tax planning, if they become part of cross-border structured financing arrangements.

5. Base Erosion and Profit Shifting (BEPS)

22. BEPS issues can arise in any sector. They arise from the exploitation of tax planning opportunities across the tax systems of different countries that result in a diversion of profits from a jurisdiction, lowering world-wide taxation of the income. BEPS may involve diverting profits to jurisdictions with low tax rates or where the profits receive some favourable tax treatment; but can also arise due to inconsistencies of treatment of transactions or business arrangements in different (high-tax) countries, that allow income to escape tax entirely.

23. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies (who generally cannot benefit from BEPS), and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole, undermining social capital.

What is BEPS?

24. BEPS is an arrangement that either shifts income to a jurisdiction where it is lower-taxed or that causes income to "disappear" leading to double-non-taxation of income. While many BEPS arrangements are very technically complicated, the basic concepts are quite simple.

Simple arbitrage

25. For a simple example (in the absence of anti-arbitrage rules), consider a New Zealand-resident company that is deciding whether to make a $1000 investment earning 10% or $100 in New Zealand or 8% or $80 in Australia. If it invests in New Zealand it will pay tax of $28 on $100 of income, for after tax income of $72. If it invests in Australia, the Australian subsidiary will earn $80 before taxation. However, if the investment is funded by a fixed rate share with a 10% interest rate issued by the Australian subsidiary, no tax will be paid Australia as it will a get a deduction for the $100 dividend on the fixed rate share. Under Australian tax rules a fixed rate share is treated as debt and so any dividend is considered to be deductible interest. However, in New Zealand the interest on the fixed rate share is treated as a dividend. The New Zealand parent company will receive a non-taxable dividend of $80, due to the active-income dividend exemption. So no tax is paid anywhere and the New Zealand company can earn more after-tax investing in Australia, even though the before tax return is higher in New Zealand. Thus the arbitrage provides an incentive for outbound investment to Australia at the expense of investment that would otherwise have been made in New Zealand.

26. There will be other cases, however, where the burden of the arbitrage is effectively borne by Australia. This would occur if an investment that would otherwise have been made through equity was made through a fixed rate share. Who bears what cost depends upon the counterfactual arrangement[4].

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[4] Arbitrage is also at the root of some structured financing schemes. If the funds in the previous example were originally invested into New Zealand from offshore in the form of debt, the New Zealand company would have a loss of $100,

27. In order to prevent this arbitrage, dividends that give rise to a deduction in the payor country were made taxable in the International Tax Review of 2007. In the example, New Zealand would regain its ability to tax the $100 of income on the assets that had been shifted to Australia.

Interposed low-tax jurisdiction

28. A similar BEPS issue can arise with low-tax jurisdictions (again in the absence of anti-arbitrage rules). In a simple example, $1000 of equity is invested from New Zealand to a third country through a company based in a low-tax jurisdiction. The investment from the low-tax jurisdiction to the third country is in the form of debt issued by a company in the third country to the 'low-tax' company, giving rise to $100 of interest expense in the third country. A non-taxable $100 dividend is then paid by the company in the low-tax jurisdiction to the New Zealand company. As in the previous example $100 of income in the third country is sheltered from tax, and no tax is paid in New Zealand.

29. Under New Zealand's controlled foreign company (CFC) rules, income from passive assets held in CFCs is taxed as it is earned. The arbitrage transaction does not eliminate tax since the $100 of interest received by the low-tax company is taxed as passive income[5]. The income is treated as passive even though it has been paid out of "active" income earned in the third country subsidiary so that the CFC rules will prevent this type of arbitrage.

Intangibles

30. As mentioned above, transfer pricing rules apply when there are transactions between related parties and there is the possibility that the prices at which the transactions are made could be manipulated to shift income between the parties to the transactions, so that it is taxed at a lower tax rate. However, the treatment of intangible assets has become particularly problematic from a BEPS point of view.

31. Intangibles by their nature are not tied to any physical location. Accordingly, multinationals have found it relatively easy to shift intangible assets to companies in low tax jurisdictions. At the same time, the transfer pricing rules allow such companies to allocate a considerable amount of income to such assets. Or, the companies can receive royalties that are deductible in the payor country.

32. The changes in the transfer pricing rules that resulted in income being allocated to intangible assets (and so weakening source country taxation) were pushed by major residence countries that had many of the headquarters of major multi-nationals. The effect was to shift income from source countries that carried out other activities of the multinational group. At the same time, some residence countries had features in their tax codes that failed to effectively tax the shifted income. The net result was some major companies were able to avoid paying tax anywhere on a large portion of their income.

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that could be used to shelter otherwise taxable income of the company from tax. In effect one loan would benefit from two interest deductions, one in New Zealand and one in Australia. This was the basic form of the structured finance transactions that caused substantial falls in taxes paid by New Zealand banks after 2000.

[5] The tax is imposed on the New Zealand investor.

33. Much of the notoriety of BEPS originates with companies taking advantage of these rules.

34. For its part, New Zealand deals with the shifting of intangibles by treating income from intangibles developed in New Zealand as passive income so long as they remain within the developer's group. This means that even if the intangibles are sold to a non-resident member of the group, the income from them is still taxed in New Zealand as it is earned.

35. However the existence of holes in other countries tax systems puts the tax bases of all countries at risk. For instance, New Zealand's sensible rules in this area may create some incentive for New Zealanders who own a company with valuable IP to sell either the company or the IP to owners in countries who can avoid domestic tax on the income generated by the IP.

36. It is fair to say that the changes in the transfer pricing rules have shifted the balance of allocation in favour of residence countries, at least in principle. From New Zealand's point of view, when we are the source country (for example, a New Zealand company is paying royalties offshore), some redress might be appropriate.

OECD and BEPS

37. In 2013 the issue of multinational businesses being able to use tax planning strategies to avoid income taxation formed part of the G20's agenda and the G20 asked the OECD to report back to it on global strategies to address countries' concerns.

38. The OECD's work on BEPS resulted in the adoption of a G20/OECD 15 point Action Plan recommending a combination of domestic reforms, tax treaty changes, and administrative measures that would allow countries to strengthen their laws in a consistent manner and work together in combatting BEPS. Recognising our own vulnerability to BEPS and the value of working cooperatively, New Zealand actively participated in the OECD/G20 project, which was finalised at the end of 2015.

BEPS initiatives in New Zealand

39. New Zealand's initiatives to further contain BEPS arrangements are contained in the Taxation (Neutralising Base Erosion and Profit Shifting) Bill. The Bill introduces amendments to the *Income Tax Act 2007* and the *Tax Administration Act 1994*.

40. The main proposals in the Bill will prevent multinationals from using the following base erosion and profit shifting (BEPS) techniques[6]:

    - artificially high interest rates on loans from related parties to shift profits out of New Zealand;

[6] A more comprehensive description of these measures is contained in *A briefing note prepared for the Finance and Expenditure Committee*, January 2018, Policy and Strategy, Inland Revenue.

- artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand;
- transfer pricing payments to shift profits out of New Zealand and into their offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore; and
- hybrid and branch mismatches that exploit differences between countries' tax rules to achieve an inappropriate tax advantage.

41. The domestic law elements of New Zealand's main response to BEPS are contained in this Bill. These are broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment. New Zealand has also previously implemented other measures to address some specific BEPS concerns. Moreover, legislation has been previously enacted to strengthen the non-resident withholding tax rules, limit the use of look-through companies as conduit vehicles, clarify that New Zealand's general anti-avoidance rule overrides tax treaties, strengthen the foreign trust disclosure rules and implement automatic exchange of information with other tax authorities.

42. New Zealand's response to BEPS also includes the OECD's *Multilateral* Convention *to Implement Tax Treaty Related Measures to Prevent BEPS* (also known as the multilateral instrument or MLI) which was signed by the Minister of Revenue on behalf of New Zealand in June 2017. The MLI is currently before the Finance and Expenditure Committee as well. It is intended to prevent tax treaties from being used to facilitate BEPS.

43. Policy trade-offs between protecting New Zealand's company tax base from BEPS arrangements and remaining an attractive destination for foreign direct investment are discussed in Section 7 on Policy Issues.

6. Digital economy and new business arrangements

44. With the internet, new ways of conducting business across borders have been developed. The digital economy is the poster child for these new arrangements, but issues can also arise in traditional lines of business. The problem that arises is that current mechanisms to allocate income from cross-border activities among countries may not be appropriate in the face of changing business arrangements. Arguably, income might be seen to result from a business carried on in a country, but is not subject to tax in that country under the current source rules for business profits.

45. In particular, various internet-based businesses are now able to carry on businesses (in the sense of being able to interact with customers and others) in a country and can earn substantial profits without having enough physical presence to constitute a permanent establishment (PE) in that country.

46. There has been considerable public concern about the level of taxes paid by internet companies. These concerns conflate BEPS issues and new business arrangements issues. Basically BEPS is a situation where profits are able to avoid taxation, altogether (or be shifted to a low tax jurisdiction that arguable has only a tenuous connection to the underlying business). New business arrangements challenge the fundamental basis of the rules for allocating income among countries. So they raise the question of where the income is taxed, rather than whether it is taxed. These two issues become difficult to separate if the internet company is able to avoid source country taxation because it does not have a PE (the allocation problem); and, at the same time, can shelter its income from taxation by the residence country (the BEPS problem).

47. Even if anti-BEPS measures were successfully and universally applied, the allocation issues with new business arrangements would remain. (Having said this, the source issue can be part of BEPS arrangements and developing new mechanisms to determine the source of income could also address some of these BEPS issues.)

48. Changing business arrangements also have implications for GST; that is, whether cross-border consumption by domestic residents avoids GST. These issues are not discussed in this report.

How have business arrangements changed?

49. The advent of the internet and international communications has allowed business activity to become more dispersed across borders. Business transactions that used to require a physical presence and face-to-face contact can now be conducted at a distance. Internet platforms can replace a store-front, and customers from across the globe can conduct sophisticated business transactions through the platforms. And the platforms can be located anywhere, or effectively nowhere.

50. These changes pose a direct challenge to the traditional basis of taxing income earned through a permanent establishment. In effect a business can carry on a significant amount of activity and earn considerable profits without a substantial

presence in a country. Some examples of changing business arrangements include:

- **Cross-border shopping** – considerable business can be conducted cross-border, by-passing traditional distribution networks. Therefore potential revenues on traditional wholesale and retail mark-ups are lost;
- **Advertising** – New Zealand businesses can advertise through offshore websites that do not operate physically in New Zealand avoiding New Zealand tax on their income from advertising;
- **Offshore software platforms** – can provide services directly to New Zealand customers that formerly would have required a physical presence in New Zealand. In this case, it is the income of the platforms that escapes New Zealand tax. The income of the New Zealand-based service providers, (the drivers and house-owners), are in principle taxable;
- **Site users** – The advertising revenue of internet platforms depends upon the users of their services even when the services provided (search, social networking, recipes etc.) are free. Thus, the users are a source of the revenue stream. Some countries are concerned that the data harvested on their citizens is a source of income for the internet company that is not taxed by the country residence of the users. These situations are akin to the concept that providing a market justifies a taxing right. This would be a departure from traditional international taxation concepts, that simply providing a market does not warrant a taxing right to the underlying income.

51. Arguably New Zealand is potentially a source of substantial profits from such activities. Traditionally the level of activity would have required a PE, attracting income tax. But new technologies allow a similar level of business to be undertaken without a PE, avoiding New Zealand tax.

Work underway at OECD on the digital economy

52. There is widespread acknowledgement that the non-taxation of internet-based companies in jurisdictions where they derive considerable income is a problem. In particular, the current definition of a “permanent establishment” in DTAs is generally seen as out-dated and in need of amendment. However there are obstacles to amending this definition, given it is contrary to the interests of capital exporting countries (such as the US).

53. The OECD considered the taxation of the digital economy as part of its BEPS Action Plan. However, its 2015 report[7] did not recommend any changes (mainly due to the failure of participating countries to agree). Since then there has been increasing pressure to find a solution and an increasing willingness of individual countries to adopt unilateral solutions. In response to this pressure, the OECD has agreed to release a further draft report on the taxation of the digital economy in April 2018. Some issues arising from these discussions are outlined in Section 7.

54. New Zealand is participating in the work at the OECD.

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[7] Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report

55. The pressure on the OECD significantly increased in September 2017, when the EU Commission (supported by a majority of EU members) proposed an equalisation tax on the gross revenues of some internet based companies. The UK then announced its support for such a tax in November 2017 (although it suggested a narrower scope for the tax than the EU and has updated its position slightly again in the last week)[8]. India has introduced a form of equalisation tax on advertising payments and Italy has announced its intention to introduce an equalisation tax.

56. The OECD is scheduled to issue an interim report on the issue in April 2018.

Current initiatives in New Zealand

57. As noted in the discussion of BEPS, New Zealand has recently proposed an anti-avoidance rule to bolster the determination of a PE. The rule would prevent companies from avoiding a permanent establishment in New Zealand when one exists in substance.

58. The proposed PE avoidance rule would not allow us to tax these internet-based companies, as it only targets companies who have a physical presence in New Zealand and are using related parties to avoid PE rules. The situations arising in the digital economy do not technically fall within these changes.

59. Possible initiatives in this area are discussed in the next section.

[8] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf

7. Policy issues

Taxing the digital economy

60. As noted there is ongoing work at the OECD on these issues. For a small country like New Zealand, there are significant advantages in being part of coordinated response. Having rules that are consistent with international norms reduces complexity and avoids unintended results. As noted, the OECD is planning to release a draft report on taxation of digital economy in April.

61. There is no certainty that the effort will succeed. There are different interests among countries that must be reconciled. In the past residence countries have asserted their primary rights to taxing such profits, even if in some cases they have failed to effectively tax such income.

62. The 2015 effort failed to reach consensus, but pressure is growing for a result. Some initiatives have been undertaken or proposed by other counties. These include diverted profit taxes and equalisation taxes.

Diverted profits tax (DPT)

63. A diverted profits tax (DPT) is essentially targeted at BEPS issues. It does not address issues that may arise when a business does not have a PE. A DPT of the kind enacted by Australia and the UK, does not depart from the current international tax framework. Instead, it only targets multinationals that attempt to avoid that framework through profit shifting and permanent establishment avoidance. A DPT would not allow us to tax internet based companies with no physical presence in New Zealand. Accordingly a DPT is not a solution to the current problems with the taxation of the digital economy.

64. It is an open question whether it would be useful for New Zealand to implement a DPT. There are multinationals who need to have a physical presence in New Zealand, but who attempt to minimise their New Zealand tax obligations through BEPS strategies. Our currently proposed transfer pricing, interest allocation and PE avoidance measures are aimed at these BEPS strategies (and incorporate some but not all of the features of a DPT).

65. The outstanding question is whether a DPT would further assist us in addressing these BEPS strategies. Officials intend to provide Ministers with advice on the desirability of a DPT in the near future.

Equalisation taxes

66. Equalisation taxes are a form of withholding taxes that are intended to address changed business practices, such as the digital economy. They would tax certain payments made to internet companies that have a significant (but non-traditional) economic presence in a country, but do not have a PE. The tax payable would be based on a simple measure, such as gross payments or revenue from sources in that country. The tax would be imposed at a flat rate on payments to the internet company by customers in New Zealand. The idea would be to approximate the tax payable by non-resident internet companies with that payable by domestic firms in a similar line of business.

67. An equalisation tax would address the recent public concern about high-profile internet companies that do considerable business with New Zealand customers, but do not have a physical presence in New Zealand and so are not subject to New Zealand income tax.

68. While equalisation taxes have attractions from a tax compliance point of view, they raise a number of important issues that would need to be considered in deciding whether New Zealand should adopt them. There are potential economic distortions. The level of profits that may be associated with different activities may vary so that a rate of tax that would be appropriate for one industry may be too high or too low for another. Moreover, unlike an income tax, the tax would apply whether the company made a profit or not on its activities in New Zealand.

69. The likely economic incidence of such a tax (i.e., how much is borne by the New Zealand customers and how much is borne by the internet based companies) would depend upon how the tax was treated by the residence country of the company. Traditional withholding taxes (such as on interest and dividends) are considered to be a form of income tax and can be used to reduce the company's tax in their residence jurisdiction. In that case, the incidence of the tax would effectively be on the company's residence country tax authority. On the other hand, if the tax were seen more as an excise tax that was in addition to residence country taxation, the tax would not qualify as a creditable tax. In that case, some portion of it would be passed forward into the New Zealand market.

70. In the absence of an international agreement in this area, equalisation taxes may not be consistent with New Zealand's international obligations. If they are seen as a form of income tax, it is not clear that they are allowed under our double taxation treaties since, by design, they are imposed in the absence of a PE under the treaty. As a result, if New Zealand were to implement an equalisation tax, there is a risk that we would be breaching the terms of all of our double tax agreements.

71. On the other hand, if equalisation taxes are not considered to be income taxes, but are seen to be more like excise taxes, they would raise issues related to international trade. They could be used by jurisdictions as a tariff to protect local businesses. This raises the question whether they would be compatible with World Trade Organisation obligations and New Zealand's various free trade agreements. Thus, if New Zealand were to impose taxes unilaterally, there is a risk of retaliatory taxes being imposed by our trading partners.

72. The issues that arise may affect not only foreign firms with a digital presence in NZ but also NZ firms with a digital presence in other countries. If equalisation taxes were introduced globally, New Zealand internet based firms would be subject to tax in their offshore markets. In any event, New Zealand would need to determine whether it should offer foreign tax credits for such taxes.

Broader issues

73. There is a question of whether or not it is sensible to distinguish between firms with a digital presence and a wider set of firms that may be exporting goods and/or services to other countries.

74. An equalisation tax is closely linked to the contentious issue of whether providing a market for a product should be recognised as providing value giving a right to income taxation. This is the position taken by some developing countries.

75. There are conceptual arguments for this approach. For example if there are location-specific market rents in the country, then arguably that country should be able to tax them. Nevertheless, taxing rights are not currently extended to consuming countries under the OECD model tax treaty.

76. In theory, these taxes could extend beyond the provision of internet-based services and into any supply of goods or services by New Zealand firms into that market - so could have a significant impact on outbound investments and New Zealand exporters.

77. These issues strike at the fundamental concepts underlying how to allocate income from cross-border business. Ill-considered steps in this direction could potentially lead to countries creating tax rules that discourage international trade and lower worldwide welfare.

BEPS and the incentive to invest in New Zealand

78. As noted above, the potential revenue risks from BEPS can arise anywhere in the company tax base. Thus, BEPS has the potential to seriously erode company tax revenues. Since New Zealand has a greater than average reliance on company taxation, protecting the company tax base has been a priority of successive governments.

79. Interest allocation rules that are arguably more sophisticated in concept than the norm were introduced in New Zealand during the 1990s. The rules were effectively extended to the banks in the early 2000s. The international tax review of 2007 contained some anti-arbitrage rules and further changes to the interest allocation rules. Since that time, BEPS has become a major issue internationally, and New Zealand is in the process of enacting BEPS-deterring rules as described earlier.

80. New Zealand's BEPS initiatives, taken together, have sharply reduced the potential for base-eroding transactions, both in the financing of investment into and out of New Zealand and in deterring structured financing transactions.

81. This level of tightening raises the question of what impact the BEPS rules might have on the incentive of non-residents to invest in New Zealand. Or put another way, what is the impact of BEPS initiatives on the cost of capital in New Zealand? In particular, what are the trade-offs between protecting the New Zealand tax base, and attracting an appropriate level of foreign direct investment?

BEPS and the level of company tax

82. At a level of generality, and with certain caveats noted below, the question of the impact of anti-BEPS measures is part of the more general question of what level of company tax should New Zealand impose on income from inbound investment by non-residents?

83. The level of tax on FDI depends upon a number of factors:

- The company tax rate;
- The NZ tax base definition;
- BEPS measures;
- Home jurisdiction tax system;
- Structures used for investment.

84. It is the combination of these provisions that determines the level of taxation and thus the incentive to invest in New Zealand. From this perspective, the discussion of BEPS and the incentive to invest can be seen as part of the broader discussion on whether or not we should reduce the company tax rate to respond to lower company tax rates in other jurisdictions. The broad issue will be addressed more generally in sessions on the company tax.

85. While BEPS initiatives should be seen in the broader context of how much tax should New Zealand impose on inbound investment, there are some particular features that pertain to BEPS measures.

BEPS and arbitrage

86. A BEPS arbitrage arrangement provides a deduction in New Zealand without any offsetting tax being paid on the offshore limb of the transaction. So by design, countering the arrangement will increase taxes on the return to the investment.

87. There are a number of cases where preventing BEPS arrangements would be unlikely to have substantial effects on deterring investments, examples of such situations include:
    - When economic rents exist;
    - With existing capital investments, where the BEPS arrangement is a post-investment rearrangement to reduce taxes; and,
    - With the purchase of existing investments from a resident investor by a non-resident investor.[9]

88. In some other cases, the increased New Zealand taxation will reduce the incentive to invest in New Zealand. But, given the policy intention to levy a certain level of tax on New Zealand-source income, the reduced incentive is an inevitable result of applying effective taxation. Allowing a BEPS arrangement in these circumstances would allow a subset of companies (those with the opportunity and will to use artificial means) to lower their tax payable.

89. On the other hand, there will be circumstances where anti-BEPS measures may raise total taxes for the non-resident investor without increasing New Zealand's tax take. That is, the investor pays the same amount of New Zealand tax, but loses the benefit of non-taxation in the residence country. This could occur when the alternative funding choice of the non-resident, assuming that BEPS funding was denied, would be debt. In that case, eliminating the BEPS arrangement would increase taxes paid by the non-resident in its home jurisdiction without

[9] A BEPS arrangement may allow the non-resident to pay a premium in certain circumstances, where the premium is effectively funded by the government and much of the benefit spills to the non-resident.

increasing New Zealand tax collections. In effect the BEPS arrangement would have provided an incentive paid for by the home jurisdiction of the non-resident[10]. In that case, New Zealand would be better off allowing the BEPS arrangement to continue, as any tax increase resulting from its reversal would accrue to the home country. This situation would be most likely to occur if companies were at their interest allocation limit (60% of total assets).

90. Inland Revenue has examined the results from information questionnaires that had been filled out by non-resident-owned companies as part of its revenue maintenance function. The questionnaires revealed that most responding companies were not at their income allocation limits. This means that, in the absence of the BEPS legislation, there could be significant scope for BEPS-type arrangements that reduced New Zealand tax revenues on profits earned in New Zealand by non-resident multinationals.

Interest allocation

91. Interest allocation can play a role in determine the effective tax rate of non-resident companies investing in New Zealand. The effective tax rate is a combination of the 28% tax rate on returns to equity and the 10% withholding tax rate on interest paid to the parent company. In practice, this means that a lower New Zealand effective tax rate can be achieved through debt funding (i.e., by increasing payments from the New Zealand subsidiary that attract the 10% withholding rate, rather than being taxed at the 28% company rate). To the extent that the New Zealand company is at its interest allocation threshold, currently 60% of assets, any tightening of the rules would increase the non-resident effective tax rate. In fact, many companies do not operate at their maximum allowable level of debt and so would be unaffected.

92. In certain cases, only a portion of the revenue cost to New Zealand may accrue to the benefit of the non-resident investor. (This is an interest allocation issue rather than an arbitrage issue.) Consider a situation where the investor is subject to tax in its home country and in New Zealand. If the home country tax rate is less than New Zealand's tax rate, then the investor has an incentive to fund its New Zealand subsidiary with debt. The interest paid on the debt is deductible in New Zealand and taxable in the home country, but at a lower rate than in New Zealand. Tightening the interest allocation rules, as in the BEPS Bill, reduces the scope for this. As company tax rates fall internationally, this will become more of an issue for New Zealand. For example, the US has recently reduced its corporate tax rate from 35 to 21 per cent. Thus US-owned companies, which formerly would have preferred to fund their New Zealand subsidiaries with equity paying non-deductible dividends will now have an incentive to recapitalise them with debt. In that case, New Zealand would lose tax at a rate of 28% of the interest paid, but only one-quarter, 7%, of the benefit would flow to the investor. The rest is a windfall for the US Treasury.

[10] Note that this situation can only occur if the residence country has failed to act to deter BEPS arrangements.

Structured financing

93. Finally, it is important to note that the above discussion relates to the taxation of real activity in New Zealand. BEPS arrangements have also been exploited in situations where there is little or no business activity in New Zealand. Structured finance deals can reduce New Zealand tax on unrelated business activities. The BEPS rules are important in protecting New Zealand from structured financing deals that are unrelated to real activity in New Zealand.

Appendix A: New Zealand's International Tax Regime

Basic approach to taxing business income

1. New Zealand's International Tax rules for business were significantly modified following the International Tax Review of 2007. For resident companies, worldwide income is subject to New Zealand income tax. However, the Review introduced a new active business exemption. Offshore business income earned within a foreign subsidiary pays no New Zealand tax as it is earned, and any income that is repatriated to a New Zealand resident company as a dividend is also tax free. Active income can be considered to be ordinary business income. In contrast, any passive income that is earned in an offshore subsidiary is subject to immediate taxation as it is earned under he controlled foreign company (CFC) rules. Passive income would generally include interest, dividends, and certain rents and royalties. However, to simplify compliance, passive income is not subject to tax if it amounts to less than five per cent of the gross income of the company.
2. Non-residents' business income sourced in New Zealand is subject to New Zealand income tax. Other types of income, such as interest, dividends and royalties, are generally taxed under the Non-Resident Withholding Tax (NRWT). Rates of NRWT vary by type of payment and country of residence of the non-resident. The rates of withholding tax that are set in domestic law are generally capped as part of bilateral Double Taxation treaties.
3. Under the Approved Issuer Levy (AIL), interest paid to non-associated lenders can be subject to a 2 per cent levy, in lieu of paying non-resident withholding tax. AIL responds to the concern that applying NRWT to interest paid to non-associated lenders would cause the interest rate on the loan to be increased, raising the cost of capital for New Zealand borrowers.

Base protection measures

4. The International Tax Review introduced or extended a number of measures that were intended to protect the New Zealand tax base. The measures were in response to the Active Business exemption. They insured New Zealand-sourced income continued to pay New Zealand company tax. That is, the active income exemption did not result in a leakage of New Zealand domestic tax revenues.
5. New Zealand has had interest allocation rules applying to non-resident investors for some two decades. The role of interest allocation rules is to prevent a disproportionate share of a non-resident-owned group's interest expenses being deducted against the New Zealand tax base of its New Zealand subsidiaries. The new international tax rules extended interest allocation rules to groups of companies owned by New Zealand residents that have offshore subsidiaries. Basically, the rules limit amount of debt for which an interest deduction is allowed to a certain proportion of the assets of the group that are in New Zealand.
6. The rules also contained a number of anti-arbitrage measures to further protect the tax base. "Arbitrage" is said to occur when a mismatch between the tax rules of two (or more) countries allows cross-border transactions that result is the

disappearance of income from taxation in either country. A number of rules prevented arbitrage.

7. As described in the section on BEPS New Zealand is in the process of enacting a number of measures to strengthen its base-protection rules as part of the OECD initiative in this area.

Appendix B: Recent developments in reporting of information

1. Effectively countering international tax avoidance and evasion depends crucially on having the information necessary to identify such situations. There have been a number of important initiatives in this area.

Disclosure of information obtained under CbC reporting

2. Country-by-Country Reporting (CbC reporting) is an international initiative arising out of the work on Action 13 of the G20/OECD Action Plan on *Base Erosion and Profit Shifting* (BEPS). Action 13 is generally aimed at introducing rules that will require Multinational Enterprises (MNEs) to provide relevant governments with information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.
3. MNEs subject to CbC reporting are those with annual consolidated group revenue of at least EUR 750 million (approximately NZ$1.3 billion). Such MNEs must report annually, for each tax jurisdiction in which they do business, their revenue, profit before income tax, and income tax paid and accrued. MNEs must also report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, MNEs must identify each entity within its group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.
4. Tax administrations will use CbC information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, help target audit enquiries.
5. CbC reports are filed in the jurisdiction of tax residence of the ultimate parent entity. The information is then shared with the tax administrations of the jurisdictions in which the MNE conducts business activities, through automatic exchange of information under tax treaties (particularly, the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*).
6. The deadlines for first reporting by New Zealand MNEs to Inland Revenue depend on each MNE's balance date, resulting in reporting by some New Zealand MNEs late last year and with the remainder to report this year. Inland Revenue's first exchanges of information will take place this year.
7. It is important to note that all countries implementing CbC reporting have agreed that the general requirement for tax administrations to maintain confidentiality of taxpayer-specific information remains of paramount importance. That is, beyond the required information exchanges between tax administrations, CbC data can only be disclosed at a level of detail that preserves taxpayer confidentiality. For example, some disclosure of aggregated and anonymised data to the OECD is envisaged. However, tax administrations will not publish the actual CbC reports.
8. There is currently discussion within the EU on a European Parliament proposal allow the public reporting of CbC reports. This is a contentious issue, with no clear decision at this time.

Disclosure of assets held in offshore accounts

9. The *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (in short, Automatic Exchange of Information, or AOEI) is a global standard currently being implemented worldwide at the direction of the G20 and OECD. The standard was developed in response to international concerns over the relative ease by which a resident can evade tax obligations in their home jurisdiction by concealing their wealth in offshore accounts ("offshore tax evasion").

10. Jurisdictions implementing the AEOI standard enact legislation to impose on their financial institutions the obligation to (i) identify any offshore accounts that they maintain that are held or (in certain circumstances) controlled by non-residents, and (ii) annually report identity and financial information in respect of those non-residents to their local tax authority. The rules to be enacted are prescribed in an element of the wider AEOI standard known as the *Common Reporting Standard* (CRS).

11. The tax authorities will exchange the reported information with the relevant jurisdictions under tax treaties, for use in verifying tax compliance. For New Zealand, first exchanges of information with other jurisdictions will begin in the second half of 2018.

12. It is envisaged that most financial assets held offshore by New Zealand residents will be subject to CRS reporting and exchange under the above rules. This is because:

    - International monitoring and peer review, backed by the G20 threat of sanctions for non-compliance, will ensure that all "relevant" jurisdictions implement the CRS, to an identical standard. Relevant jurisdictions currently include all G20 and OECD member countries and any other jurisdiction identified as having or operating as an offshore financial centre.
    - The range of offshore "entities" that are subject to CRS reporting and exchange is very broad. It includes companies, partnerships, trusts, and any other legal person or legal arrangement.
    - When a financial account is held in the name of an entity, the CRS due diligence rules generally require the financial institution maintaining the account to look-through the account to determine the natural persons who are the ultimate beneficial owners.

13. The application of the CRS requires stepping through a considerable amount of technical detail. This applies in particular in relation to trusts. Very generally, there are essentially two main ways in which a trust may be subject to the CRS rules:

    The trust is itself a reporting financial institution (RFI) for CRS purposes.

14. An RFI must report information on its "account holders". For an RFI that is a trust, the account holders are typically deemed to include all (i) settlors, (ii) mandatory beneficiaries, (iii) discretionary beneficiaries that actually receive a distribution in the relevant period, and (iv) any other natural person that has ultimate effective control (which will often include trustees and protectors).

The trust holds an account with an RFI.

15. When a trust merely holds an account with an RFI, complications can arise in treating the trust itself as a reportable person (for example, because in many countries trusts do not have tax residence). However, the CRS also treats an account as reportable if it is a passive non-financial entity with one or more controlling persons that are reportable persons. Trusts will typically be a non-financial entity for AEOI purposes. (Although a trust would not usually be considered to be an entity, in the CRS context an entity is defined as including a trust.)

16. The RFI must report information on each "controlling person" that is a reportable person. The controlling persons of a trust are deemed (whether or not they actually have control) to include all (i) settlors, (ii) trustees, (iii) protectors, (iv) beneficiaries or classes of beneficiaries, and (iv) any other natural person that has ultimate effective control. Note, however, that the RFI can elect to only report on beneficiaries that are (i) mandatory beneficiaries or (ii) discretionary beneficiaries that actually receive a distribution in the relevant period.

17. However, despite the broad reach of CRS reporting, some offshore entities will escape reporting under the CRS. This could happen, for example, because the entity is excluded by virtue of being in a category of entity or account that is recognised in the CRS as having a low risk of being used to facilitate tax evasion.