

Regulatory Impact Statement

Relationship between double tax agreements and anti-avoidance rules

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue. It provides an analysis of options to address the uncertainty in the current law as to the relationship between the anti-avoidance rules in New Zealand's tax legislation and New Zealand's double tax agreements (DTAs).

The issue affects a small number of taxpayers. However, the amounts of tax at stake can be significant depending on the transaction involved. The argument that the DTA prevents the general anti-avoidance rule (GAAR) from applying has been an issue in eight disputes within the past five years. The total tax in dispute for those eight disputes was \$105 million. Most or all of this tax has or will be collected pursuant to Inland Revenue's current interpretation of the law. But the proposed change would put the matter beyond doubt.

The question of whether the provision that empowers New Zealand's DTAs prevents the anti-avoidance rules in New Zealand's income tax legislation from applying has not been tested by a New Zealand court. However, the analysis in this RIS has been informed by Inland Revenue's view of the current law, arguments by taxpayers in recent disputes, and the approach that Inland Revenue has taken in those disputes. Feedback from consultation has also helped to inform this analysis and our view of the law.

The preferred option will specifically provide in law that New Zealand's DTAs do not prevent the anti-avoidance rules from applying.

The preferred option will not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. New Zealand, like many other countries, has a general anti-avoidance rule (GAAR) in its income tax legislation. New Zealand's GAAR effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. New Zealand also has specific anti-avoidance rules (SAARs) which override other provisions of the tax legislation in specific avoidance situations.
2. Anti-avoidance rules potentially apply to all income tax transactions, including those with an international dimension (that is, New Zealand residents investing offshore or non-New Zealand residents investing in or through New Zealand).
3. Double tax agreements (DTAs) are international treaties that are entered into between governments primarily to prevent double taxation on cross-border income. The tax incidence for taxpayers using international transactions can be reduced where there is a DTA between the taxpayer's country of residence and the country from which the income is sourced.
4. There is a lack of clarity in the current legislation. This is due to an apparent conflict between the general anti-avoidance rule and the provision which empowers New Zealand's DTAs. The provision in the Income Tax Act 2007 (ITA 2007) which governs the domestic implementation of DTAs states that DTAs override the other provisions of the ITA 2007. However, the ITA 2007 also states that the GAAR has overriding effect. There may also be a similar issue in relation to specific anti-avoidance rules (SAARs). The legislation is not explicit as to the ordering between the provision that governs the domestic implementation of DTAs and the anti-avoidance rules.
5. Inland Revenue's view is that a DTA does not prevent the GAAR or a SAAR from applying. In Inland Revenue's view, the GAAR should first be applied to establish the relevant fact situation. New Zealand's domestic tax law and the DTA then apply to that recharacterised fact situation. If the proceeds of a share sale, for example, is recharacterised as a dividend under domestic law due to the application of the GAAR, then the dividend provisions of domestic law and the dividend article of the relevant DTA would apply, rather than the article of the DTA which deals with disposal of property. Similarly, a SAAR should first be applied to establish the relevant fact situation.
6. Further, where there is mischief arising through misuse of provisions in the DTA (such as treaty shopping), Inland Revenue considers that, if the criteria for the GAAR applies, the GAAR can be used to reconstruct the arrangement to give the appropriate tax outcome for New Zealand purposes.
7. However, it has been argued by some taxpayers (including in recent disputes that have been considered by Inland Revenue's Disputes Review Unit) that DTAs override the GAAR, which would mean that the GAAR cannot be applied in an avoidance situation where a treaty provision is also used. There has been no New Zealand case law on this issue to date.
8. The lack of clarity in New Zealand's legislation contrasts with Canada and Australia, who amended their legislation to explicitly ensure that DTAs do not override the GAAR. As New Zealand's legislation is silent on whether DTAs override the GAAR, it has been suggested that there might be a possible inference that "*the New Zealand Parliament is content to allow New Zealand's tax legislation to be overridden by a DTA*".

Zealand taxpayers to use structures that employ the provisions of tax treaties to avoid New Zealand income tax.”¹

9. More recently (2014) the United Kingdom also amended its legislation to explicitly provide that DTAs do not override the GAAR.

10. Accordingly, if no similar amendment is made to New Zealand’s tax legislation, a lack of action by the New Zealand Government may support the argument that DTAs override New Zealand’s GAAR. In other words, a lack of legislative action is likely to increase the uncertainty given the responses from Canada, Australia and the United Kingdom.

11. As a result of this uncertainty, some taxpayers may argue that DTAs override the anti-avoidance rules and as a consequence tax avoidance arrangements cannot be prevented by relying on an anti-avoidance rule.

12. Because of the lack of an express provision, some taxpayers may be encouraged to engage in tax avoidance behaviour in an international context if those taxpayers can argue that their behaviour is sheltered by international tax agreements. In contrast, taxpayers are prohibited from engaging in tax avoidance behaviour where there is no DTA.

13. Further, the lack of an express provision in the current legislation may lead to arguments about the appropriate application of penalties if taxpayers can make an argument that their behaviour is sheltered by international tax agreements. Penalties are applied to discourage tax avoidance behaviour.

14. Accordingly, the status quo is likely to encourage certain taxpayers to enter into avoidance arrangements.

15. This has a negative impact on fairness between taxpayers.

16. The lack of certainty means that disputes can involve more of Inland Revenue’s legal resources (i.e., increased hours). Compliance costs for taxpayers are, in theory, higher for taxpayers under this option, although it should be noted that these compliance costs may be offset by the potential for lower income tax liability.

Scale of the problem

17. The issue affects a small number of taxpayers. However, the amounts of tax at stake can be significant depending on the transaction involved. The argument that the DTA prevents the GAAR from applying has been an issue in eight disputes within the past five years. The total tax in dispute for those eight disputes was \$105 million. Most or all of this tax has or will be collected pursuant to the Commissioner’s current interpretation of the law. However, the proposed change would put the matter beyond doubt.

¹ See discussion in Elliffe, Craig and Prebble, John (2009) "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective," *Revenue Law Journal*: Vol. 19: Iss. 1, Article 4.

OBJECTIVES

18. The overarching goal of the reform is to reduce tax avoidance in an international context.
19. Within this context the options will be assessed against the following criteria:
 - Efficiency and integrity: The preferred option should minimise the distortions to taxpayer decision making and opportunities for tax avoidance and tax arbitrage between jurisdictions.
 - Fairness: The preferred option should, to the extent possible, be fair - this involves both horizontal equity (which is, fair treatment of those in similar circumstances) and vertical equity (which is, fair treatment of those with differing abilities to pay tax).
 - Compliance and administrative costs: The preferred option should minimise, to the extent possible, administrative and compliance costs.
20. All criteria are important but within this context the efficiency and integrity and fairness criteria are particularly significant.

OPTIONS AND IMPACT ANALYSIS

21. Two options are discussed below.
 - Option 1: This option would retain the status quo – that is, there would be no change to the tax legislation to clarify whether the GAAR or SAARs override the DTA.
 - Option 2: This option would amend the tax legislation to clarify that the GAAR or SAARs override the DTA.
22. A further option was briefly considered but discounted. This option would have explicitly provided that DTAs override the GAAR and SAARs. This option was discounted because it did not meet the objective of preventing tax avoidance.

Option 1 (status quo)

23. The first option would retain the status quo. That is, no change would be made to the legislation to clarify whether anti-avoidance rules override the DTA. Inland Revenue would retain its interpretation. This may be tested in a future court decision.
24. It is not clear whether the status quo meets the objective of reducing avoidance in an international context. As noted above, Inland Revenue considers that under current law the anti-avoidance rules do override the DTA.

Efficiency and integrity

25. The lack of an express provision in the current legislation may lead to arguments about the appropriate application of penalties if taxpayers can make an argument that their behaviour is sheltered by international tax agreements. Penalties are applied to discourage tax avoidance behaviour.

26. Accordingly, the status quo is likely to encourage certain taxpayers to enter into avoidance arrangements. This undermines the integrity of the tax system.

27. This option is likely to have a negative effect on efficiency, as it may result in reduced efficiency if businesses' resources are diverted into creating such arrangements.

Fairness

28. As noted above, some taxpayers may be encouraged to engage in tax avoidance behaviour in an international context if those taxpayers can argue that their behaviour is sheltered by international tax agreements. In contrast, taxpayers are prohibited from engaging in tax avoidance behaviour where they cannot rely on a DTA. This has a negative impact on fairness.

Administrative and compliance costs

29. This option is likely to be administratively more costly for Inland Revenue than option 2, as the lack of certainty means that disputes can involve more of Inland Revenue's legal resources (i.e., increased hours). This option therefore has a negative impact on administrative costs.

30. Compliance costs for taxpayers are, in theory, higher for taxpayers under this option, although it should be noted that this may be offset by the potential for lower income tax liability.

Option 2 (amend the tax legislation)

31. The second option would amend the income tax legislation to clarify that the anti-avoidance rules override the DTA. This option meets the objective of reducing avoidance in an international context.

Efficiency and integrity

32. Inland Revenue considers that this option provides more certainty than the status quo. It would remove the arguments about the appropriate application of penalties, as taxpayers would be unable to argue that their avoidance behaviour is sheltered by international tax agreements. This improves the integrity of the tax system.

33. This option is likely to have a positive effect on efficiency, as it may increase efficiency if fewer resources are diverted into creating tax avoidance arrangements.

Fairness

34. Taxpayers would be prohibited from engaging in tax avoidance behaviour regardless of whether there is a DTA. This would have a positive impact on fairness between taxpayers.

Administrative and compliance costs

35. This is likely to be administratively less costly for Inland Revenue than the status quo, as increased certainty should mean that disputes are less likely. Where they do arise, they should involve less of Inland Revenue's legal resources (i.e., increased hours). This option therefore is likely to reduce administrative costs.

36. Compliance costs for taxpayers are, in theory, lower for taxpayers under this option, although it should be noted that this may be offset by potentially higher income tax liability.

CONSULTATION

37. Inland Revenue has discussed option 2 with the Ministry of Foreign Affairs and Trade, the New Zealand Law Society, Chartered Accountants Australia and New Zealand, and the Corporate Taxpayers Group.

38. Several issues were raised during these discussions. One issue was whether the proposal was consistent with New Zealand's international obligations under its DTAs, because New Zealand commits to providing relief from double taxation for residents of the other state in certain circumstances. As noted above, Inland Revenue considers that this is the position under New Zealand's domestic law.

39. Officials consider that option 2 is consistent with New Zealand's DTA obligations. New Zealand's DTAs are based on the OECD's Model Tax Convention. The OECD's Commentary to the Model Tax Convention (the "OECD Commentary") is an important part of context in which these DTAs are internationally understood. The Commentary notes that States do not have to grant the benefits of a DTA where the DTA has been abused, although the Commentary also notes that it should not be "lightly assumed" that a taxpayer is entering into an abusive transaction. The OECD Commentary notes that, for some countries, their domestic GAAR (or similar rules) applies to their DTAs. Examples of countries that have made the relationship explicit include Australia, the United Kingdom and Canada. The OECD Commentary further notes that, where the GAAR is used to determine the proper construction of facts to which the DTA would apply (which Inland Revenue considers is the current legal setting in New Zealand), then there is generally no conflict.

40. A concern was raised that since the GAAR is not a "bright line" test, the proposal could add to uncertainty. As noted above, Inland Revenue's current practice and interpretation of the law is that the GAAR does apply. Officials' view is that option 2 will reduce uncertainty by making it explicit that anti-avoidance rules can apply. Further, we note that the GAAR applies to all other situations and the growing body of case law provides considerable guidance to taxpayers.

41. A suggestion was that it was not necessary to clarify the law. Rather, Inland Revenue could simply make a statement of its view. We consider that this would not resolve the problem, as the Commissioner's view is not binding upon taxpayers.

42. A further suggestion was that the work should be undertaken after New Zealand's response on BEPS has been finalised. Officials do not consider that it is appropriate to delay this work. Implementing option 2 is not contingent on New Zealand's responses to the BEPS proposals. It will clarify the existing position which would remove arguments about the appropriate application of penalties. Further, option 2 would make it clear to other DTA partners that New Zealand's law meets the criteria in Action 6 of the BEPS plan. This may give New

Zealand additional flexibility to meet the minimum international standards to prevent treaty abuse.

CONCLUSIONS AND RECOMMENDATIONS

43. Option 1 (status quo) is not supported because it is unlikely to meet the objective of reducing avoidance in an international context. Furthermore, this option is likely to have a negative effect on the integrity of the tax system, fairness, and administrative costs.

44. Officials support option 2. The legislative amendment proposed under this option will clarify that the provision which empowers DTAs does not prevent the GAAR (or the SAARs) in the ITA 2007 from applying, consistent with Inland Revenue's current approach.

45. Option 2 would meet the objective of reducing tax avoidance in an international context and is likely to have a positive effect on integrity of the tax system, fairness, and administrative costs.

IMPLEMENTATION PLAN

46. The preferred option will require amendments to the ITA 2007. It is proposed that these amendments be included in the first omnibus tax bill in early 2016 and apply from the date of Royal assent.

47. When the amendments are introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a *Tax Information Bulletin*, which will be released shortly after the bill receives Royal assent.

48. Inland Revenue will administer the proposed changes. The proposals will have no systems implications for Inland Revenue but may result in some additional administrative costs, such as costs associated with publications to communicate the changes. These costs are expected to be insignificant and can be met within existing baselines.

MONITORING, EVALUATION AND REVIEW

49. Inland Revenue will closely monitor the effectiveness of the proposed changes in the first 12 months of operation.

50. In general, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Opportunities for external consultation are built into various stages of the process. In practice, any changes identified as necessary following enactment will be considered for inclusion in the tax policy work programme, and proposals would go through the GTPP.