New Zealand Gets Tougher On TRANSFER PRICING

New Zealand gets tougher on transfer pricing

Inland Revenue has a new set of tools to combat foreign companies that are perceived not to be paying their fair share of tax through BEPS (base erosion and profit shifting) activities.

BEPS covers many 'sins' which are a significant threat to the integrity of New Zealand's corporate tax base. Excess related-party debt funding and transfer pricing of goods and services are highlighted as two areas responsible for BEPS mischief. These new anti-BEPS tools are estimated to bring in around $200m per annum additional corporate tax and are effective for income years beginning on or after 1 July 2018 (or 1 January 2019 for December balance date companies).

Alignment with the OECD

New Zealand largely endorsed all the OECD's BEPS action plans and has implemented its own legislative changes as part of the Taxation (Base Erosion and Profit Shifting) Act 2018. This has made the application of New Zealand's transfer pricing rules consistent with OECD's extensively revised 600-odd page transfer pricing guidance. The broad goals are to ensure that transfer pricing outcomes better align with value creation and to provide more prescriptive transfer pricing documentation rules.

New Zealand's transfer pricing rules did not previously align with the OECD model and became markedly different from Australian law when Australia changed their rules some years ago.

Changed landscape for New Zealand companies

Now that New Zealand fully aligns with OECD transfer pricing rules, there are matters that New Zealand companies will need to consider:

- Ensuring transfer pricing is based on economic substance and actual actions, not simply the contractual form of an arrangement;
- Inland Revenue now has the ability to modify or ignore a transaction for pricing purposes where it is not commercially rational (similar to the general anti-avoidance provision);
- Special consideration needs to be given to the existence of intangibles and which party is entitled to a return from an intangible;
- Ensuring a proper comparability analysis is undertaken; and
- Whether transfer pricing documentation meets the prescribed format.

Audit activity from Inland Revenue

In September 2018, Inland Revenue advised that it had 17 transfer pricing audit cases and seven cases in the disputes process. Some of these cases centre on the extent to which a New Zealand subsidiary's activities create value for the group's business (vis-à-vis their offshore affiliates), whether brand-related intangibles have been created through sales and marketing efforts in New Zealand and whether the independent companies selected as benchmarks, are reliable comparables. Some of those in dispute were considered by the taxpayer to be vanilla 'limited risk distributors'.

New rule limiting interest rate on related-party loans

This BEPS legislation does depart somewhat from standard OECD recommendations in the way it restricts interest rates on 'high-risk' related party loans of $10m or more into New Zealand (called the 'restricted transfer pricing rule').

The new restricted transfer pricing rule has partially codified the pricing of inbound related-party loans. This rule complements the thin capitalisation rules, which have also been tightened. The latter restricts the volume of debt and the new restricted transfer pricing rule limits the interest rate on related-party debt.

Taxpayers have a few options as to the credit rating to use to price the interest rate. A credit rating more representative of the worldwide group's credit profile, rather than the New Zealand borrower's own profile, may have to be used to price the interest rate, where:

- the borrower has a thin capitalisation percentage of at least 40% and at least 110% of the worldwide thin capitalisation percentage; or
- the lender is in a low tax country (subject to a tax rate less than 15%).

While a 60% debt-to-asset (less non-debt liabilities) ratio is allowed as a safe harbour threshold for thin capitalisation purposes, a lower 40% thin capitalisation ratio has been set as the threshold for potential interest rate restriction to apply. Inland Revenue is clearly steering taxpayers to reduce debt levels to have a thin capitalisation percentage well below the 60% safe harbour.

The rules may also modify some features of the intercompany loan. Loans are generally only able to have a term up to five years and have no subordination feature for interest rate pricing purposes.

The restricted transfer pricing rule is a complex area, particularly when applied to pricing financial arrangements and guarantees. For more detail, see *Transfer Pricing: A Practical Guide for New Zealand Businesses*.

MARK LOVEDAY | FEBRUARY 2019