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Te Kāhui Ture o Aotearoa

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Deputy Commissioner
Policy and Regulatory Stewardship

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

Re: OECD Pillar Two – GloBE rules for New Zealand

1. The New Zealand Law Society Te Kāhui Ture o Aotearoa (the **Law Society**) welcomes the opportunity to comment on the Officials Issues Paper, *OECD Pillar Two: GloBE rules for New Zealand* (the **Issues Paper**).

2. This submission has been prepared with assistance from the Law Society's Tax Law Committee. It comments only on chapter 10 of the Issues Paper, '*Mode of Implementation in New Zealand*', in which Inland Revenue has asked:

    a. Should New Zealand use repetition, incorporation by reference, or some other method to implement Pillar Two into our domestic legislation?

    b. If incorporation by reference is used, is a fully or partially ambulatory approach the best approach?

    c. If a partially ambulatory approach is used, what type of updating mechanism should be used?

    d. Is there a reason for not imposing them using the Income Tax Act 2007?

Summary

3. In summary, it is the Law Society's view that:

    - Should Parliament decide to incorporate the GloBE rules into New Zealand law,[1] it should do so by reference (rather than by repetition or any other method), via amendment of the Income Tax Act. As far as is possible, the amendments should not repeat the OECD documentation.
    - A static approach should be used, so that the references are to the OCED document as published on a particular date, not as amended from time to time. The Law Society does not agree with Officials' view that a partially ambulatory approach should be used. Consequently, if the OECD revises its document, it will likely be necessary for Parliament to amend the legislation. That may be inconvenient, but less inconvenient than having to reverse an 'automatic' amendment resulting from an ambulatory reference.
    - However, if Parliament does decide to adopt an ambulatory or partially ambulatory reference to the GloBE rules, it would be preferable to incorporate a 'positive update' approach, rather than a 'negative update' approach.

[1] The Law Society does not express an opinion on *whether* Parliament should decide to incorporate the GloBE rules into New Zealand law.

4. The Law Society's reason for preferring a static approach is that the GloBE rules, if incorporated, will constitute a radical change to the basic scope of the tax system; and any amendment of any such rules should be made by Parliament amending the primary legislation (the Income Tax Act), not by Order in Council; nor, a fortiori, should a 'negative approach' to updating be adopted.

5. As indicated in the Issues Paper, it will likely be necessary for the Act, as amended, to provide for '*the legal scaffolding necessary to support the OECD rules*.'[2] In other words, it will be necessary for the Act, together with the document referred to, to add up to a coherent set of rules. The Law Society considers it is desirable for such 'scaffolding' to be as succinct as possible. To the greatest extent possible, the scope of the rules should be defined by the OECD text, rather than by the amending legislation. The reason for this is that the wordier the legislation is, the more likely it is to lead to difficulties of interpretation – especially if the Act inadvertently suggests one interpretation and the OECD text another.

6. Similarly, where the wording of the Act is in any relevant respect different from the wording of the OECD document, the Act itself should state whether the intention, in departing from the OECD's text, was to give effect to the OECD's recommendations or to achieve something different.[3]

7. It would be desirable for there to be as much consistency as possible between New Zealand's GloBE Rules and those of other countries. Incorporation by reference would seem to be the legislative technique most likely to achieve that objective.

Lessons to be learned from the 2018 and 2019 BEPS Amendments

8. In 2018 and 2019, the Government effected a slew of amendments to the Income Tax Act 2007 and the Tax Administration Act 1994, to give effect to most of the OECD's recommendations relating to Base Erosion and Profit Shifting (BEPS). Several of these amendments use the 'incorporation by reference' method, and expressly referred to instruments produced by the OECD to incorporate them, or parts of them, into New Zealand Law.

9. These amendments provide useful guidance as to the merits of the several methods by which it would be possible for Parliament to incorporate the GloBE rules in New Zealand. The lessons are outlined below, alongside the Law Society's view as to what this means for incorporation of the GloBE rules.

<u>The 2018 and 2019 amendments</u>

10. Specifically, the 2018 and 2019 amendments refer to the following documents:

    a. OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015 (the **Hybrid Mismatch Report**).

    b. OECD, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2017 (the **Branch Mismatch Report**).

    c. OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris, 2017 (the **Transfer Pricing Guidelines 2017**).

[2] Issues Paper, at 10.6.
[3] See comments on section FH 1(7), below.

d. OECD, Model Tax Convention on Income and on Capital 2017 (Full Version), OECD Publishing, Paris, 2019 (the **OECD Model Tax Convention**).

11. These documents, or at least sections of them, are now part of New Zealand law.

12. Insofar as is relevant, the amendments to the Income Tax Act:

    a. introduced new rules dealing with **hybrid mismatches** (subpart HF);

    b. strengthened the **transfer pricing** rules that the Act already contained (sections GC 6 – GC 14);

    c. introduced a new rule addressing the **artificial avoidance of permanent establishment status** (section GB 54); and

    d. extended the **source rules** (sections YD 4(17C) and YD 4B and schedule 23).

13. Insofar as is relevant, the amendments to the Tax Administration Act (sections 17B to 17G and sections 78G, 139AB and 142GB) expanded the Commissioner's powers of **requiring "large multinational groups" to supply information**.

14. This may well have been a sensible approach to dealing with the complex problem of cross-border tax avoidance by large enterprises, but it is novel, and its appropriateness is not self-evident. While most of the legislation's references to OECD materials are static (referring to documents published at a specified time), one of them is ambulatory – that is, the reference is to the document as amended from time to time by the OECD. Thus, Parliament seems in effect to have authorised the OECD to change New Zealand law by amending the document. For Parliament to have delegated legislative power to a body over which it has no control does seem to be jurisprudentially and constitutionally novel.

<u>Lessons learned</u>

Hybrids

15. Subpart FH was added to the Income Tax Act in 2018. Sections FH 1(4)(a) – (i) state that each of sections FH 3 to FH 11 "implements" one or other of the various recommendations made by the OECD in the two hybrids reports. It is unclear why the section is drafted in this way, but the reason for this was presumably twofold:

    a. First, Parliament had decided to amend the Act (by adding subpart FH to it) to implement the OECD's recommendations relating to the taxation of hybrids, and presumably thought that it might be helpful to state in the Act that its intention was to implement the recommendations. While those practising in this area would have been aware that subpart FH was intended to give effect to the OECD's recommendations, even without section FH 1(4) specifying this, however the provision spells out precisely which section is intended to implement which recommendation – and that may be helpful.

    b. More importantly, it is assumed that Parliament intended that, if difficulties arise in interpreting subpart FH, the two reports might assist in resolving them – and that, too, might well be helpful. The Act does not, however, expressly provide that sections FH 1 to FH 15 are to be interpreted consistently with the two Hybrids Reports. This may be contrasted with the transfer pricing rules, which, as is explained below, expressly provide that they "apply consistently with the OECD transfer pricing guidelines". While it seems reasonably plain that Parliament intended that Subpart FH should be interpreted consistently with the two reports, it may have been more useful for this to be made explicit.

16. Therefore, if Parliament enacts rules intended to give effect to the GloBE rules, and if its intention is that those rules are to be interpreted consistently with the OECD's Pillar Two reports, it would be helpful for the Act to expressly state that this is Parliament's intention.

17. Section FH 1(7) then provides:

> *Variations of the implementing provisions from details of the recommendations in the report [sic] are intended to assist in the implementation and application of the recommendations.*[4]

18. The rationale for this provision seems to be as follows. The term "implementing provisions" is not defined but it clearly means sections FH 3 to FH 11, each of which, as section FH 1(4) puts it, "implements" one or other of the recommendations set out in the two reports. The implementing provisions do not recite the recommendations verbatim. Rather, Parliament has in numerous respects refined the wording, so as, as section FH 1(7) puts it, "to assist in the implementation and application of the recommendations."

19. This seems sensible, given that the reports were not intended to serve as model statutes, and so are not drafted in a style suitable for legislation. Moreover, every country has its own approach to legislative drafting, and New Zealand's Income Tax Act is drafted in a particular style. Even if the OECD were to produce a model statute designed to implement its hybrids recommendations, it would require considerable refinement before it could be used in New Zealand. The function of section FH 1(7), therefore, would seem to be to make clear that the reason the statutory wording differs from the wording of the reports is generally not to depart from the recommendations but to give effect to them.

20. The principal advantage of referring, in the statute, to the two Hybrid Reports would seem to be that it might have made it possible for the legislation implementing the OECD's recommendations to be considerably simpler than would otherwise have been possible. To this, it might be added that the two Hybrids Reports would be relevant to the interpretation of subpart FH even if it did not expressly refer to them – so it may prove useful for the statute to have reduced the scope for argument over that point.

21. Similarly, if Parliament enacts rules intended to give effect the GloBE rules, it is likely they will not be the same as the OECD's document. It would be helpful for the amending legislation to include a provision analogous to section FH 1(7) – that is, a provision stating that the reason the statutory wording differs from the wording of the reports is not to depart from the recommendations but to give effect to them.

Transfer Pricing

22. Section GC 6(1B), which was added to section GC 6 in 2019, provides (emphasis added):

> *This section and sections GC 7 to GC 14 apply* ***consistently with the OECD transfer pricing guidelines****.*

23. In this provision, Parliament has made it clear that the five transfer-pricing methods are to be interpreted and applied in the manner prescribed by the OECD Guidelines. It is presumably still legitimate to refer to the cases and the literature on transfer pricing, but priority must be given to the Guidelines. Once again, this seems sensible.

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[4] Section FH 1(7) refers to "report", singular. This seems a lapse from the very high standard of drafting of most of the rest of the 2018 amendments. It seems clear, however, that "report" in s FH 1(7) is intended to mean "whichever of the two reports (the Hybrid Mismatch Report or the Branch Mismatch Report) contains the particular recommendation that the implementing provision in question is intended to implement".

24. The version of the Guidelines that the Act treats as authoritative is that published in 2017. This reference is static, in the sense that any updating of the Guidelines by the OECD will not automatically change New Zealand law. Rather, if Parliament wants the law to be amended to refer to any updated version of the Guidelines, it must amend the Act accordingly. As it happens, the Guidelines were amended in early 2022, but Parliament has not amended the Act. While the reference is out of date, this is a lesser risk than using an ambulatory reference, which would result in any amendment to the Guidelines automatically changing New Zealand law.

25. Section GC 13(1C), which was added to the Act in 2018, goes on to provides as follows (emphasis added):

> *If the requirements of the OECD transfer pricing guidelines, **paragraph 1.122**, are met, **the approach described in the OECD transfer pricing guidelines, chapter I, section D.2 must be used** to treat a transfer pricing arrangement involving a supply and acquisition as instead involving*
>
> *a) no supply and acquisitions; or*
>
> *b) an identified transaction that differs from the supply and acquisition under the accurately delineated transfer pricing arrangement.*

26. These references are very specific. This specificity is appropriate because it achieves the intended meaning. However, this works only because the references are static. If they were ambulatory and the OECD were to amend the Guidelines in such way as to change the paragraph numbers, the result could be that the references become nonsensical.

27. Section GC 13(2), as amended in 2018, then provides that arm's length prices are to be determined "by performing a comparability analysis as required by the OECD transfer pricing guidelines, chapter III, using any 1 or a combination" of the five prescribed methods. This provision seems to effect a more radical change than section GC 6(1B). Section GC 6(1B) merely requires regard to be had to the Guidelines as a matter of interpretation, whereas section GC 13(2) requires the "performing" of a "comparability analysis" as prescribed by the OECD as an operational rule. If the GloBE rules were to be incorporated in the Act by reference, they, too, would presumably be operational rules, not merely guides to interpretation.

28. As with the Hybrids Reports, the principal advantage of incorporating the Transfer Pricing Guidelines by reference in New Zealand law is that the legislation is simpler than would otherwise have been possible. In this instance, however, the advantage is greater. The rules in the Act – sections GC 6 to GC 14 – are relatively straightforward, whereas the Guidelines comprise 608 pages. Moreover, the Guidelines are comprehensive, detailed, and very competently put together.

29. It would have been possible for Parliament to incorporate the Guidelines in the Act by "repetition" rather than by "reference". That is, it would have been possible for Parliament to incorporate the entire text of the Guidelines in the Income Tax Act. This would have added 608 pages or more to an already unwieldy statute, yet would have achieved nothing that has not been achieved by incorporating it by reference.

30. Moreover, if Parliament had incorporated the Guidelines by repetition, it would have likely found it necessary to make very substantial changes to the wording so as to achieve a tolerable degree of consistency with the rest of the Act. That would have required significant

resource, and potential arguments as to the significance of the differences between the wording of the Act and the wording of the Guidelines.[5]

31. In summary, the amendments to the transfer pricing rules suggest that:

    a. If Parliament decides to incorporate the GloBE rules in New Zealand, it should do so by reference; and

    b. The reference should be static, not ambulatory.

The Artificial Avoidance of Permanent Establishment Status

32. Section GB 54, added to the Act in 2018, addresses what is referred to as "the artificial avoidance of permanent establishment status".

33. Section GB 54(1)(j) provides that s GB 54 only applies where the taxpayer in question is a member of a "large multinational group"; and s YA 1 defines that term as meaning a group of companies that "has annual consolidated group revenue equal to or exceeding the exemption threshold referred to in paragraph 5.53 of the OECD transfer pricing guidelines". Section YA 1 also defines "OECD transfer pricing guidelines" as meaning the document having that title and published by the OECD in 2017; and paragraph 5.53 of that document specifies a threshold of €750 million.

34. Section GB 54 therefore only applies where the taxpayer is a member of a group of companies with an annual turnover of €750 million or more. But this is drafted less clearly than it could have been. It would have been simpler to specify the threshold of €750 million in section GB 54 itself. Section GB 54(1)(j) is an example of where "incorporation by reference" was not an appropriate drafting technique.

35. The lesson to be learnt from section GB 54, is that incorporation by reference should be used only where it achieves some manifest advantage – such as brevity.

The Source Rules

36. The amendments to the Income Tax Act enacted in 2018 included a new section YD 4(17C), which provides that "[i]ncome attributable to a permanent establishment in New Zealand of a non-resident has a source in New Zealand". Such income is therefore taxable under the source principle.

37. Having decided to include a reference to "permanent establishment" in section YD 4(17C), Parliament also defined the term; and s YD 4B(3) provides that the definition is as set out in schedule 23 (which was also added to the Act in 2018). The definition was lifted, almost verbatim, from article 5 of the 2017 version of the OECD's Model Tax Convention. It is unclear why this definition was placed in the schedule, rather than incorporated in s YD 4(17C) itself. Potentially, this is because the drafting is in the non-common-law style favoured by the OECD, or because it is complex – the schedule is four and a half pages long and comprises 11 clauses, several of which are themselves hard to follow.

38. Section YD 4B(4), which was also added to the Act in 2018, provides (emphasis added):

> *Schedule 23 is [to be] treated as applying consistently with the guidance relevant to the schedule that is provided by* ***the Commentary on Article 5 of the Model Tax Convention on Income and on Capital, in Model Tax Convention on Income and on Capital published by the Organisation for***

[5] See the comments on schedule 23 of the Act, below.

***Economic Co-operation and Development**, as amended at the beginning of the income year in which the enterprise makes the supply.*

39. The Commentary itself is extensive: it is currently at 2,624 pages long. The part of the Commentary that is directly relevant to article 5 is only about 152 pages, but it seems likely that various of the other 2,472 pages might be relevant to the interpretation of those 152 pages.

40. Given that section YD 4(17C) uses the term "permanent establishment", it follows that a definition of the term is necessary, or at least helpful. However, the drafting of this is convoluted, entailing both a separate section (section YD 4B) in addition to the operative provision (section YD 4(17C)) and a four-and-a-half-page schedule. It would have been simpler, to define "permanent establishment" as having the same meaning as in article 5 of the Model Tax Convention, as revised from time to time.

41. The reason for defining 'permanent establishment' in this way appears to be that:

    a. some of New Zealand's DTAs contain definitions of the term that are different to that set out in article 5 of the Model Treaty;

    b. some of the differences are to New Zealand's advantage; and

    c. it would be inappropriate to give companies resident in jurisdictions with which we do not have a DTA any advantage over companies resident in jurisdictions with which we do have one.

42. This reasoning is unsound in that, while sections YD 4(17C) and YD 4B and schedule 23 can be justified as filling a gap in the legislation, the amount of tax that escapes through that gap is likely to be zero. It would have been better, therefore, if "permanent establishment" had been defined as having the same meaning as in article 5 of the Model Tax Convention, as revised from time to time.

43. The lesson to be learned from sections YD 4(17C) and YD 4B) and schedule 23 is that using both incorporation by repetition (schedule 23) and incorporation by reference tends to be unnecessarily unwieldy.

44. In the case of these provisions, the fact that the reference is ambulatory rather than static is unlikely to be problematic because:

    a. these provisions are unlikely to be applied often (if ever);

    b. any amendments to the commentary on Article 5 are likely to be to New Zealand's advantage.

    However, it does not follow that a reference to the GloBE Rules should be ambulatory, for the reasons stated elsewhere in this letter.

Requiring Large Multinational Groups to Supply Information

45. In 2019, Parliament enacted a series of amendments to the Tax Administration Act, giving effect to the OECD's recommendations relating to requiring large multinational groups to supply information. The new rules are contained in sections 17B to 17G and sections 78G, 139AB and 142GB. For present purposes, the more important of them are as follows.

46. Section 17G provides that the Commissioner may require a member of a "large multinational group" to provide information relating not only to itself, but also to any other member of the group, or to the group as a whole. This is supported by section 17E. The meaning of this section is not entirely clear, but it seems to mean that every member of a large multinational group is deemed to be in possession of all information and documents in the possession of any

member of the group. Section 139AB imposes penalties for non-compliance and section 142GB provides for the date by which such penalties must be paid.

47. These rules apply to any company that is a member of a "large multinational group". This term is therefore fundamental to their scope. Section 3 of the Tax Administration Act was therefore amended by adding to it the following definition (emphasis added):

> ***Large multinational group****, for an income year or a period set by the Commissioner under section 78G, means a consolidated accounting group that, in the income year or period, —*
>
> *a) has a member resident in New Zealand or income with a source in New Zealand; and*
>
> *b) has a member resident in a country or territory other than New Zealand; and*
>
> *c) in the preceding income year or period, has annual consolidated group revenue equal to or exceeding the exemption threshold referred to in* ***paragraph 5.53 of the OECD transfer pricing guidelines****…*[6]

48. As is explained above, the Income Tax Act defines "OECD transfer pricing guidelines" as meaning the version published in 2017. The Tax Administration Act, however, does not define the term. It is therefore unclear whether Parliament intended it to have the same static meaning as in the Income Tax Act, or to mean the Guidelines as amended from time to time (an ambulatory meaning). For the time being, this lack of clarity is unimportant because, as indicated above, paragraph 5.53 of both the 2017 and 2022 versions of the Guidelines prescribe a threshold of €750 million. However, if the OECD were to produce a version of the Guidelines with a different threshold, or a version in which the threshold was move to a paragraph other than 5.53, it is unclear what effect this would have on New Zealand law.

49. The most important of the amendments to the Tax Administration Act was section 78G, which has effectively incorporated in New Zealand law Annex 3 to chapter 5 of the Guidelines. The key component of this is section 78G(1)(a), which provides (emphasis added):

> *A large multinational group with an ultimate owner that is a New Zealand resident must provide to the Commissioner a report, for each period set by the Commissioner, that includes —*
>
> *a) the information described in* ***the OECD transfer pricing guidelines, Chapter V, Annex III****…*

50. Accordingly, every "large multinational group with an ultimate owner that is a New Zealand resident" is required to periodically provide country-by-country reports complying with Annex 3. As with most of the amendments discussed above, the reference to Annex 3 seems sensible. The alternative would have been to amend the Tax Administration Act to set out what was required. Had that approach been adopted, it would most likely have been done by adding a new schedule to the Act – much as schedule 23 was added to the Income Tax Act to incorporate in New Zealand law a definition of "permanent establishment" (see above).

51. If Annex 3 had been incorporated in the Tax Administration Act by repetition, it seems likely it would have been redrafted, to comply with the style in which New Zealand's legislation is drafted and ensure consistency of language across the Act. This may have raised difficult questions about the significance of the differences between the wording of the Annex and the

[6] This definition, it seems worth noting, is not exactly the same as the definition of "large multinational group" in s YA 1 of the Income Tax Act (recited above). The rationale for the difference is unclear, as is whether it matters.

wording of the statute. It would also have lengthened and complicated it for no advantage – just as adding schedule 23 to the Income Tax Act seems to have lengthened and complicated that Act without serving any useful purpose.

52. Sections 17B to 17G and ss 78G, 139AB and 142GB therefore demonstrate that incorporation by reference can be a highly advantageous drafting technique.

53. In the case of those sections, the negative approach to updating would seem to be relatively unproblematic, because any changes are likely to be in the direction of increasing the burden on MNEs to supply information. It does not follow, however, that the negative approach would be appropriate in the case of the GloBE Rules. This is because adding GloBE Rules to the Income Tax Act would constitute a radical change to basic rules relating to the scope of the charge to tax; and it would be inappropriate for Parliament to allow rules of that nature to be amended by the OECD.

Conclusion

54. The 2018 and 2019 amendments provide a useful demonstration of the various drafting techniques that can be employed to incorporate OECD materials into New Zealand law. In the Law Society's view, these learnings support the following approach for incorporation of the GloBE rules:

    a. Incorporation of the rules should be by reference, rather than repetition, via amendment of the Income Tax Act. Repetition of OECD material should be avoided.

    b. The references should be static, not ambulatory. If a partially ambulatory approach is taken, it is essential that a 'positive approach' to amendment is taken. The changes effected by the GloBE rules are of such significance, that any amendment of those rules should be undertaken by Parliament through amendment of the primary legislation.

55. The Law Society is available to provide further information and to answer any additional questions Inland Revenue may have. To get in touch, please contact Aimee Bryant: aimee.bryant@lawsociety.org.nz

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