JAMES JONATHAN SIMMONDS KEATE

Venturing beyond the OECD: An Analysis of New Zealand's Response to Multinational Corporate Tax Avoidance

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Abstract

Multinational tax avoidance is a major economic issue that has generated significant political traction in recent years. Multinational corporations have been eroding the tax bases of states by shifting profits around the globe. The OECD has recently finalised a co-ordinated response to this so called "base erosion profit shifting". The OECD has created "action plans" that states can adopt by renegotiating existing tax treaties. New Zealand has chosen to venture beyond the OECD's action plans and create domestic legislation to target multinational tax avoidance. This paper examines whether New Zealand's proposed legislation will be consistent with its tax treaties. It is argued there will be some inconsistencies, which may engage New Zealand's state responsibility in international law and cause double taxation. I also analyse the legal and policy implications of New Zealand's proposals, and draw on comparative perspectives. I ultimately conclude that New Zealand's proposals may reduce commercial certainty and foreign investment. However, I suggest both New Zealand's proposals and the OECD's initiatives are a novel step towards harmonising the international tax regime. The effects of which will likely be felt for years to come.

Keywords

Tax; base erosion and profit shifting; multinational enterprises; international law; OECD; multilateral instrument; double tax agreements.

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I Introduction

"At some point . . . such conduct passes from clever accounting and lawyering, to theft from the people." – David Kelley.[1]

There is a growing global concern that Multi-National Enterprises (MNEs) are not paying their fair share of tax. MNEs erode the tax bases of states by artificially shifting profits to low or no tax jurisdictions (base erosion profit shifting "BEPS").[2] The Organisation for Economic Co-operation and Development (OECD) has developed a number of soft-law "action plans" to help states combat BEPS. The OECD has also created a multi-lateral instrument (MLI) which allows states to rapidly adopt action plans into their double tax agreements (DTAs) if they agree to. More than 70 countries, including New Zealand, signed the MLI, on 7 June 2017.[3]

New Zealand issued its final decisions on BEPS on 3 August 2017.[4] New Zealand is choosing to go further than the OECD and enact its own domestic laws to target MNEs. New Zealand is not contravening international law by doing this, as the OECD is a standard-setting body that does not issue binding measures. However, adopting a different position to the international community could allow MNEs to exploit the differences to shift profits.[5] There is also a risk that New Zealand's proposed legislative changes may be inconsistent with its DTAs. My thesis is that there are some inconsistencies which may contravene international law and cause double taxation.

This paper will provide some background into BEPS, the OECD and DTAs. I will then examine New Zealand's response to the OECD's proposals. In my analysis, I will focus particularly on comparative and international perspectives. I will also analyse the legal and policy consequences of New Zealand's decisions on BEPS. I conclude that a states' response to BEPS

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[1] A New York attorney in charge of a case against KPMG on selling fraudulent tax shelters.
[2] Clemens Fuest and Nadine Riedel "Tax Evasion and Tax Avoidance: The Role of International Profit Shifting" in Peter Reuter (ed) *Draining Development? The Sources, Consequences and Control of Illicit Funds from Developing Countries* (The World Bank, Washington, DC, 2012) 109 at 111.
[3] See Organisation for Economic Co-operation and Development "Ground-breaking multilateral BEPS convention signed at OECD will close loopholes in thousands of tax treaties world wide" (press release, 7 June 2017).
[4] See Inland Revenue "Government announces BEPS decisions" (press release, 3 August 2017).
[5] Yariv Brauner "What the BEPS" (2014) 16 Fla Tax Rev 55 at 66.

requires striking a delicate balance between preventing MNEs abusing the tax system, and maintaining a fair tax burden that will not reduce foreign investment. In venturing beyond the OECD, New Zealand may have upset this delicate balance in some respects.

II Background on Base Erosion Profit Shifting

It is first necessary to explain BEPS and its consequences. A study by the International Monetary Fund has estimated global losses from BEPS at around US $500 billion a year,[6] a sum nearly equivalent to one per cent of the world GDP. New Zealand alone has estimated losses of $600 million per year.[7] MNEs are becoming increasingly dominant on the global stage. Of the world's 100 largest economies, 42 are MNEs, not nation states.[8] Moreover, it has been suggested that BEPS is becoming more widespread and aggressive.[9] For example, Apple paid $0 in tax in New Zealand over the past decade despite reported sales of NZ $4.2 billion.[10] Due to the prevalence of BEPS, paying a "fair" share of tax has become a competitive disadvantage for MNEs. It also makes it difficult for smaller business to compete on pricing, as they do not have the same resources to engage in BEPS.[11]

BEPS occurs when a MNE shifts profits from one entity in its group in a high tax jurisdiction to another entity in the group in a lower or no tax jurisdiction.[12] This results in a lower tax burden for the MNE group overall. This kind of profit shifting is not a normal incidence of business, but rather the result of deliberate tax planning. If individuals or local companies tried to create similar structures in New Zealand they could be declared void by s BG 1 of the Income Tax Act (the general anti-avoidance provision "GAAR"). However, BEPS is more difficult to police as it operates in the realm of international taxation.

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[6] Ernesto Crivelli, Ruud De Mooij and Michael Keen (eds) *IMF Working Paper: Base Erosion, Profit Shifting and Developing Countries* (International Monetary Fund, Washington DC, 2015) at 21.
[7] Tax Justice Network "The Scale of Base Erosion Profit Shifting" (2015) <www.taxjustice.net/scaleBEPS/>.
[8] Lorraine Eden "Transfer price manipulation and developing countries" in Peter Reuter (ed.) *Draining Development? The Sources, Consequences and Control of Illicit Funds from Developing Countries* (The World Bank, Washington, DC, 2012) 205 at 206.
[9] Dhammika Dharmapala "What Do We Know about Base Erosion and Profit Shifting? A Review of the Empirical Literature" (2014) 35 Fiscal Studies Journal of Applied Public Economics 421 at 423.
[10] Matt Nippert "Apple pays zero tax in NZ despite sales of $4.2 billion" *The New Zealand Herald* (online ed, New Zealand, 18 March 2017).
[11] Sonja Olhoft Rego "Tax Avoidance Activities of U.S. Multinational Corporations" (2003) 20 Contemporary Accounting Research 805 at 807.
[12] Jost Heckemeyer and Michael Overesch *Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels* (Centre for European Economic Research, Discussion Paper No. 13-045, 30 July 2013) at 1.

International taxation is distinct from domestic taxation, and revolves around the concepts of source and residence.[13] Source refers to the country where the income is derived by the company. Residence refers to the country where the company is resident.[14] For a non-resident MNE operating in New Zealand to be taxed on income sourced there, it must have a "permanent establishment" (PE). MNEs deliberately avoid gaining a PE to avoid being taxed at source. If the MNE's profit is not taxed at source, it should then be taxed in the country where the company is resident. However, MNEs can structure their affairs so that they are resident in countries that are considered to be tax havens such as Luxemburg or Bermuda.[15] For example, Chevron Corporation has created over 200 corporations in Bermuda for this purpose.[16] Therefore, BEPS allows MNEs to avoid taxation both where their income is sourced, and then again when it arrives at their place of "residence". As a result, the worldwide tax base is eroded. This global tax erosion means there is US $500 billion less per year to go towards public spending.[17]

III The OECD's Role in International Taxation and BEPS

A The OECD

The OECD is an international economic organisation with the goal of improving the economic and social wellbeing of people across the globe.[18] The OECD issues no binding measures and is primarily a standard-setting organisation that promulgates guidelines which countries can implement at their own discretion.[19] The OECD has proved extremely influential in taxation.[20]

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[13] Claudio Cimetta "Base Erosion and Profit Shifting: Treaty aspects" (2014) 17 Tax Specialist 146 at 152.

[14] If a company is resident in a country, they will be liable to pay tax there. Residency requires more than just presence. For a MNE to be resident in New Zealand it must have its head office and central management there (see s YD 2 of the Income Tax Act 2007).

[15] Marika Toumi "Anti-Avoidance and Harmful Tax Competition: From Unilateral to Multilateral Strategies?" in Andrew Lymer and John Hasseldine *The International Taxation System* (Springer US, New York, 2002) 83 at 84.

[16] Heath Aston "Chevron hits out at 'tax dodger' claims at fiery Senate inquiry" *The Sydney Morning Herald* (online ed, 18 November 2015).

[17] This global figure comes from the International Monetary Fund study, above n 6, at 21.

[18] David Ernick "Base Erosion, Profiting Shifting and the Future of the Corporate Income Tax" [2013] 54 Tax Management Memorandum 451 at 451.

[19] Ernick, above n 18, at 452.

[20] Angharad Miller and Lynee Oats *Principles of International Taxation* (3rd ed, Bloomsbury Professional, London, 2011) at 30.

The OECD Model Tax Convention of Income and Capital is the basis for thousands of tax treaties worldwide.[21]

The OECD is comprised of 35 member countries. Most OECD members are high-income developed countries. In its response to BEPS, the OECD has also engaged developing countries. Studies show developing countries are even more vulnerable to BEPS due to a greater dependence on corporate taxes.[22] Over 100 countries have come together to collaborate on the OECD's BEPS project. It is preferable that states respond to BEPS with a unified front. If states act unilaterally, then MNEs will be able to take advantage of mismatches in the international tax regime to continue avoiding tax.[23]

The OECD has been working on a coordinated response to BEPS since 2014. Between 2014 and 2016 the OECD's proposals have been continually refined through a process of extensive consultation with stakeholders.[24] The BEPS project received over 1,400 submissions from industry professionals and academics.[25] The OECD member states, and particularly the G20 countries, also provided input throughout the process.[26] This extensive stakeholder input helped to ensure the measures proposed were not unduly burdensome for businesses, while also addressing the policy concerns behind BEPS.

B The Multilateral Instrument (MLI)

The OECD's measures to combat BEPS are to be implemented via a multilateral instrument (the MLI). The MLI is not a binding treaty. Instead, it is mainly an administrative mechanism used to facilitate adoption of the OECD's "action plans". In addition to the optional action plans, the MLI contains four mandatory minimum standards. The minimum standards are:[27]

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[21] Brian Arnold and Michael McIntyre *International Tax Primer* (2nd ed, Kluwer Law International, The Hague, 2002) at 7.
[22] Crivelli, De Mooij and Keen, above n 6, at 2.
[23] Allison Christians "BEPS and the New International Tax Order" (2017) 6 BYU L Rev 1603 at 1635.
[24] Raffaele Russo "Base erosion and profit shifting" in Francesco Boccia and Robert Leonardi (eds) *The Challenge of the Digital Economy: Markets, Taxation and Appropriate Economic Models* (Springer, Switzerland, 2016) 39 at 45.
[25] Russo, above n 24, at 45.
[26] OECD *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 Final Reports* (OECD Publishing, OECD/G20 Base Erosion and Profit Shifting Project, 5 October 2015) at 3.
[27] Brendan Brown and Josh Aird "Double tax agreements and the multilateral instrument" [2017] NZLJ 118 at 119.

- the preamble to a DTA should state that as well as intending to eliminate double taxation, the parties intend to prevent opportunities for non-taxation or reduced taxation;
- the introduction of anti-abuse rules;
- amendments to the DTA dispute resolution provisions to make it easier for taxpayers to invoke the mutual agreement procedure;
- facilitation of ongoing monitoring and peer reviewing between participating countries.

The minimum standards do not go very far towards preventing BEPS. The action plans are much more impactful. For a country to adopt any of the OECD's action plans, they must negotiate with parties to their existing DTAs and reach a consensus. If both countries agree to an action plan, then the MLI amends the DTA between the two countries to adopt the action plan. There are thousands of DTAs worldwide, so implementing the action plans without the assistance of the MLI would be extremely time-consuming.

The goal of the MLI is to increase the harmonisation of tax rules, which will facilitate trade while preventing tax abuses.[28] This objective is undermined when a country party to a DTA chooses not to adopt an action plan. The consequence is that the other country will not be able to either. As an alternative, the country may circumvent the DTA and adopt domestic legislation that is similar to the action plan. There is a risk that such unilateral legislation will be inconsistent with the country's DTAs. As DTAs are a central theme in this paper, it is necessary to provide some background to explain how they operate.

IV Background to Double Tax Agreements (DTAs)

Double tax agreements are designed to facilitate cross border investment by preventing double taxation. Double taxation occurs when an MNE is taxed in two countries on the same income. When capital and goods can move around the globe with little restrictions, multiple countries may tax the same taxpayer on the same activity.[29] DTAs reallocate the taxing rights between the countries involved to ensure the taxpayer is only taxed once. To do this, treaty partners agree to override their domestic tax laws to the extent they conflict with negotiated treaty

[28] David Kleist "A Multilateral Instrument for Implementing Changes to Double Tax Treaties: Problems and Prospects" 44 Intertax 823 at 830.
[29] Allison Christians "How Nations Share" (2012) 87 IND LJ 1407 at 1414.

provisions.[30] Therefore, treaty partners sacrifice some of their source taxing rights in exchange for increased inward investment. Without DTAs and the resulting reallocation of taxing rights, companies and individuals would be hesitant to trade internationally due to the uncertain tax position.[31]

The risk of preventing double taxation via DTAs is that it can facilitate double non-taxation. Double non-taxation occurs when a taxpayer's activity or transaction falls within the space between jurisdictional rules and is not subject to taxation in either country.[32] Pascal Saint-Amans,[33] has stated DTAs have been so efficient in their stated purpose of reducing double taxation, that they have facilitated double non-taxation in some circumstances.[34] There is a fine balance in negotiating DTAs between making them too friendly to MNEs (and thereby facilitating double non-taxation and avoidance), and making them too strict and causing double taxation and decreased foreign investment.

The purpose of the OECD's action plans is to strengthen the protections in DTAs to decrease BEPS opportunities. However, the OECD also states that the action plans should be enacted by countries in a way that ensures consistency with DTAs.[35] The author argues that some aspects of New Zealand's response to the OECD's action plans may be inconsistent with its DTAs. As DTAs are binding treaties, this could engage New Zealand's state responsibility in international law.[36] New Zealand may be contravening its international obligations if treaty partners protest against its unilateral changes to negotiated positions. Moreover, inconsistencies could negatively affect New Zealand's reputation as a good international citizen.

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[30] Cimetta, above n 13, at 148. In New Zealand this is achieved by s BH(1) of the Income Tax Act 2007, which states that DTAs will override domestic tax law.

[31] Ulrich Schreiber *International Company Taxation: An Introduction to the Legal and Economic Principles* (Springer–Verlag, Berlin, 2013) at 51.

[32] Christians "BEPS and the New International Tax Order", above n 23, at 1612.

[33] Pascal Saint-Amans is the leader of the OECD's co-ordinated response to BEPS.

[34] Presentation slides for OECD webcast, 23 January 2014.

[35] Saint-Amans, above n 34.

[36] According to *Draft Articles on Responsibility of States for internationally wrongful acts* [2001] vol 2 YILC 43, art 1: every internationally wrongful act of a state entails the international responsibility of that state. Article 2 states that an internationally wrongful act of a state requires conduct that is attributable to the state under international law; and constitutes a breach of an international obligation by the state.

V New Zealand's Response to The OECD's Proposals

On 3 August 2017, New Zealand made decisions on the following OECD action plans: permanent establishment (PE) avoidance, transfer pricing, related-party lending interest cap, and hybrid arrangements. These are four of the most common and effective methods of BEPS. This paper will not focus on New Zealand's response to hybrid arrangements, but will analyse the other three decisions more closely.[37]

New Zealand's proposals are partially in line with the OECD's action plans, but go further in some respects. Due to the differences and the fact that many of New Zealand's major trading partners are not adopting the same action plans, New Zealand has been unable to use the MLI to implement its new proposals. Instead, New Zealand has chosen to adopt its BEPS proposals into domestic law. The New Zealand government has stated that the "new measures will significantly strengthen our tax rules and our ability to ensure that multinationals are taxed fairly".[38]

The New Zealand government also stated that we "need to be mindful of the New Zealand context so the proposals address some specific BEPS arrangements that Inland Revenue has observed."[39] This may explain why New Zealand has decided to go further than the OECD proposals. A key question is whether the proposed laws will be consistent with the international community and with New Zealand's DTAs. This paper examines whether such inconsistency exists, and also analyses the legal and policy consequences of New Zealand's decisions.

A Permanent establishment avoidance

Permanent establishment (PE) avoidance is a method of BEPS New Zealand is proposing to legislate to prevent. PE is a widely used concept in tax systems around the world. DTAs generally provide that the activities of non-resident MNEs are only taxable in a country if the

[37] Hybrids is an area that raises a number of complex issues. It is more suited to a separate paper with a longer word count.
[38] Steven Joyce quoted in Inland Revenue "Government announces BEPS decisions" (press release, 3 August 2014).
[39] Above n 38. Judith Collins quoted in the same press release.

MNE has a PE there.[40] Under the current definition in New Zealand's DTAs, a MNE will generally have a PE in New Zealand if either:[41]

- a non-resident (MNE) has a fixed physical place in New Zealand through which it carries on its business (excluding any preparatory or auxiliary activities); or
- there is a person in New Zealand who has, and habitually exercises, an authority to conclude contracts on behalf of the non-resident.

Essentially, the PE concept requires the MNE to have a fixed physical presence in a country or a person concluding contracts on its behalf to be liable to pay tax. This is problematic as globalisation and digitisation of the economy have made it easier for MNEs to produce economic output in locations without much of a physical presence. MNEs are now able to structure their affairs to avoid a PE in New Zealand despite carrying on significant economic activity there. Common approaches include using a local person to sell products on behalf of the MNE, or substantially negotiating the contract in the country, but then finalising it in a different country. [42] These strategies have placed pressure on the traditional PE concept.[43]

The OECD's view is that "the definition of PE must be updated to prevent abuses".[44] Action plan 7 proposes a rule to tax economic activity where it should result in a PE, but it doesn't due to the way the MNE has structured its legal arrangements.[45] The proposed amendment to the PE rule is designed to focus more on the underlying economic substance of the arrangement.

New Zealand has expressed an intention to adopt the OECD's wider PE definition. However, New Zealand can only adopt the OECD's definition of PE through the MLI if its DTA partners agree to. Several of New Zealand's major trading partners have decided not to agree to the

[40] OECD *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 Final Report* (OECD Publishing, OECD/G20 Base Erosion and Profit Shifting Project, 5 October 2015) at 19.
[41] See for example, art 5 of the Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and The Prevention of Fiscal Evasion, New Zealand–Australia (signed 26 June 2009, entered into force 19 March 2010) or art 5 of the Convention between the Government of New Zealand and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, New Zealand–United Kingdom (signed 4 August 1983, entered into force 16 March 1984).
[42] The OECD, above n 40, at 15.
[43] Cimetta, above n 13, at 151.
[44] The OECD, above n 40, at 19.
[45] At 19.

wider PE definition.[46] This means New Zealand will not be able to adopt the OECD's PE definition into many of its DTAs. Instead, New Zealand proposes to adopt a similar PE definition into its domestic law.

New Zealand's proposed PE avoidance rule would deem a non-resident MNE to have a PE in New Zealand if there is an arrangement under which:[47]

- A non-resident supplies goods or services to a person in New Zealand; and
- An entity either associated with or commercially dependent on the non-resident carries out an activity in New Zealand in connection with that particular sale for the purposes of bringing it about; and
- Some or all of the sales income is not attributed to a New Zealand PE of the non-resident; and
- The arrangement defeats the purpose of the DTA's PE provision.

The main difference between New Zealand's proposed PE rule and its current PE rule is the ability to invalidate arrangements when they are deemed to defeat the purpose of a DTA's PE provision. This change will allow Inland Revenue to focus on the economic reality of the arrangement, and reconstruct it if it decides the MNE is deliberately avoiding a PE. The government has decided to proceed with the new PE rule, and aims to enact it into legislation in 2018.[48]

1 Comparison to other jurisdictions representing major trading partners

Neither the United Kingdom nor Australia adopted the OECD's wider PE definition into its DTAs.[49] Both countries have specific domestic law provisions to address PE avoidance. The United Kingdom and Australian rules are very similar, and broadly apply where:[50]

- a non-resident supplies goods or services to local customers; and
- a related local entity undertakes activities in relation to the sales; and

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[46] Inland Revenue *BEPS – Transfer pricing and permanent establishment avoidance: a Government discussion document* (March, 2017) at 3.15. These trading partners include Australia, The United Kingdom, The United States and China.
[47] Inland Revenue, above n 46, at 3.21.
[48] Inland Revenue, above n 46, at 1.1
[49] At 3.15.
[50] At 3.16.

- some or all of the sales income is not attributed to a local PE of the non-resident; and
- the arrangement is designed to avoid tax.

The PE definitions in the United Kingdom and Australia are similar to New Zealand's proposed PE definition. All three PE definitions focus on the purpose and underlying substance of the arrangement. However, the United Kingdom and Australian provisions are more targeted than the New Zealand proposal, as they focus specifically on avoidance arrangements.[51] To invoke the PE provision in the United Kingdom or Australia the tax authority must prove the MNE designed the arrangement to avoid tax. This is considered to be a higher burden than in the New Zealand proposal.[52] Aside from this slightly wider application, New Zealand's proposal is consistent with the domestic law of the United Kingdom and Australia.

China and the United States have refrained from adopting the OECD's wider PE definition. Both countries also lack a PE avoidance rule in domestic law. Instead, they rely on comparatively narrower PE definitions in their DTAs. The definitions in China and the United States' DTAs are similar and broadly apply if:[53]

- a foreign MNE has an establishment or a place of business in the country; or
- it appoints an agent in the country to conclude contracts.

New Zealand's proposed PE definition is much wider than the approach taken by China or the United States. The approaches of China and the United States do not focus on the underlying economic substance of the arrangement. New Zealand, Australia and the United Kingdom are taking a more aggressive approach to PE avoidance. However, problems may arise when PE definitions in DTAs and domestic law differ between the five trading partners.

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[51] This is because the United Kingdom and Australian provisions require that the arrangement is "designed to avoid tax".

[52] Brendan Brown and Tim Stewart "New Zealand's BEPS proposals go beyond OECD's recommendations" [2017] International Tax Review 1 at 1.

[53] See art 5 of the Agreement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, New Zealand–China (signed 16 September 1986, entered into force 17 December 1986); art 5 of Convention between New Zealand and the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, New Zealand–United States of America (signed 23 July 1983, entered into force 2 November 1983); Ross MacDonald "Songs of Innocence and Experience: Changes to the Scope and Interpretation of the Permanent Establishment in U.S. Income Tax Treaties, 1950-2010" (2010) 63 The Tax Lawyer 285 at 288.

2 *International law implications*

Since none of New Zealand's major trading partners want to amend their DTAs to adopt the OECD's wider PE definition, New Zealand has had to adopt its wider PE rule through domestic law. This raises questions as to whether New Zealand's domestic PE definition will be consistent with the PE definitions in its DTAs. Inconsistencies may put New Zealand in breach of its international obligations and increase the risk of double taxation for MNEs trading in New Zealand.

Article 26 of the Vienna Convention on the Law of Treaties (to which New Zealand is a party) states that treaties are binding on the country and must be performed in good faith.[54] The author argues New Zealand may not be performing its treaty obligations by enacting a new PE rule which is different to the PE definitions in its DTAs. New Zealand cannot rely on its domestic law as justification for failing to adhere to its treaties, because article 27 of the Convention states a country cannot invoke its "internal law as justification for failure to perform a treaty".[55]

Inconsistency with international law is particularly problematic in the context of DTAs. This is because New Zealand's DTAs usually override its domestic law.[56] This is necessary, as for DTAs to function effectively, both countries have to sacrifice some source taxing rights. New Zealand wants to reverse this orthodox position by stating that its proposed domestic PE rule will expressly override its DTAs. This is a major and unusual step in taxation law, and may suggest that New Zealand is departing from its treaty obligations. However, article 31(3)(b) of the Vienna Convention states that subsequent practice between the parties can affect the interpretation of a treaty. Therefore, if DTA partners do not object to New Zealand's legislative changes, then New Zealand may not be contravening international law.

New Zealand's position is that adoption of the wider PE definition will be mostly consistent with its DTAs.[57] A justification the government has provided is that it would be too time-consuming and resource-intensive to check for consistency with DTAs when applying the wider PE rule. The author suggests that this alone is not a convincing justification. Indeed, in

[54] United Nations Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, entered into force 27 January 1980), art 26.
[55] United Nations Vienna Convention, above n 54, art 27.
[56] This is achieved in New Zealand by s BH 1(4) of the Income Tax Act, which states that DTAs will override domestic tax law.
[57] Inland Revenue, above n 46, at 3.40.

Belgium v Senegal, the ICJ held that a state cannot rely on internal financial difficulties or time constraints to justify breaching a treaty.[58]

A more convincing justification the government has provided is that its proposed domestic law change to the PE rule is an anti-avoidance measure.[59] As a general rule, there will be no conflict between domestic anti-avoidance provisions and provisions of a DTA, as treaties should not operate to protect abusive arrangements.[60] This rule is mentioned in the OECD Model Commentary and New Zealand seeks to make it express.[61] Countries party to DTAs generally accept the existence of domestic anti-avoidance provisions, and recognise they may defeat the tax treatment established in a DTA.[62]

However, this argument ignores the fact that New Zealand's DTAs already contain specific PE definitions to prevent avoidance. So New Zealand will be overriding the PE avoidance rules in its DTAs with its own domestic PE avoidance rule. New Zealand has justified this proposed change by stating that the United Kingdom and Australia have also chosen to unilaterally enact domestic PE rules.[63] As feared by the OECD, all three countries are implementing their own unilateral BEPS measures which may "differ, duplicate or even contradict one another."[64]

3 Legal and policy implications of the New Zealand position on PE avoidance

New Zealand, Australia and the United Kingdom are responding aggressively to PE avoidance, perhaps because it is the most effective form of BEPS. If a MNE is able to artificially avoid a PE, it can avoid paying any tax in the country. Other forms of BEPS minimise a tax burden, but PE avoidance can remove it entirely. However, there is a competing concern. If the PE rule is too onerous, MNEs will decrease their investment in New Zealand. This could be significant, as foreign direct investment makes up 39 per cent of New Zealand's GDP.[65]

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[58] *Questions Relating to the Obligation to Prosecute or Extradite (Belgium v Senegal)* [2012] ICJ Rep 422 at 459.
[59] Inland Revenue, above n 46, at 3.43.
[60] Inland Revenue, above n 46, at 3.45.
[61] See OECD *Model Tax Convention on Income and on Capital* 2014, art 7.
[62] Cimetta, above n 13, at 152.
[63] As mentioned earlier, the United Kingdom has its Diverted Profit Tax and Australia has its Multinational Anti Avoidance Law to combat PE avoidance.
[64] Pascal Saint-Amans (OECD Director, Centre for Tax Policy and Administration) in an untitled letter to the Senate Economics Reference Committee, 18 February 2015.
[65] Inland Revenue, above n 46, at 5.11. Note that this is (NZD) 97 billion, which is massively out of proportion to the (NZD) 600 million of tax revenue lost to BEPS.

The author suggests that New Zealand's proposed PE rule is not too onerous. It only aims to invalidate MNE arrangements that do not align with economic reality. However, it may create a worrying lacuna for MNEs operating in New Zealand. For example, a company resident in Australia which expands its operations to New Zealand may fall outside the narrow PE definition in the DTA. However, the proposed wider PE definition in New Zealand's domestic law may apply, and override the PE definition in the DTA. As the MNE is also resident in Australia, double taxation may result.

This outcome is contrary to the purposes of DTAs, which are designed to prevent double taxation.[66] Generally when double taxation occurs, DTAs will operate to provide relief. For example, article 22 of New Zealand's DTA with the United Kingdom states that when a foreign company is paying tax in both countries, a tax credit will be provided for relief. However, this will not be the case for New Zealand's wider PE rule, because tax relief is only provided for double tax paid in accordance with the DTA.[67] Seeing as New Zealand is implementing its wider rule through domestic law, the DTA will not recognise it. For MNEs in this lacuna, the result may be double taxation without relief. This consequence may reduce multinational investment in New Zealand.

However it is worth noting that this lacuna will rarely apply. All of the following conditions have to be present:

- the MNE must have yearly revenue of over (EUR) €750 million;[68] and
- it must have an arrangement that is caught by New Zealand's PE definition; and
- the same arrangement must not also be caught by a PE definition in a DTA.

A MNC can only fall into the lacuna if it meets New Zealand's proposed PE definition, but not a PE definition in a DTA. If it meets the DTA definition the treaty will recognise the PE and give relief for the double taxation. The author suggests that as the lacuna is so specific, it is

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[66] Note the preamble to New Zealand's DTAs which state they are designed to prevent double taxation. See for example the preamble to the Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and The Prevention of Fiscal Evasion, New Zealand–Australia (signed 26 June 2009, entered into force 19 March 2010).

[67] See for example art 23(1) of the Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and The Prevention of Fiscal Evasion, New Zealand–Australia (signed 26 June 2009, entered into force 19 March 2010) or article 22(1) of Convention between the Government of New Zealand and the Government of The United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, New Zealand–United Kingdom (signed 4 August 1983, entered into force 16 March 1984).

[68] See Inland Revenue, above n 46, at 3.19. This is the threshold New Zealand is seeking to use before its PE rule will apply.

unlikely to have a significant impact on MNE investment in New Zealand. Moreover, if it does apply, it is likely to be to an abusive arrangement.

4 Conclusions and potential solutions

The author suggests that New Zealand should ensure its PE rule is specifically targeted to avoidance transactions. This would put it beyond doubt that only abusive MNE arrangements will be caught. It would also further decrease the chance of MNEs falling into the "lacuna". Fortunately, the government has already recognised it may need to make this change to ensure the PE rule is workable in practice.[69]

A more pressing issue for New Zealand is that it could be breaching its treaty obligations if it enacts an overriding PE definition.[70] The author suggests New Zealand should seek to renegotiate with trading partners to ensure consistency between the PE definition in its DTAs and domestic law. Negotiations may well succeed with the United Kingdom and Australia. This is because all three countries now have similar approaches to PE avoidance in domestic law. Reaching an agreement with the United States and China may be more difficult, as they have refrained from adopting wider PE rules. Regardless, if negotiations were successful between New Zealand and its major trading partners, the result will be increased international consistency, a reduced risk of double taxation, and a new PE rule that could prove valuable in combatting BEPS.

B Transfer Pricing

Transfer pricing is another method of BEPS that New Zealand is proposing to legislate to prevent. Transfer pricing involves cross border payments between related-parties within a multinational group. The related-parties can agree to pay artificially high or low sums depending on where the tax will fall. Transfer pricing can be used in this way as a tool to accrue artificially high costs in high tax jurisdictions, and thus to reduce taxable profits in those jurisdictions.[71] Academic studies have found that MNEs declare more income in low-tax

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[69] See Brendan Brown and Tim Stewart "New Zealand's BEPS proposals go beyond OECD's recommendations" [2017] International Tax Review 1 at 1. Note, this change would also fully align the proposed provision with the PE avoidance provisions in the United Kingdom and Australia.
[70] Note that New Zealand is not the only country possibly in breach of international obligations as Australia and the United Kingdom have also unilaterally enacted domestic PE rules.
[71] David Harris and others "Income Shifting in U.S. Multinational Corporations" in Alberto Giovannini, Glen Hubbard and Joel Slemrod (eds) *Studies in International Taxation* (The University of Chicago Press, Chicago, 1993) 227 at 227.

jurisdictions.[72] The shifting of profits from high to low tax jurisdictions results in a lower overall tax bill for the multinational group.[73]

1 The New Zealand position on transfer pricing

New Zealand's current transfer pricing rules are found in Part GC of the Income Tax Act 2007. These rules are designed to ensure related parties within a multinational group deal with each other at arm's length.[74] This means MNEs must trade intra-group with the same price and terms as they would with external parties. Under the current rules, provided an MNE can find a comparable transaction in the market, its arrangement can stand.[75] Additionally, the burden of proving the transaction is not at arm's length lies with Inland Revenue. The current transfer pricing rules have been so difficult for Inland Revenue to enforce that not a single case has been brought against a taxpayer in a court in New Zealand.[76]

Similarly to New Zealand, the OECD's transfer pricing guidelines also require related-parties to trade at arm's length.[77] The OECD raised concerns that the arm's length standard can be misapplied to result in an allocation of profits that is not aligned with the economic activity that produced those profits.[78] MNEs are able to manipulate the arm's length standard by adding commercially irrational terms to their intra-group contracts to justify a higher transfer price.[79] The OECD's action plans 8-10 aim to strengthen transfer pricing rules to ensure they align with value creation.[80]

New Zealand wants to strengthen its existing transfer pricing rules so they align with the OECD's proposals. This will involve amending its current transfer pricing rules so that:[81]

- they disregard the legal form of a transaction if it does not align with the underlying economic substance; and

[72] Harry Grubert and John Mutti "Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making" (1991) 73 Review of Economics and Statistics 285 at 287.
[73] Harris and others, above n 71, at 228.
[74] See s GC 13. It states that arm's length pricing must be used.
[75] Kirsty Keating "New Zealand versus the world: The battle for international tax revenue reaches our shores" (2017) 908 LawTalk 32 at 32.
[76] Keating, above n 75, at 33. Note, that this does not mean transfer pricing is never disputed by the Inland Revenue, as cases have been settled before they reach a court.
[77] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Publishing, 10 July 2017) at 35.
[78] The OECD, above n 26, at 9.
[79] The OECD, above n 26, at 10.
[80] At 13.
[81] Inland Revenue, above n 46, at 4.

- in cases where independent entities would not have entered into the contracted conditions, the Commissioner will be able to reconstruct the arrangement to add arm's length conditions (or to eliminate the arrangement entirely); and
- the legislation specifically refers to arm's length conditions and the latest OECD Transfer Pricing guidelines.

New Zealand is also proposing to shift the burden of proof for transfer pricing matters from the Commissioner to the taxpayer. The onus will be on MNEs to prove the conditions in their intra-group arrangements are at arm's length.[82]

2 Analysis of New Zealand's proposed changes

New Zealand's proposal will let the Commissioner reconstruct transfer pricing arrangements when they do not reflect economic substance. The Commissioner will be able to replace the existing conditions with arm's length conditions, or eliminate the arrangement entirely.[83] The OECD guidelines say reconstruction should only be used in exceptional circumstances. New Zealand proposes to remove the phrase "exceptional circumstances", which may imply reconstruction will occur more frequently in New Zealand than the OECD suggests.[84]

An uncertainty is whether the Commissioner's reconstruction powers will be limited to changing the price of the arrangement, or whether they will include the power to change other terms as well. The Australian Full Federal Court, in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2015] FCA 1092, interpreted a similar provision in Australian tax legislation to allow wide-ranging reconstruction powers. The Court found that the Commissioner could make adjustments not only to the price of the transaction but also to other conditions of the contract. In *Chevron*, this was the security and loan covenants. This approach could conceivably be extended to other conditions of the transaction. Inland Revenue noted the approach in *Chevron,*[85] but did not comment on whether its proposed reconstruction powers would go that far.

[82] Inland Revenue, above n 46, at 4.
[83] At 5.35.
[84] At 5.39.
[85] At 5.42.

Australia's reconstruction powers have been criticised as being wide ranging and reducing commercial certainty.[86] The United Kingdom, France and the United States all reserve reconstruction for "exceptional circumstances".[87] If New Zealand adopts the same approach as Australia, a concern is that it results in state over-encroachment into commercial affairs. It may be going beyond the scope of a tax authority's role of identifying and taxing profits to potentially interfering with parties' contractual autonomy. New Zealand has defended this position by saying that only avoidance transactions will be reconstructed.[88]

New Zealand is also proposing to reverse the burden of proof, so that the MNE must prove the transaction is at arm's length. It has been difficult for Inland Revenue to prove that inappropriate transfer pricing was occurring, and doing so took significant time and taxpayer money.[89] This is because MNE structures and transactions have vastly increased in complexity since the transfer pricing rules were introduced.[90] Additionally, the MNE often has better information than Inland Revenue, and pertinent information is usually held outside of New Zealand.[91] This change seems justifiable as it will allow Inland Revenue to more effectively enforce transfer pricing rules. Moreover, in tax matters it is common for the burden of proof to rest with the taxpayer. Transfer pricing was an exception to this general rule, and New Zealand's position was out of line with most of the OECD and G20 member countries.[92]

3 International comparisons and perspectives on transfer pricing

Australia's transfer pricing legislation was updated in 2013 to focus on the economic substance of the relevant transaction. The legislation requires the legal form and economic substance to align, or be disregarded.[93] New Zealand's proposed changes are based on Australia's approach.[94] It is desirable for New Zealand and Australia to have similar transfer pricing legislation as they enjoy one of the closest bilateral economic relationships in the world.[95]

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[86] Deloitte "Final guidance on the ATO's controversial transfer pricing reconstruction powers" (14 November 2014) at 2.
[87] Ernst & Young "Transfer pricing global reference guide" (2016) <www.ey.com>.
[88] Inland Revenue, above n 46, at 5.40.
[89] Inland Revenue, above n 46, at 5.45.
[90] At 5.45.
[91] At 5.45.
[92] At 5.46.
[93] See the Australian Income Tax Assessment Act 1997, ss 815.130(1) and 815.130(2).
[94] Inland Revenue, above n 46, at 5.26.
[95] Monique Ross, Jarrod Walker and John Walker "Multinationals Targeted Down Under" [2017] 52 Taxation in Australia 22 at 22; although note the exception to this would be aligning the reconstruction provisions, as was noted above, Australia's reconstruction provision has proved controversial.

Indeed, fifty one per cent of New Zealand's foreign direct investment is from Australian MNEs.[96]

New Zealand and Australia having similar transfer pricing rules reduces the risk of double taxation or double non-taxation.[97] It is decreases the chance of MNEs substituting investment to one country over the other. John Nash from Inland Revenue has admitted that New Zealand is at the end of the international value chain.[98] Australia is also typically seen as an end-user market place for MNEs.[99] If New Zealand had chosen to adopt stricter transfer pricing rules than Australia, It could have led to a greater share of profits from MNE investment being allocated to Australia.[100]

New Zealand's proposed transfer pricing amendments are also generally consistent with the international community. The United Kingdom, China, the United States and France already have domestic transfer pricing legislation that is consistent with the OECD's proposals.[101] Moreover, New Zealand is retaining the arm's length approach, which is used by over 70 countries.[102] It is desirable that New Zealand is realigning itself with the international community on transfer pricing. The increased harmonisation of tax rules will prevent MNEs from exploiting gaps in the international tax regime.

Harmonisation of tax rules is generally positive. However, some commentators argue harmonisation is undesirable when it is based on the arm's length standard. A key problem, highlighted by almost all transfer pricing professionals,[103] is that the arm's length standard requires prices between MNEs to be set based on prices that unrelated parties would negotiate for. However, the integration of economies and greater efficiencies of the MNE compared to

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[96] Inland Revenue, above n 46, at 5.13.
[97] Ross, Walker and Walker, above n 95, at 23.
[98] John Nash is the officer within Inland Revenue responsible for administering New Zealand's international tax obligations (the Competent Authority).
[99] Ross, Walker and Walker, above n 95, at 22.
[100] Inland Revenue, above n 46, at 5.13.
[101] Deloitte "BEPS Actions Implementation Matrices" (2017) <www.deloitte.com>.
[102] Lorraine Eden "The Arm's Length Standard: Making it Work in a 21st Century World of Multinationals and Nation States" in Thomas Pogge and Krishen Mehta (eds) Global Tax Fairness (Oxford University Press, Oxford, 2015) 153 at 154.
[103] Eden "The Arm's Length Standard: Making it Work in a 21st Century World of Multinationals and Nation States", above n 102, at 156.

unrelated parties prevents realistic comparisons.[104] Studies have shown that MNEs are abusing the arm's length standard to avoid tax by mispricing international trade flows.[105]

A harmonised arm's length standard may be problematic for New Zealand as an end-user market. If most MNEs are required to price at arm's length, it has been predicted that greater costs will be passed to New Zealand, due to the minimal value New Zealand adds to global transactions.[106] These greater costs will reduce the taxable profit of MNEs in New Zealand. Some writers argue the arm's length standard should be replaced by an apportionment system that allocates profits of an MNE between countries based on capital, labour and sales.[107]

4 Conclusions and potential solutions

The arm's length standard may have limitations, but it would be difficult for New Zealand to depart from. It is widely used,[108] and if it were to be reformed, it should be done globally via the OECD, as opposed to unilaterally by nation states.[109] New Zealand's proposed changes to transfer pricing are a positive step to harmonising its tax laws with major trading partners. However, they may not lead to the desired $100 million increase in tax revenue,[110] because of New Zealand's position as an end-user market and the deficiencies of the arm's length standard.[111]

Even if strengthening the transfer pricing rules does not substantially increase tax revenue,[112] the change will still prove effective in capturing abusive MNE arrangements. The proposed changes will give the Commissioner greater power to invalidate commercially irrational arrangements. The reversal of the burden of proof will help to enforce the proposed changes. The author notes the only real substantive concern relates to the possible extent of the Commissioner's reconstruction powers. Inland Revenue should clarify the scope of these

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[104] Rosanne Altshuler and Harry Grubert "Formula Apportionment: Is it Better than the Current System and are there Better Alternatives?" (2010) 63 National Tax Journal 1145 at 1146.
[105] Fuest and Riedel, above n 2, at 114.
[106] Keating, above n 75, at 33.
[107] Eden "The Arm's Length Standard: Making it Work in a 21st Century World of Multinationals and Nation States", above n 102, at 156.
[108] Eden "The Arm's Length Standard: Making it Work in a 21st Century World of Multinationals and Nation States", above n 102, at 154.
[109] At 155.
[110] Inland Revenue, above n 46, at 2.7.
[111] Lorraine Eden "Went for Cost, Priced at Cost? An Economic Approach to the Transfer Pricing of Offshored Business Services" in UNCTAD *Transnational Corporations* (The United Nations, New York and Geneva, 2005) 1 at 3.
[112] Inland Revenue, above n 46, at 2.7.

powers, and preferably prevent them from interfering with the terms of loan agreements other than the pricing.

C Interest Limitation Proposals

MNEs charge interest on their intra-group loans. Instead of using an interest rate that reflects the market, they may choose to charge an artificially high interest rate. This allows the subsidiary to claim greater interest deductions to reduce their taxable income. This is problematic as the profit of the MNE group is not actually lessened by the high interest rate; it is merely transferred intra-group. Academic studies have shown a relationship between tax rules and the location of debt with a multinational group.[113] This evidences that MNEs are structuring their loans to acquire higher deductions in high tax jurisdictions, and, therefore, lower taxable profits in those jurisdictions.[114]

1 The New Zealand position on interest limitations for MNEs

Currently, New Zealand has no specific cap on the interest rate allowable for related-party lending. Instead, the problem has been dealt with by New Zealand's transfer pricing rules in s GC 4 of the Income Tax Act. The transfer pricing rules require the interest rate for the intra-group lending to be at an arm's length rate. Some commentators have argued no specific cap on the interest rate is needed, as these existing transfer pricing rules are robust enough to prevent abuses.[115] However, there is global concern stemming from the OECD, that an arm's length standard has proved insufficient to deal with intra-group interest deductions.[116]

OECD action plan 4 proposes to cap the interest rate on related-party loans to prevent MNEs using artificially high interest rates. The OECD's recommendation is to limit interest deductions by using a fixed ratio which is based on a MNEs EBITDA.[117] Allowable interest deductions are to be limited to somewhere between 10%-30% of the MNE's EBITDA.

New Zealand has decided to depart from the OECD's proposal. The government stated it would prefer to strengthen its current interest framework, rather than adopt a different approach, as

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[113] OECD *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 Final Report* (OECD Publishing, OECD/G20 Base Erosion and Profit Shifting Project, 5 October 2015) at 4.
[114] The OECD, above n 113, at 20.
[115] Chapman Tripp "Incoming turbulence: tax proposals target multinationals" (10 March 2017) <www.chapmantripp.com>.
[116] The OECD, above n 113, at 7.
[117] EBITDA stands for earnings before interest, tax, depreciation and amortisation.

the OECD proposed.[118] The government is proposing to strengthen its rules by adopting a "restricted transfer pricing" method to determine the allowable interest rate for related-party loans. The starting point is that the interest rate must be at arm's length, but Inland Revenue has stated there will also be two new additional elements:[119]

- a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent in the event of a default; and
- all circumstances, terms and conditions that could result in an excessive rate will be required to be ignored – unless the taxpayer can demonstrate that they have substantial third party debt featuring those terms and conditions.

In summary, the 'restricted transfer pricing' proposal is comprised of three components: the normal transfer pricing arm's length principle, a rebuttable presumption of parental support, and the exclusion of terms that would create an excessive interest rate. The Commissioner will be able to reconstruct loan arrangements if she views the interest rate as being inconsistent with the arm's length principle. The rebuttable presumption and exclusion of commercially unrealistic terms will aid the Commissioner in making a final determination as to whether the interest rate is at arm's length.

2 *Meaning of 'parental support'?*

The most difficult question the restricted transfer pricing model raises relates to the presumption that the New Zealand subsidiary would be supported by the foreign parent in the event of a default. Commentators have noted that it is unclear whether the presumption is intended to confirm that the pricing of the interest rate will take into account mere support from the parent in the event of default, or whether it is meant to amount to a legal guarantee.[120] If it is meant to amount to a legally binding guarantee from the parent, then this raises questions as to whether that assumption is reasonable, and how the value of such a guarantee should be quantified.[121]

If the presumption amounts to a legally binding guarantee of parental support in the event of subsidiary default, then loan agreements in New Zealand will generally be priced with lower

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[118] Inland Revenue *BEPS – Strengthening our interest limitation rules: a Government discussion document* (March, 2017) at 2.17.
[119] Cabinet paper "BEPS – strengthening our interest limitation rules" (13 July 2017) CAB 15 at [3].
[120] Brendan Brown and Tim Stewart "New Zealand's BEPS proposals go beyond OECD's recommendations" [2017] International Tax Review 1 at 2.
[121] Brown and Stewart, above n 120, at 2.

interest rates. This is because a parental guarantee of a "bail out" makes the loan agreement less risky for the lender. To reflect the decreased risk, the lender will have to offer a lower interest rate. A lower interest rate means the MNE gets fewer interest deductions, and, therefore, has a higher taxable profit.

The issue of parental guarantee was examined in *General Electric Capital Canada Inc*. ("GECC") v *The Queen* 2009 TCC 563. In that case, the GE parent charged the GE Canadian subsidiary a fee for providing a guarantee in the case of default. The Minister of National Revenue disallowed deductions for the guarantee fees on the basis that the arm's length price should be zero, as the guarantee fees provided no economic benefit to the subsidiary. The Tax Court of Canada overturned this finding and held that economic benefits were derived by the subsidiary due to the parental guarantee. Justice Hogan stated that it was consistent with arm's length pricing for the subsidiary to pay a fee for a parental guarantee.

This decision, although in the Canadian context, raises doubts about Inland Revenue's presumption if it is meant to amount to a parental guarantee. This is because *GE* suggests it is consistent with arm's length pricing for a subsidiary to have to pay a fee for a guarantee from the parent. So Inland Revenue presuming that such a guarantee exists without a fee being paid may not reflect realistic commercial pricing.

However, in *Chevron*, the Australian courts decided somewhat differently, although on a subtly different issue. The taxpayer tried to argue that when pricing the interest rate, parental support should not be considered.[122] The Australian court rejected that argument, and held that when pricing the loan, the taxpayer should be assumed to be the subsidiary of a major multinational. However, the court did not rule on whether the support from the parent was implicit or explicit.[123] In other words, whether the parental support amounted to a legal guarantee in the event of default, or not.

If the government does not clarify whether the presumption of parental support amounts to a guarantee or not, then it may well be up to the New Zealand courts to decide. It is unclear whether they would take an approach more similar to the Canadian or Australian courts. The author suggests it is preferable for the presumption to be of implicit parental support. This is

[122] *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2015] FCA 1092 at 200.
[123] Deloitte "New Zealand implications of Australian debt pricing decision" (June 2017) <www.deloitte.com>.

because it seems unrealistic to assume a multinational parent will bail out its New Zealand subsidiary in all cases, especially without a fee.

MNEs can choose between operating via a branch (joint legal entity), or, operating via a subsidiary (separate legal entity).[124] A key advantage of operating via a subsidiary is that liability is limited to the losses of the subsidiary.[125] As such if the subsidiary defaults, the parent generally does not have to pay the creditors. So it would seem unusual if Inland Revenue assumed the parent would legally guarantee the subsidiary's losses, when a common motive for creating a subsidiary is protection from the subsidiary's losses.[126]

3 "Vanilla" loan agreement

Another feature of the proposed restricted transfer pricing is that the related-party loans will be priced on the basis that they are "vanilla".[127] This means when the Commissioner prices the loan she ignores any terms or conditions that would result in an excessive interest rate. This is to prevent MNEs deliberately including un-commercial terms to justify a high intra-group interest rate. The purpose of the "vanilla" provision is to ensure the MNE's loan agreement coincides with economic reality. It is also more consistent with relevant case law, as in the *Chevron* case; Chevron Corporations' intra-group loans were legitimately reconstructed by the tax authority for containing commercially unrealistic terms.[128]

4 Comparison to major trading partners

New Zealand's approach is similar to many of its major trading partners, but may lead to slightly different results in some circumstances. China, Australia, and the United States have all refrained from adopting the OECD's EBITDA rule. All three countries price intra-group interest rates based on the arm's length principle. This is fairly consistent with New Zealand's approach, but there may be a risk of double taxation depending on the interpretation of New Zealand's parental support presumption.

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[124] Thomas Harr and Thomas Ronde *Branch or Subsidary? Capital Regulation of Multinational Banks* (Working Paper, University of Copenhagen, 2005) at 3.
[125] Mark Masek "Foreign Branch or Foreign Subsidary?" (1991) 17 Intl Tax J 28 at 28.
[126] Above, n 124, at 3.
[127] Cabinet paper, above n 119, at [18].
[128] *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation*, above n 122, at 166.

If the presumption of parental support in the event of default proposed by New Zealand is to amount to a guarantee, the consequence could be double taxation. For example, consider a Chinese or American MNE trading in New Zealand through a subsidiary. The starting point in all countries would be that the interest rate must be consistent with the arm's length principle. However, it is foreseeable that New Zealand would decide on a lower interest rate. This is because the New Zealand proposal may also assume there is a parental guarantee from the Chinese or American parent. This will reduce the risk involved for the lender, and thereby reduce the arm's length interest rate. If New Zealand and China or America decide on a different allowable interest rate, then to the extent of the difference, the MNE will be subject to double taxation.[129] This is because the amount of the difference will be taxable in one country and non-deductible in the other. Double taxation is inconsistent with the purposes of the DTAs negotiated between these countries.[130]

5 Conclusions and potential solutions

New Zealand's "restricted transfer pricing" methodology retains the arm's length principle and is generally consistent with the international community. It is logical to exclude terms in loan agreements that artificially lift the price and cannot be justified by the MNE. The only area for potential concern is the meaning of "parental support". New Zealand should clarify whether that "support" amounts to a mere implication of support, or whether it amounts to a legally binding guarantee. The author submits that it should be the former of the two. The latter approach is potentially inconsistent with case law on the matter,[131] and may lead to different pricing of loans to other countries. The consequence would be double taxation suffered by the MNE to the extent of the difference.

VI Conclusion

Base erosion profit shifting is a significant problem in New Zealand and the rest of the world. The OECD has created action plans to combat BEPS that states can adopt through DTAs using a multi-lateral instrument. New Zealand is planning to use domestic legislation to adopt its own

[129] See Emilio Cencerrado Millá and María Teresa Soler Roch "Limit Base Erosion via Interest Deduction and Others" (2015) 43 Intertax 58 at 70 for a further discussion of the risk of double taxation if countries have different approaches to interest deductions between related-parties.
[130] The preamble to New Zealand's DTAs with these three countries state their purpose is to reduce double taxation.
[131] *See General Electric Capital Canada Inc ("GECC") v The Queen 2009 TCC 563.*

BEPS reforms. New Zealand cannot use the MLI to implement its proposals because they go further than some of the OECD action plans.

New Zealand's BEPS proposals are likely to prove effective in combatting MNEs who abuse the tax system. However, this paper argues New Zealand should be careful to ensure its proposals are consistent with its DTAs. I conclude that New Zealand's PE proposal may be inconsistent with its DTAs. However, this problem could be solved if bilateral renegotiations to amend the PE definition in the DTAs were successful. I suggest that New Zealand's response to transfer pricing is consistent with its DTAs. However, limiting the scope of the reconstruction powers to the OECDs guidelines would be preferable to increase commercial certainty. I also conclude that New Zealand's position on interest deductions for related-party lending is generally consistent with its DTAs. However, if New Zealand is seeking to presume a parental guarantee, the result could be double taxation.

Throughout this paper I examine the inherent tension between BEPS measures and the interests of MNEs. While BEPS is clearly problematic, it is important for New Zealand to ensure its law changes do not jeopardise MNE investment. As perspective, BEPS is estimated at eroding (NZD) $600 million in tax per year in New Zealand. However, foreign direct investment in New Zealand amounts to (NZD) $98.7 billion per year.[132] Fortunately, New Zealand is conscious of this tension, as it has stated:[133]

> *"[The] Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest. At the same time, it is important that firms operating here pay a fair amount of tax."*

In venturing beyond the OECD's proposals, the question is whether New Zealand has struck the appropriate balance. The author suggests that in some areas New Zealand may be at risk of jeopardising foreign investment and commercial certainty. The consequences will not be fully clear until 2018 when the legislation is enacted. Regardless, New Zealand's proposals, and the OECD's BEPS initiatives, are a powerful step towards strengthening the international tax order. The effects of these initiatives in New Zealand and the world will be felt for years to come.

[132] Statistics New Zealand and the Ministry of Foreign Affairs and Trade "Global New Zealand – International trade, investment and travel profile" (30 June 2016).
[133] Steven Joyce in Inland Revenue "Government announces BEPS decisions" (press release, 3 August 2014).

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