NEW ZEALAND LAW SOCIETY
NZLS EST 1869

Law Society Building, 26 Waring Taylor Street, Wellington
DX SP20202, Wellington
PO Box 5041, Wellington 6140, New Zealand

TEL +64 4 472 7837 · FAX +64 4 473 7909
E inquiries@lawsociety.org.nz · www.lawsociety.org.nz

12 October 2018

Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

By email: policy.webmaster@ird.govt.nz

Base Erosion and Profit Shifting - Permanent establishment anti-avoidance rules – draft guidance

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on Inland Revenue's draft special report: *Permanent establishment anti-avoidance rules* (draft guidance) and to ensure this area of law is consistently treated and clearly explained by the draft guidance.

2. Introducing permanent establishment (PE) rules to domestic law is novel and complex, justifying the care the Commissioner has taken when creating the draft guidance, which is intended to help taxpayers comply with their obligations under the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 (the Act).

3. For ease of reference, the Law Society's substantive comments are listed in the order that they arise in the draft guidance.

4. By way of preliminary comment, the Law Society notes that clear sub-headings are useful in directing readers to parts of the draft guidance that are most likely to apply to their individual situation. To further improve the readability of the draft guidance, especially for non-experts, the Law Society also recommends the layout or format could include a comprehensive contents page to facilitate rapid navigation and a "quick reference" glossary of various acronyms used for example, DTA, MLI, PE[1] (notwithstanding that these are defined in the body of the draft guidance).

Comments

Use of the word "structure"

5. The use of the word *"structure"* as a verb in the first paragraph of the draft guidance (at p 1) emphasises the avoidance focus of the draft guidance (as it indicates a deliberateness or purposeful use of a particular structure to avoid tax). Further, the context suggests that the purpose of the structure, not the outcome, is the focus of these new measures. While the Law Society understands that the structure must have a more than merely incidental purpose of tax avoidance, we are concerned that focusing on the structure's purpose may

[1] Double Tax Agreement (DTA), Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) and Permanent Establishment (PE).

result in readers incorrectly inferring that they are not affected. Rather than *"large multinationals […] that structure to avoid having a permanent establishment"*, the Law Society suggests the text should read *"large multinationals […] with a structure intended to avoid having a permanent establishment*". This would signal that the purpose of a company's structure is not determinative of whether the company falls within the ambit of this rule, as the intention of avoidance and the outcome of the arrangement can also be indicative.

6. This approach is supported by the new law, as section GB 54(h) of the Act states:

> *"the arrangement has a purpose or effect of affecting the imposition on the non-resident of income tax, or of income tax and the income tax of a country or territory other than New Zealand".*

7. The use of *"purpose or effect"* suggests that the structure, outcome, and intention should all be equally emphasised. Finally, the use of *"structure"* as a verb in this context is potentially a term of art and may not be a use recognised by all readers.

Link to Transfer Pricing Regime

8. The permanent establishment anti-avoidance rules have historically been discussed in conjunction with the new transfer pricing regime. While the Law Society acknowledges that these rules should not be conflated, and there is a risk of losing clarity if they are discussed in tandem here, there may be value in referring to the transfer pricing rules while discussing the permanent establishment anti-avoidance rules. For example, in the second paragraph on p 2, consider the following sentence:

> *"This usually involves the non-resident entity establishing a New Zealand subsidiary to carry out local sales related activities".*

9. This could be expanded to give a more complete picture of the issue the permanent establishment rules are partially addressing, by continuing with:

> *"and shifting the profits from these arrangements offshore through the targeted application of transfer pricing rules".*

10. In this way the co-dependent nature of these arrangements, whereby both the permanent establishment rules and the related party rules are avoided, is recognised by the draft guidance. This will indicate to interested parties that they may need to familiarise themselves with both topics.

Definition of Permanent Establishment

11. The definition of "permanent establishment" has been drafted widely and will potentially apply in a broad and possibly unexpected range of circumstances. Clear and comprehensive guidance including examples is important to clarify how the definition will apply in practice and to confirm those areas where it will not apply.

12. The fifth paragraph on p 2 states that the *"OECD's widened PE definition will not be sufficient to address the issue of PE avoidance in New Zealand"*. Firstly, while alluded to in the preceding sentences, the Law Society proposes further clarifying that the OECD's definition is not at fault. This could be done by amending the sentence to read that the:

> *"OECD's widened PE definition **is curtailed by not being incorporated into DTAs** and will **therefore** not be sufficient to address the issue of PE avoidance in New Zealand"*.

13. Secondly, the addition of the phrase *"an issue which the new permanent establishment anti-avoidance rule aims to address"*, could clarify the purpose of this background information and how it has led to New Zealand's domestic law response.

14. The drafting of the new PE definition is different from the definition in the OECD convention. The new PE definition applies where a person:

> *"habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"*.

15. Whereas, the PE definition applies where the person carries out *"an activity bringing about the facilitated supply".* This indicates a requirement for a more direct nexus between the activity of the facilitator and actual conclusion of the contract before a particular supply will give rise to a PE. This seems clear from the examples provided, however, the Law Society recommends that it should be more clearly stated in the draft guidance, possibly in the last paragraph of p 7.

16. It is noted at p 17 in the draft guidance that there will be differences in the application of these two definitions. The Law Society suggests the draft guidance should be expanded to explain the differences between the two definitions.

<u>Third Party Channel Providers</u>

17. On p 3, the paragraph starting *"Section GB 54 may…"* mentions an application of the new rules to specific circumstances, namely, the deeming of a PE when a third-party channel provider is involved in a multinational's structure. By commenting on precise considerations so early in the draft guidance, under the heading *"key features"*, there is a risk of lending unwarranted weight to the matter of third party channel providers. The more detailed analysis on p 6 may be a more appropriate place for this consideration to be first explicitly mentioned. However, we would suggest adding the words "*(being either the ultimate recipient or an intermediary who on-supplies to a recipient known to the non-resident)*" to the second bullet point on page 3 to both capture this concept and better reflect the wording of section GB 54(1).

18. Further, the Law Society notes that in the second paragraph on p 6, the draft guidance acknowledges that:

> *"there can be good commercial reasons for third-party channel provider arrangements. However, they should also give rise to a PE for the non-resident in respect of its sale to the third party in appropriate circumstances".*

19. This introduces potential confusion when the draft guidance up to this point has heavily focused on structures with a tax avoidance purpose, as clearly contemplated by the new rules. The suggestion that structures which are largely guided by sound commercial reasons could still result in a deemed PE (assumedly if they have a more than merely incidental purpose of tax avoidance) should be addressed with care. Imprecise terms such as *"appropriate circumstances"* need further clarification. While the circumstances intended to be caught are explored in the draft guidance, the possibility of a reader skimming the initial

summary and getting the wrong impression should be addressed. Further, this is an unusually specific possibility to explore in draft guidance which intended to give general guidance on the new rules. It may be more appropriate to address this specific consideration in the context of an example rather than focusing on this issue in the main body of the draft guidance.

Flowchart

20. The Law Society appreciates the clear and precise nature of the flowchart on p 5, however the use of the phrase *"requires a tax avoidance purpose"* appears to restrict the companies to which this rule would apply contrary to section GB 54(h) of the Act and the third-party channel providers example. The Law Society considers that this does not accurately explain the law for the reasons stated above. Were someone to briefly review this material, and place too much emphasis upon this flowchart, they may not realise that an arrangement with the mere effect of affecting the imposition of income tax on a non-resident may result in a deemed PE, despite the structure being largely guided by commercial considerations.

"Particular customer"

21. The phrase *"particular customer"* has been used initially on p 8, and then regularly in the examples listed on pp 10-12. The Law Society presumes this is in reference to section GB 54 (1)(a)(ii) of the Act: "*a supply of the goods or services to another person in New Zealand (the recipient) whose existence is known to the facilitator*". For clarity, it may be useful to offer a definition of *"particular customer"*. This may be best done using an example, to clarify how precisely a customer needs to be identifiable to be considered a *"particular customer"*. For instance, it may be unclear if on-supply to a company is envisaged by *"particular customer"* despite falling within the normal legal definition of *"another person"*. To that end, it may be useful to instead appropriate the phrase *"another person"* for the sake of internal consistency between the amended Act and the draft guidance.

"Non-resident"

22. Example 8 (p 11) states that if a New Zealand subsidiary facilitated an order by an New Zealand customer for a product sold by a non-resident (i.e. giving rise to a PE in respect of that sale), and then the New Zealand customer orders from the offshore company, a completely different product and negotiates the terms of the sale for that product directly, then the PE definition would not be satisfied for that subsequent sale. It should be made clear that any one of those factors, i.e. the product purchased, the terms of sale, or the quantity purchased, can be significant in determining whether a separate supply is made. For example, if the New Zealand customer undertakes direct negotiation with the non-resident in relation to a subsequent supply, without the involvement of the facilitator, this should not give rise to a PE.

23. It would also be useful to include an example outlining the position for a non-resident company which stores its products in a New Zealand warehouse operated by a third party, for example, on a consignment basis, including consideration of the position of warehouse employees who are involved in the receipt and delivery of products to customers and receiving product returns, assuming the warehouse is not generally at the disposal of the non-resident. While it is not expected that this example would satisfy the sales test in the PE

definition, and it may also be regarded as preparatory or auxiliary, it is a common arrangement and a specific example would be helpful.

24. On p 12, the heading "*The domestic law definition of a PE does not apply to a non-resident – paragraph (f)"* appears to contradict the ensuing explanatory paragraph. The following sentence notes that *"New section YD 4B(3) inserts a definition of a PE into the Act for non-residents to whom no DTA with New Zealand applies"*. This appears to suggest that the domestic law definition of a permanent establishment does apply to a non-resident, as is the case for the PE anti-avoidance rules depending on the application of DTAs to non-residents.

Parliamentary contemplation test

25. On p 13, the draft guidance remarks upon the *Ben Nevis* case, and limits the Parliamentary contemplation test specifically to GAARs as opposed to SAARs, such as section GB 54. The draft guidance continues with the following comment:

> *"It would not be appropriate to refer directly to the Parliamentary contemplation test in the legislation, as this is a judicial rather than a statutory requirement (and so might change in the future)".*

26. As the Parliamentary contemplation test is currently Supreme Court precedent, in relation to avoidance, it seems inevitable that it may be applied when interpreting section GB 54. We suggest that this sentence be removed entirely, as the current judicial guidance and discretion does not definitively support this statement.

Override Power

27. The example starting on p 14 raises the question of how section GB 54 overrides the definition of a PE in a DTA for companies with a turnover above €750 million. We note that the term *"override"* is not used until p 16, paragraph 2. For the sake of clarity, it may be useful to more clearly outline the amendment to BH 1(4), and the override power of GB 54, earlier in the draft guidance. For example, on p 1, paragraph 2 could be amended as follows:

> *"The rule deems a non-resident to have a PE in New Zealand if a related entity carries out sales-related activities for it here under an arrangement with a more than merely incidental purpose of tax avoidance (and the other requirements of the rule are met). This PE is deemed to exist for the purpose of any applicable double tax agreement (DTA),* ***overriding the DTAs definition of a PE*** *unless the DTA incorporates the OECD's latest PE article".*

28. By clearly outlining when the new definition is imposed, this addition would bring greater clarity to the flowchart on page 5, and the draft guidance as a whole. Further, section BH 1(4) should be included in the initial list of sections to which this draft guidance relates on page 1.

"Sales" and "Supply"

29. The draft guidance uses the terms *"sales"* and *"supply"*, for example, in the flow chart on page 5. For consistency, the guidance should refer to *"supply"* rather than *"sales"*. However, we note that the use of the term "*sales test"* as defined in the last paragraph on p 9 and as used in the subsequent examples seems appropriate.

"More than merely incidental" example

30. On p 15, the example concludes with the following:

> *"In applying the more than merely incidental test to the arrangement, it is significant that all the sales activity is carried out by Subsidiary in New Zealand. Parent's only role is the pro-forma execution of the contracts negotiated by Subsidiary. There is no convincing commercial purpose for the non-resident to formally execute the contracts offshore when it was not involved in negotiating the contracts. In addition, the legal form of the arrangement does not reflect its substance. This is because in reality subsidiary creates the customer contracts in New Zealand. The formal execution of the customer contracts by Parent offshore is thus artificial. It is also this feature that also allows Parent to avoid having a PE in New Zealand, and so allows the non-resident to avoid tax in New Zealand. Accordingly it can be objectively concluded that Parent's execution of the contracts offshore was inserted into the arrangement for the purpose of avoiding New Zealand tax. Consequently this tax avoidance purpose is not merely incidental to another purpose of the arrangement".*

31. This example risks oversimplifying the circumstances in which GB 54 will apply. For instance, suggesting that having a parent company sign off contracts organised by a subsidiary is objectively determinative proof of a tax avoidance purpose may overlook the nuances of the new anti-avoidance permanent establishment rule. A customer may only contract with the subsidiary because the good name of the parent company has attracted their business, and they expect the guarantee that the parent's involvement offers. Alternately, a customer may strongly prefer dealing with a local subsidiary instead of directly with the parent, preferring the assurance of local support and knowledge. Therefore, the parent company's sign off may be commercially crucial, and tax avoidance would not be merely incidental. The Law Society recommends that this be revisited to present a less arguable example of a more than merely incidental tax avoidance purpose.

Minor matters and suggested wording changes

32. As a general comment, the table of examples illustrating the application of the "sales test" on pp 10-12 is useful but does not present well visually. For ease of reference, the Law Society suggests that the text be edited for brevity as much as possible and broken up (for example by the use of headings (where appropriate) and bullet points).

33. On p 17 the use of the word *"not"* in the following sentence may affect the clarity of the point:

> *"The reason for this exclusion is so that income earned overseas by a subsidiary of a non-resident does **not** become **not** subject to New Zealand tax just because the shareholding of the subsidiary is managed by the New Zealand PE".*

34. The Law Society suggests the following sentence instead:

> *"The reason for this exclusion is so that income earned overseas by a subsidiary of a non-resident has an unchanged New Zealand tax treatment regardless of whether the shareholding of the subsidiary is managed by the New Zealand PE".*

35. We also note the following typographical errors in the draft guidance:

- P 8, paragraph 4: should refer to the preceding income **year** (rather than the preceding income **years**).
- P 8, paragraph 6: last sentence, first clause should read "representative" (rather than representative**s**).
- In the 5th example on p 10, the sentence contains an unnecessary **"are"**:

  *"The platform is accessed via a smartphone app, with the serve and all staff responsible for maintaining it **are** located outside New Zealand".*

- P 15:

  *"As a result, section GB 54 will apply if the reduction in tax for the Parent is a more than **a** merely incidental purpose of the arrangement between Parent and Subsidiary".*

- Further:

  "This is because Parent's consolidated accounting group has: - over EUR €750 of revenue for the preceding income year" should read as:

  "This is because Parent's consolidated accounting group has: - *over EUR €750 **million** of revenue for the preceding income year".*

- P 17, paragraph 2:

  *"This means that non-residents to whom section GB 54 **applies** will also have income years starting on 1 April…"*

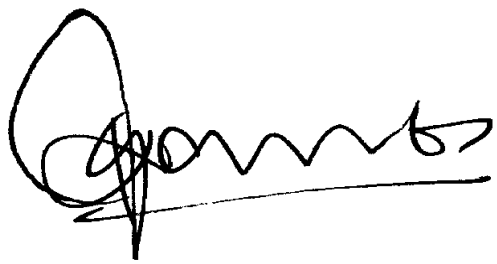
- Page 20:

  *"In respect of S Co's income from its shipping PE, the source of this income is specifically dealt **with** under section YD 4(15) and YD 6".*

Further information

36. This submission was prepared with assistance of the Law Society's Tax Law Committee. If you wish to discuss his further, please contact the committee's convenor Neil Russ, via the committee secretary, Emily Sutton at Emily.Sutton@lawsociety.org.nz, (04) 463 2978.

Yours faithfully



Tim Jones
Vice President