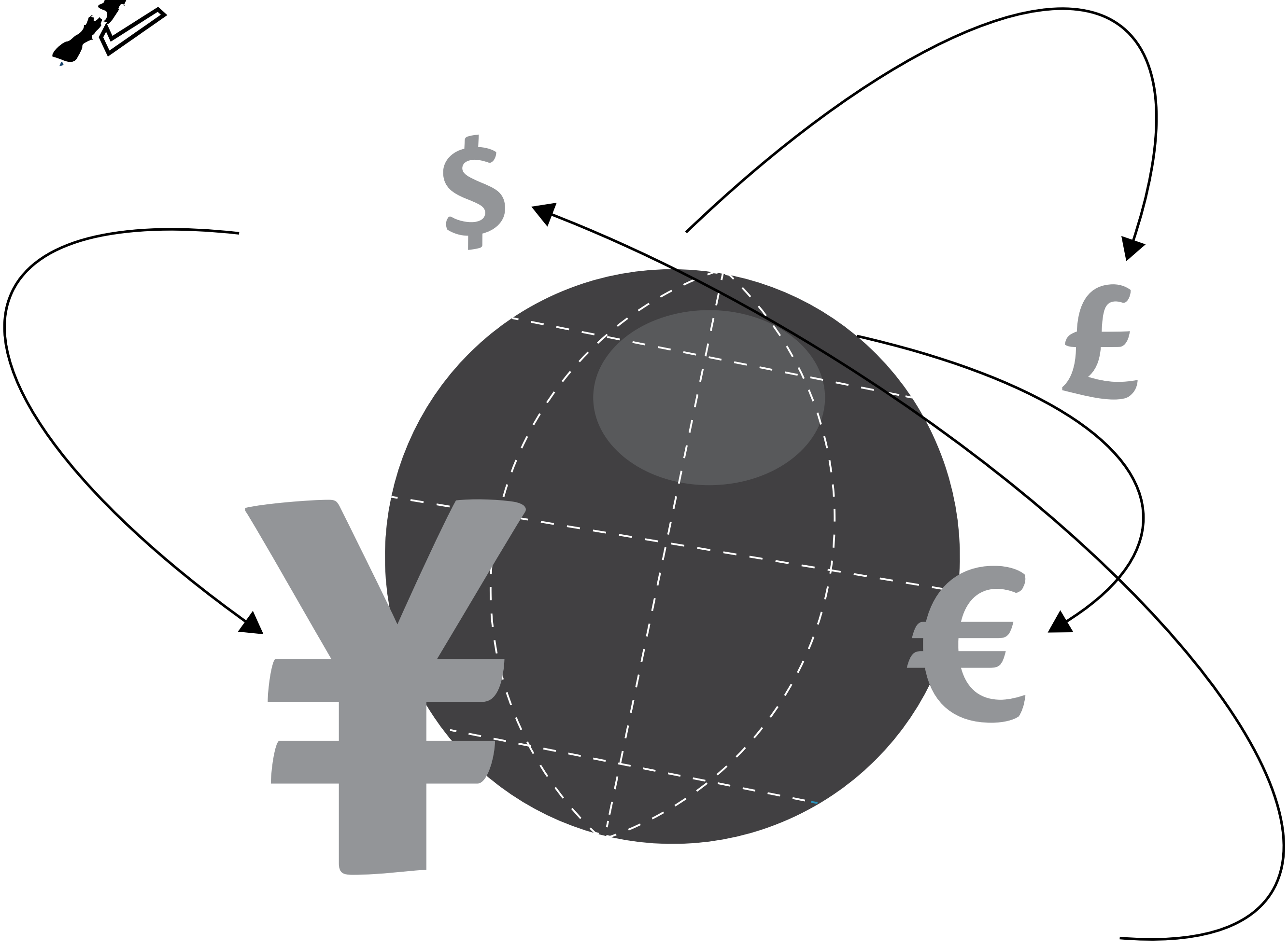
Multinational Enterprises

Compliance Focus



Inland Revenue
Te Tari Taake

IR 947
OCTOBER 2013

Multinational Enterprises

Compliance Focus

Contributing to New Zealand

Good business helps build a healthy economy for New Zealand. Inland Revenue wants to provide transparency on tax compliance so business can get on with business.

Managing tax risk is a key element of a multinational's global risk plan. This booklet will inform your planning by openly describing Inland Revenue's compliance priorities. We list the familiar ten red flags that always attract Inland Revenue attention, and highlight the particular areas to which we pay special attention.

Transfer pricing and international financing arrangements are key issues. The OECD is working to combat base erosion and profit shifting across the world, and that work is supported by the G20. Change in the international tax landscape is inevitable.

Inland Revenue is actively contributing to OECD dialogue. You'll see this reflected in local activities, including our focus on international financing arrangements and controlled foreign companies.

GST refunds and non-resident remuneration feature. For New Zealand-based tax activities we routinely screen all GST refunds, and we continue to pay attention to tax arrangements for non-resident contractors.

Alongside this, we keep looking across all other tax areas to ensure we make tax responsibilities clear and provide straightforward options for people and businesses to file, pay and claim the right amount.

The vast majority of New Zealanders and businesses do the right thing and contribute to New Zealand's prosperity. Inland Revenue's job is to make it as easy as possible for customers to manage their business with us. We will also take action where companies or individuals are actively avoiding their obligations, and we'll continue to publish the results of those actions.

I am proud of Inland Revenue's work to support customers and protect New Zealand's economy and wellbeing. New Zealand already rates highly on international scales for ease of doing business and for integrity — this guide encourages both.

Naomi Ferguson

Naomi Ferguson

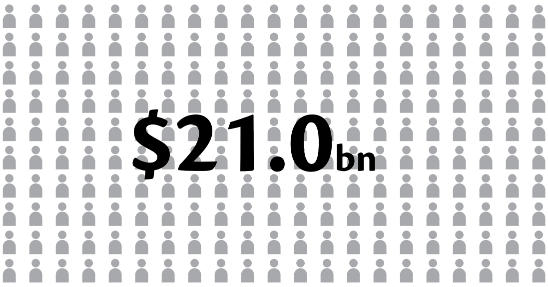
Commissioner of Inland Revenue

What your taxes pay for

Revenue

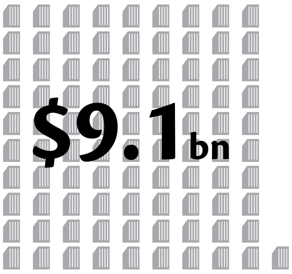
(Inland Revenue Annual Report 2012)

Core Crown revenue $49.1bn



PAYE

Goods and services tax



Company tax

Employer superannuation contribution tax

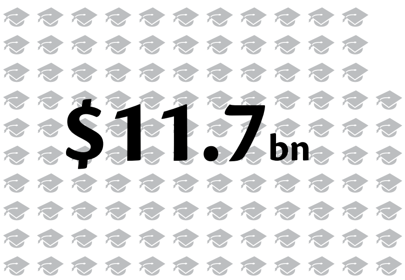
Fringe benefit tax

Expenditure

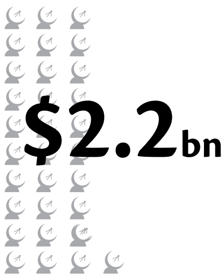
(Financial Statements of the Government of New Zealand: Treasury 2012)

Core Crown expenses $69.1bn

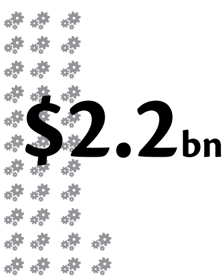
Health



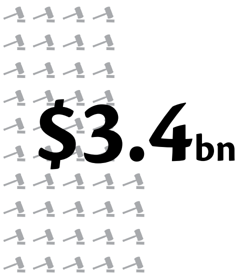
Education



Transport and communications



Economic and industrial services



Law and order

How we manage multinationals' compliance

In addition to our established compliance programme, our Significant Enterprises Initiative 2013 marks a major change in how we approach the risk assessment of multinationals.

We have introduced a basic compliance package for most groups of companies with annual turnover in excess of $80 million.

In total, we have 500 major groups either under direct compliance management or subject to the Significant Enterprises Initiative.

These groups now provide us with copies of their financial statements, tax reconciliations and group structures at return filing time.

This lets us examine a wider range of multinationals more closely, carry out additional macro-analysis of industries and identify variations by jurisdiction.

As a result, multinationals can expect to receive far more tailored information requests and audit inquiries from us.

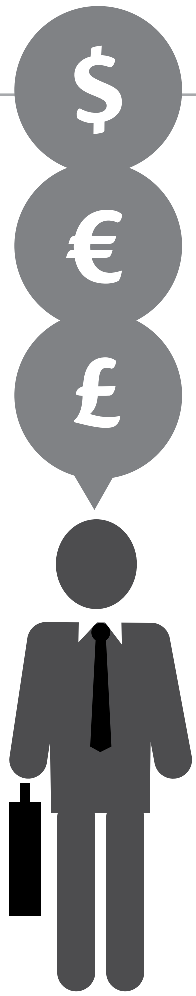
We will cover all groups over $30 million in annual turnover using this approach.

Tax governance by multinationals

Managing tax risk should be a key element in any multinational's global risk management policy. New Zealand members of multinationals should be no exception.

You should ask yourself these key questions.

- Are appropriate resources (including local capability) being applied to tax matters?
- Are sufficient internal controls, checks and balances in place and actually carried out?
- Is there good tax awareness in critical business areas beyond the central tax or finance team?
- Are you aware of legislation changes affecting your business?



The familiar red flags

We are often quizzed about which particular issues attract our attention and the questions multinationals should expect from us.

This 'familiar red flags' list may seem obvious, but is worth repeating here so you can prepare in advance, and be able to give us explanations with supporting documentation.

1. Effective tax rate – is the group's effective tax rate substantially less than the statutory rate of 28%?
2. "Low or no tax" jurisdictions – has the group participated in any material transactions involving these jurisdictions?
3. Differing accounting treatments – are there material differences in the treatment of major items for financial reporting and tax reporting purposes?
4. Large tax benefits – has the group taken part in any transactions where the anticipated net return is predominantly due to projected tax benefits?
5. Cross-border mismatches – are there any differences in tax treatment of a transaction or an entity between countries (eg, debt in one, but equity in another)?
6. Complexity – has the group been involved in any complicated arrangements (eg, major restructures, use of special purpose vehicles or innovative financial arrangements)?
7. Capital gains/tax credits – have any untaxed profits been derived or unusually high foreign tax/imputation credits been claimed by the group?
8. Tax losses – have any uncharacteristic losses arisen (or been utilised) within or across the group as a whole?
9. Ownership changes – have any mergers, takeovers or ownership changes occurred and affected continuity tests for losses and imputation credits?
10. Variances between years – are there any material variances in profitability, tax payable, or major line items in supporting financial statements for the group?

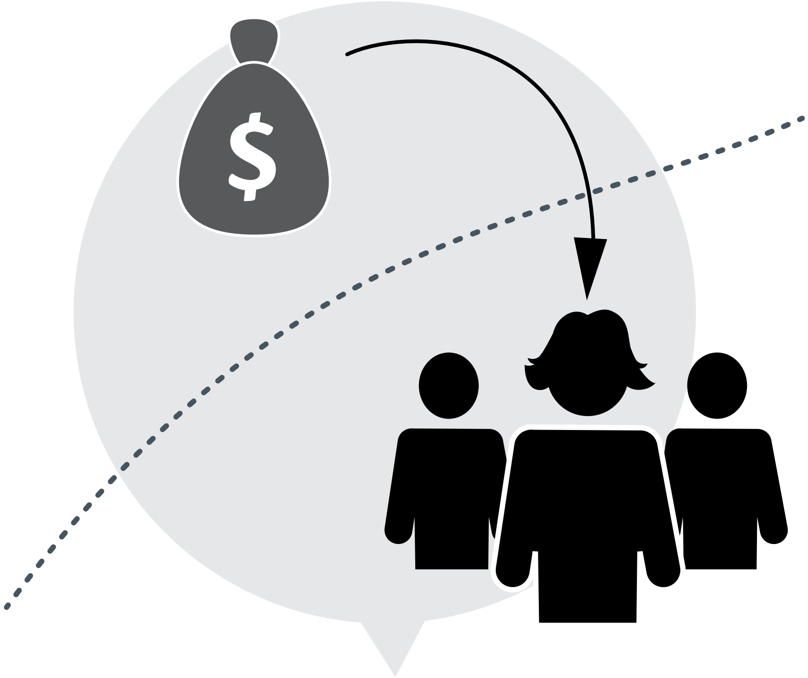
Tax avoidance – our interpretation statement

Even when an arrangement is complex or unusual, or produces tax results that may be undesirable from a policy perspective, it may not be interpreted as tax avoidance.

Features like undue complexity, artificiality and circularity can indicate tax avoidance. However, these features on their own do not establish tax avoidance.

The Commissioner's approach to reaching a view on whether there is tax avoidance is set out in our Interpretation Statement IS 13/01 at www.ird.govt.nz [keyword : IS 13/01]

Briefly, there is tax avoidance if an arrangement uses tax legislation in a way that Parliament did not intend, when the commercial reality and economic effects of the arrangement are taken into account.



International financing arrangements

Cross-border financing forms a substantial part of total associated party dealings by New Zealand members of multinational groups.

Key issues include the pricing of interest and guarantee fees at market rates, and capital structuring within New Zealand's thin capitalisation rules.

New Zealand-owned multinationals also need to account for the very same issues in their outbound financing activities.

In our work programme, we are paying close attention to:

- structured financing arrangements
- hybrid instruments (eg, mandatory convertible notes) and hybrid entities (eg, certain foreign limited partnerships)
- unusual financings (eg, long-term subordinated debt facilities)
- exotic or novel financial products
- all inbound loans of more than $10 million
- outbound loans of all sizes (no or low-interest loans, or no fees charged for guarantees).

We will ask for explanations whenever an interest deduction is taken on cross-border funding arrangements, without any corresponding non-resident withholding tax or approved issuer levy being paid.

When interest has been paid to a branch without any non-resident withholding tax impost, we will check the bona fides of the branch to ensure the substance truly matches the form.

We will examine closely any capital restructurings, which result in major reductions in New Zealand tax paid, especially if an interest deduction results with no economic cost suffered by the New Zealand entity.

We do not routinely deny interest deductions to taxpayers carrying high debt levels that satisfy the thin capitalisation rules. If a loan transaction would not have taken place in the open market, we may question the commerciality of the financing arrangement between the associated parties. In such extreme circumstances, we would consider using the general anti-avoidance provision.

Getting it right

The 2% approved issuer levy is not available to associated parties. Unfortunately, this mistake does occur, which can be very costly to taxpayers.

Transfer pricing

The overall goal of our transfer pricing compliance programme is to maintain New Zealand's share of multinational tax, in accordance with our tax law, acceptable income recognition principles and best international practices.

We are not alone in wanting to maintain our fair share of the multinational tax pie. Other tax authorities are also implementing and updating their rules and regulations on international transactions, and increasing their audit activities.

As other tax authorities put more emphasis on transfer pricing issues, the likelihood of lengthy disputes with these overseas administrations will increase, along with costly double taxation.

Where there are difficult or complex issues, we prefer to work through arrangements with multinationals upfront, avoiding disputes where possible.

The attraction of this approach for business is certainty – multinationals that behave transparently can expect an earlier resolution of tax issues with less intrusive audits and lower compliance costs.

Transfer pricing and New Zealand exporters

A large number of New Zealand businesses export through their overseas associates. We focus especially on:

- use of correct commodity price benchmarks
- low/no-interest loans or credit support
- recovery of New Zealand costs, eg, research and development and head office overheads
- offshore operations returning abnormally high profits.

The major transfer pricing risks

Our main interest in transfer pricing is in the bottom line. Has the group reported sufficient profit locally?

Other fundamental transfer pricing risks include:

- no documentation to support transfer prices
- material levels of untested transactions
- major downward shifts in profitability of a New Zealand company when acquired by a multinational
- widely differing profits between the local company, other members of the group, the group as a whole and the industry
- New Zealand management accepting prices set by overseas associates without question
- the payment of unsustainable levels of royalties and/or management fees
- transactions with no or low tax jurisdictions
- losses, especially chronic recurring ones.

Ask yourself these key transfer pricing governance questions

1. Do you know the nature and extent of your cross-border associated party transactions?
2. If material, do you have documentation to support the transfer prices and do you keep it updated?
3. Has your finance team been fully involved in the documentation process and signed off the factual analysis, as well as the final outcomes?
4. Have you considered an advance pricing agreement?

Advance pricing agreements

Advance pricing agreements (APAs) are a good example of a more cooperative approach to addressing transfer pricing compliance.

Compared with audits, APAs produce significant time and cost savings for both multinationals and tax authorities.

We have completed over 100 APAs since the programme started, including a record 21 APAs being finalised in the year to 30 June 2013.

Common questions exporters ask us about transfer pricing

Some jurisdictions have reputations for aggressive tax collection activities. Should I leave more income in those jurisdictions to avoid conflict?

Definitely not – overseas associates should pay the right amount of tax. They should also adopt the arm's length standard promoted by the OECD and respected by all our major tax treaty partners.

What effect does a brand or knowhow have on transfer pricing?

The benefit of any intellectual property should lie with the owner. It is important to establish where the intellectual property was created and where it is legally owned. For exporters, we would expect the ownership to lie in New Zealand. The intellectual property owner can be rewarded either through the pricing of goods sold to the overseas distributor or direct through a royalty charge.

How do I find out if offshore associates have created any intellectual property?

You should closely examine any research and development costs and/or above average marketing expenditure, including any spending on market penetration. As the New Zealand parent, you should consider either reimbursing this expenditure (but not at a later date) or some other reward strategy to ensure that the overseas associate cannot claim ownership of the intellectual property.

How do I know if offshore associates are performing any specialised functions or providing additional services?

Staff remuneration is a good barometer, with highly paid staff generally providing special skills (leading to greater economic value added). Job descriptions are also useful.

How can a New Zealand exporter get a quick picture of major international transfer pricing risks?

You should closely examine the bottom line returns of your associates. Most New Zealand exporters operate through buy/sell distributors and/or service providers. Ask yourself:

- Do their operating margins reflect commercial reality?
- Have any targeted strategies been pursued?

These may not be easy to explain to tax authorities some years later, especially if plans do not quite work out. If a market development strategy has been pursued, make sure you fully document the expenditure, sales, cost savings, duration and likely payback period from the start.

How should I identify and charge out management and other support services provided to offshore associates?

You could consider applying Inland Revenue's guidelines, ie, cost plus 7.5% for non-core/de minimis services. Also, look out for any services requiring specialist knowledge or expertise provided from New Zealand requiring higher mark-ups.

Have market interest rates been charged for loans to offshore associates?

In general, an offshore associate's credit rating will not be as strong as the New Zealand parent's credit rating, so interest charges should exceed the parent's domestic weighted average cost of debt. As a guideline, an interest rate set at the current bank bill rate plus 275 basis points will be fair and reasonable for small-value loans (less than $2 million in loan principal).

What about New Zealand Customs' requirements?

Be careful of the 28-day rule. The New Zealand business must generally export the goods within 28 days of the time of supply to qualify for zero-rating of GST. The standard rate of 15% GST will apply otherwise.

Controlled foreign companies

For income years starting on or after 1 July 2009, New Zealand's amended tax rules for controlled foreign companies (CFCs) have included an active/passive division.

In focusing on CFCs, we check technical compliance with these new rules. We also watch for any possible abuse of the rules through aggressive tax planning schemes.

Given the total exemption from attribution of income for holders of sufficient interests in active CFCs, there are flow-on tax risks around:

- whether foreign incorporated companies are New Zealand tax resident through their management, control or director decision making
- the correctness of cross-border associated party transfer pricing methodologies.

In examining compliance with the CFC rules, we look closely at:

- any changes in CFC operations between the old and new CFC rules (such as restructuring operations or shifting functions/assets/risks)
- how results compare between years
- intellectual property transfers and significant financing transactions
- utilisation of any carried forward loss and foreign tax credit balances
- any unusual transactions or unexpected outcomes.

For many enterprises, the comprehensiveness of the old CFC rules meant that transfer pricing matters received little attention, the approach being that a zero sum game would generally result from any lack of pricing policies.

Even if this was true, the new CFC rules put an end to this approach.

We recommend you have adequate transfer pricing documentation in place to ensure transfer prices involving CFCs are in line with the arm's-length standard.

The OECD base erosion and profit shifting (BEPS) project

Addressing international tax evasion

From late 2012, global media and political reactions suggest that some multinationals seem to pay little or no tax anywhere in the world. The wide range of international tax planning techniques used to achieve these results is collectively referred to as base erosion and profit shifting (BEPS).

Part of the problem is that international tax standards have not kept pace with developments in the global economy. For example, problems arise from complex interactions between the tax rules of different countries. Other difficulties come from an increasing source of multinational profits resulting from intangibles or digital services that can be located anywhere in the world.

Just as multinationals are becoming more integrated across their global supply chains, tax authorities are also moving towards greater cooperation and coordination of their compliance activities.

New Zealand has been closely involved in the development of the OECD BEPS Action Plan. It will continue to support future initiatives strongly because it recognises that effective action on BEPS requires a coordinated international effort.

New Zealand has joined more than 70 other countries in signing the Convention on Mutual Administrative Assistance in Tax Matters. The convention provides a multilateral basis for a wide variety of tax administration assistance, including international exchanges of information and facilitating simultaneous/joint audits and assistance in collecting tax debts.

Closer to home

In New Zealand's case, we have a wide tax treaty network, including double tax agreements (DTAs) and tax information exchange agreements which we are growing progressively.

We have a very close relationship with our major tax treaty partner, Australia, and routinely exchange information on taxpayers and industries with the Australian Taxation Office. We also operate a trans-Tasman financing desk to exchange new or emerging issues about funding arrangements, staffed by experts from both tax administrations.

Across Asia, we have definitely noticed an upward trend in exchanges of information between tax authorities. These exchanges are a great help in the earlier identification of aggressive arrangements, which may adversely affect the New Zealand tax base.

OECD BEPS Action Plan – the highlights

The OECD BEPS Action Plan is both comprehensive and multilateral. Over the next two and a half years, the OECD will work on 15 action items.

Significant areas of interest to New Zealand include:

- considering whether special tax rules are needed to tax digital goods and services provided over the internet
- reviewing hybrid mismatches which occur because countries have different tax rules for distinguishing between debt and shares or companies and partnerships
- improving CFC rules that allow countries to tax their multinationals on passive/mobile income earned through foreign subsidiaries
- reviewing domestic rules for limiting interest deductions (eg: thin capitalisation rules)
- preventing the misuse of tax treaties
- improving the permanent establishment rules for determining when an overseas business has a taxable presence in a foreign country
- improving transfer pricing rules, particularly in relation to debt and intangibles.

In each work area, the OECD will develop specific recommendations for member countries to implement.

Some will be implemented through a multilateral agreement or updates to the OECD's existing guidelines and agreements (in particular, the Transfer Pricing Guidelines and Model Tax Convention).

Other recommendations will rely on countries being willing and able to make reforms to their domestic laws.

International disputes – the mutual agreement procedure

Our double tax agreements contain a provision called the Mutual Agreement Procedure, also known as a request for competent authority assistance.

This allows a taxpayer to present their case to the competent authority to resolve a dispute.

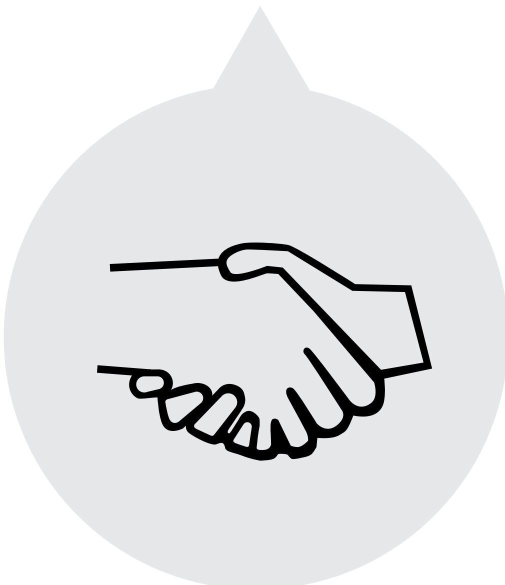
As the competent authority, we may:

- agree with the merits of the overseas adjustment and give a corresponding downwards adjustment in New Zealand, or
- try to persuade the treaty partner to reduce or withdraw their adjustment.

We recommend you tell us as soon as possible about any pending dispute with another tax authority.

In nearly all cases when there has been early intervention by us as the competent authority, the double tax issue has been successfully resolved.

If you have any questions or would like advice, please email us at CompetentAuthority@ird.govt.nz



Addressing common GST risk areas

A review of GST returns over the last 12 months has revealed five key areas where multinational enterprises need to pay more attention.

Failing to recognise associated party transactions

Enterprises sometimes fail to report the proper GST on transactions with associated parties.

Common oversights include property leases, management services or provision of employee time and supplies of stock.

Getting it right

Special timing rules apply to transactions between associated parties.

- You may disregard supplied goods and services where the parties are GST grouped.
- If the parties are not GST grouped, you must account for GST at the right time.

Incorrect treatment of non-routine transactions

If you engage in non-routine transactions, there is an inherent risk that the usual treatments, processes and controls may not apply.

Common oversights include failing to return GST when required, eg, insurance settlements can be subject to GST.

Getting it right

Apply the correct GST treatment to non-routine transactions, eg, a new property lease with incentive payments, or the sale of a capital asset such as disposal of plant.

Accounting for GST later than required

If you are registered on an invoice basis, you must account for the full amount of the GST when any part-payment (eg, a deposit) is received, or any invoice is issued.

If you are GST registered on a payments basis, you must generally account for GST when you receive payments.

Getting it right

You must take care to correctly account for the GST when you take deposits.

- Correctly apply the rules for your type of GST registration.
- Correctly apply the time of supply rules

Zero-rating

Supplies of exported goods or services may be zero-rated if certain conditions are met, but supplies are often zero-rated when these conditions are not met.

Getting it right

Generally, for goods to be zero-rated, the supplier must export them. It is not usually possible to zero-rate if the customer exports the goods instead.

Preparation errors

We receive many GST returns with small errors that can make a big difference to whether the return is correct or not. For example:

- mistakes in arithmetic
- transposed numbers
- blank fields
- not including transactions in the correct return period.

Getting it right

- Take care when filling in your return.
- Consider having it independently checked before filing it with us.
- Check that you have declared all the relevant transactions for the return period.

When the people you pay are not New Zealand tax residents

First things first

When you hire people who are not New Zealand tax residents, they generally fall into a couple of categories:

- an employee
- a contractor, who might be an individual or a company.

Employees usually work at the employer's premises for specified hours and pay, and have signed either a collective or individual employment agreement. If you are a New Zealand resident with employees from overseas, they are treated the same as your other employees.

Contractors usually have a contract, agreement or arrangement with an organisation to supply services or equipment under a lease. The organisation generally views the contractor as a supplier, not an employee.

Note: This information does not apply to anyone who has migrated to New Zealand with the intention of living here permanently.

Where things get tricky

If a non-resident contractor receives contract payments, for physically performing work in New Zealand, it is New Zealand-sourced income and in the first instance taxable in New Zealand. Tax must be withheld at the time the contract payments are made.

This is the case even if the non-resident contractor is paid by an overseas entity or the money is paid to an overseas bank account.

A non-resident contractor will not have tax deducted from contract payments if Inland Revenue has issued them with a Certificate of Exemption, under the terms of a double tax agreement New Zealand has with the country where they are a tax resident.

Non-resident contractors can apply for a Certificate of Exemption by completing the form at www.ird.govt.nz/nrcwt.

For detailed information about non-resident contractor tax obligations, please email our Non-Resident Contractors' Team at nr.contractors@ird.govt.nz

Getting it right

If your business employs non-resident contractors, you must deduct the correct amount of New Zealand tax from their contract payments unless the non-resident contractor gives you a Certificate of Exemption.

It's a good idea to recommend to your non-resident contractors that they contact a trusted tax advisor to obtain their own advice about their New Zealand tax obligations.

For employees – benefits and allowances such as cost of living allowances, free accommodation, accommodation allowances, rental support payments, employee share schemes, superannuation payments and home travel are generally subject to tax. These need to be considered when accounting for a person's total gross income.

Check that the right tax type is deducted from benefits and allowances. For example, provision of accommodation is subject to PAYE, not fringe benefit tax.

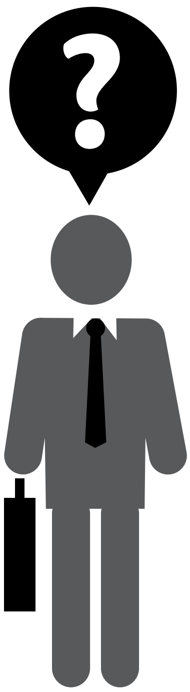
If your company's payroll and human resources function are outside New Zealand, ensure that payments are converted to New Zealand dollars using the correct exchange rate, before deducting tax.

So who pays what tax where?

Johan is an IT specialist in the Melbourne office of an American company. You've been having issues with your computer systems so you've contracted with his American employer to bring him to Auckland for five months to sort things out. When you start the paperwork, you see that Johan is an Australian tax resident even though he is currently working for an American company. Contract payments are being made to his American employer who continues to pay Johan's salary while he is in New Zealand.

Because Johan is physically performing the work in Auckland on behalf of his employer, you should deduct schedular tax from the contract payments made to his employer. These are paid through your New Zealand payroll system.
If his employer wants to apply for a Certificate of Exemption, its eligibility will be assessed under New Zealand's double tax agreement with the US.

At that time Inland Revenue will address any issues the American company has relating to Johan's remuneration.



Executive remuneration

Senior executives often receive benefits and allowances as part of their total remuneration package.

We usually find that organisations apply the correct tax type and rate to each part of these packages, but we have seen mistakes in taxing less common benefits. For example, cars provided to spouses and low-interest loans to employees can have fringe benefit tax implications.

We recommend you take great care around employee tax equalisation arrangements, which commonly occur in executive remuneration packages. Additional sums arising from disparities in personal tax rates, or allowances paid outside New Zealand for services performed by employees in New Zealand are subject to PAYE.

Getting it right

Benefits and allowances, eg, cost-of-living allowances, free accommodation, accommodation allowances, rental support payments, employee share schemes and superannuation payments are generally subject to tax. These need to be considered when accounting for a person's total gross income.

Check that the right tax type is deducted from benefits and allowances. For example, accommodation is subject to PAYE, not fringe benefit tax.

Binding rulings, factual reviews and indicative views

To provide you with greater certainty about tax issues we have a range of options in place.

Binding rulings

We can issue binding rulings for customers to provide certainty about the interpretation of tax laws.

A binding ruling is Inland Revenue's interpretation of how a tax law applies to a particular arrangement. An arrangement is any agreement, contract, plan or understanding (whether or not it's enforceable), including any steps and transactions that carry it into effect.

If you have been given a binding ruling, you are not required to follow the approach. But if you do follow a binding ruling exactly as described in the ruling and satisfy any stated assumptions or conditions, Inland Revenue is bound by it. A binding ruling does not remove the requirement to file an income tax return and pay any taxes arising from the arrangement.

Before you apply for a binding ruling, you can set up a pre-lodgement meeting to help clarify the issues and determine the scope of the ruling. We aim to complete binding rulings within three months of an application.

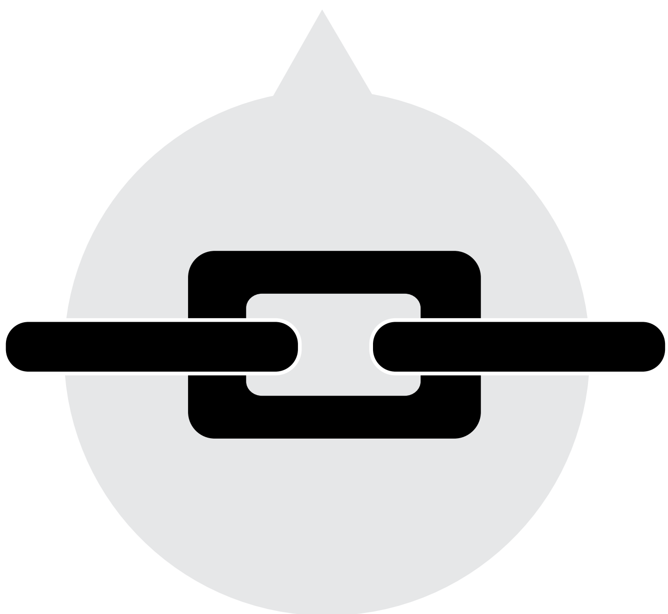
Factual reviews

If you have applied for a binding ruling, you may request a factual review to obtain a level of certainty on whether a critical factual condition or assumption in the ruling will be satisfied. You can request a factual review (in writing) at any time before or immediately after the issue of the ruling.

Indicative views

In some circumstances, a request for an indicative view may be a more suitable option.

Indicative views are non-binding on the Commissioner and are available to larger enterprises. An indicative view would generally be provided for prospective major transactions. It will not be provided for arrangements involving potential tax avoidance or hypothetical situations.



Bribery awareness

Worldwide, governments are actively working to curtail bribery with all its negative effects on international trade and investment, political stability, welfare and economic development.

New Zealand strongly supports the OECD Anti-Bribery Convention.

Emerging markets pose particular risks when securing contracts and starting business activities. Check your business's risk exposure by answering the ten key questions below.

For further information, read the OECD's Good Practice Guidance on Internal Controls, Ethics and Compliance at www.oecd.org [keyword: good practice guidance].

Combating bribery internationally

10 key questions to assess your risk:

1. Do directors and senior management display zero-tolerance to corruption and bribery?
2. Is the group operating in any high-risk jurisdictions (see the Transparency International's Corruption Perceptions Index) or high-risk sectors (eg: defence, oil and gas, property development, shipping)?
3. Do you have a comprehensive code of conduct that must be signed by staff and agents in all countries where the group is operating?
4. Is there a full suite of system processes and internal controls in place to support the code of conduct? In particular, are there clear gifting/corporate hospitality/entertainment procedures, and staff training and whistle-blower protection?
5. Do you have a dedicated position (eg, a compliance officer) with responsibility for the organisation's anti-corruption programme across all countries?
6. Are staff implementing the organisation's anti-corruption policies?
7. Are any employees or agents circumventing established organisational processes or arguing special cases?
8. Do any employees or agents have an unusual interest in a particular contract or a specific contractor?
9. Is an employee's lifestyle out of kilter with their known level of income?
10. Are you fully aware of the activities of your overseas agents (eg, no indication of "splashing the cash" to attract business)?