SUBMISSION

NEW ZEALAND INSTITUTE OF CHARTERED ACCOUNTANTS

SUBMISSION ON

Boosting productivity in the service sector – 2nd interim report

7 March 2014

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New Zealand Productivity Commission
PO Box 8036
The Terrace
WELLINGTON 6143
New Zealand

Dear Sir/Madam

Boosting productivity in the service sector – 2nd interim report

Thank you for the opportunity to comment on the New Zealand Productivity Commission's 2^{nd} interim report on boosting productivity in the services sector.

Our submission focuses on the following recommendations:

- R8.1: New Zealand should negotiate taxation arrangements with other countries that allow more efficient temporary transfer of employees between New Zealand and those countries; and

- R9.3: New Zealand should promote – and participate in – international forums with the aim of reducing the ability of multi-national firms providing digital services to shift their profits across national borders to avoid paying tax.

Summary

In summary, our submissions are as follows:

- The tax liability of non-residents who are present in New Zealand for more than 92 days in an income year should not be backdated;
- The threshold for exempting income should be extended from 92 days to 183 days; and
- The New Zealand Government should fully engage with the OECD but proceed with caution with regard to its response to BEPS.

Temporary transfer of employees

We are pleased that the Productivity Commission has recognised tax inefficiencies arise from the temporary transfer of employees between countries.

By way of background, the taxation of temporary transfers of employees between countries is governed by an interaction between New Zealand's domestic taxation laws and New Zealand's network of double tax agreements. Under domestic taxation laws, income derived by a non-resident from performing personal or professional services within New Zealand is exempt, provided the non-resident is present in New Zealand for less than 92 days in a tax year.

This exemption may be supplemented by any of New Zealand's double tax agreements. For example, Article 14 of the Australia-New Zealand double tax agreement states that remunerations derived by an Australia resident shall only be taxable if the recipient is present in New Zealand for a period(s) exceeding 183 days in any 12-month period. This normally only applies where the employer is non-resident.

Retrospectivity

Where the 92 day threshold is exceeded, the exemption does not apply and the taxpayer is liable for tax on the entire amount earned while present in New Zealand (this threshold may be adjusted for non-residents of a jurisdiction with a double tax agreement). This means the tax liability is essentially backdated to day one.

This backdated tax liability can cause issues for businesses required to withhold under various withholding tax regimes (such as PAYE for employers). For example, a project has an expected life of 90 days. As this does not exceed the 92 day exemption threshold, the business will not be required to withhold tax from payments to non-resident contractors so does not do so. However let us assume that, because of delays, the project goes over schedule and finishes after 105 days. On day 93, the business realises it was required to withhold tax from payments made on days one to 92. As the tax liability is backdated, the withholding will be incorrect and business could be liable for penalties for the shortfall.

Any tax liability will likely be built into the pricing of the agreement, so the uncertainty over the backdating of tax liability will not assist businesses looking to make commercial decisions. This is likely to hinder productivity in the services sector.

In addition to the backdated tax liability, there are significant compliance costs associated with exceeding the 92 day threshold. For example:

- The employee must apply for an IRD number;
- The employee must file a New Zealand income tax return;
- The employer may have to register as an employer with Inland Revenue; and
- The employer must deduct PAYE and file PAYE returns with Inland Revenue.

To avoid these additional compliance costs, employers may choose to send their employees home before the 92 day threshold is breached (irrespective of whether their duties or projects are complete). This could also hinder productivity in the services sector.

In our view, the backdating of tax liability for non-residents is an issue which employers (both resident and non-resident) find difficult.

We submit the tax liability of non-residents who are present in New Zealand for more than 92 days in an income year should not be backdated.

These issues could be remedied by exempting income for the first 92 days and taxing income from the 93rd day onwards.

Extension of exempt income threshold

The exempt income threshold is dependent on whether the employee or contractor is resident in a country with which New Zealand has a double tax agreement. If the employee or contractor is resident in a jurisdiction without a double tax agreement, domestic law will apply and the threshold is 92 days. Alternatively, if the employee or contactor is resident in a double tax agreement jurisdiction, the double tax agreement will override New Zealand domestic law and the threshold may be up to 183 days.

Recommendation 8.1 focuses on negotiating taxation arrangements with other countries. While we would support this work, we believe there is also a domestic solution to this problem.

In our view, an amendment to New Zealand's domestic legislation would be a much faster process. Accordingly, we submit that the Income Tax Act 2007 should be amended to increase the threshold from 92 days to 183 days.

This will align the domestic provision with the threshold commonly provided for in New Zealand's double tax agreements.

Non-resident employer requirement

In some circumstances, having an employee in New Zealand may create a permanent establishment here. Under most double tax agreements, employees working on construction projects will create a permanent establishment for the employer once the employee has been in New Zealand for 183 days in a 12 month period. We understand from our members that Inland Revenue has used this as a proxy for determining whether the physical presence of an employee for non-construction projects creates a permanent establishment.

A construction projects results in a tangible output that remains in New Zealand after the project has been completed. However, outputs from projects in the services sector are more likely to be intangible and may have no physical presence in New Zealand upon the project's completion. For this reason, it may be appropriate for the services sector to have its own unique criteria rather than proxies obtained from other industries. It may not be appropriate to use construction project permanent establishment requirements as a proxy for service-based projects.

Multi-national firms providing digital services

We are pleased that the Productivity Commission has recognised that New Zealand should participate in international forums on base erosion and profit shifting (BEPS). NZICA has taken an active role in discussing and providing input to Officials in this regard.

General approach

We note that the following BEPS-related projects have already been added to the government's tax policy work programme:

- Active income exemption for offshore branches;
- Mutual recognition of imputation credits;
- Profit shifting using related-party debt;
- Foreign hybrid instruments and entities;
- Non-resident withholding tax on related-party debt;
- Approved issuer levy disclosure requirements;
- GST and online shopping; and
- Double tax agreements and tax information exchange agreements.

The current international tax framework is developed by the United Nations and the OECD. The framework seeks to increase the free flow of trade and capital by reducing the possibility that trade in goods and services and cross-border capital will be penalised by the imposition of double taxation. For example, where one country taxes on a source and the other taxes on a residence basis.

NZICA is counselling caution with regard to the response to BEPS. We have suggested to the Minister of Revenue and Inland Revenue that the New Zealand Government should engage with the OECD fully but should be mindful of New Zealand's economic and tax profile (being different from many of the larger OECD member states' profiles). That is, what is right for the G20 and other OECD member states may not be right for New Zealand.

To illustrate, there is a discussion currently about whether taxpayers should be deemed to have a "digital permanent establishment" in countries where they offer goods and services to residents of that country (the host country). This would allow the host country to tax some part of the profits from the provision of those goods and services.

The Commission may have concerns that, if New Zealand does not engage in the BEPS project, software as a service (SaaS) productivity will be limited because providers will be encouraged to place their hardware offshore, which may affect service standards. However, in our experience the hardware is often already located offshore for commercial reasons.

In our view, the use of offshore server farms is not to achieve profit shifting but rather reflects the commercial reality that an offshore provider of hardware is often able to provide higher capacity at lower cost. A recent amendment to the Tax Administration Act that allows online accounting software service providers to store information offshore recognises the fact that New Zealand businesses already hold and process information through offshore servers.

Extending tax rights to situations in which a digital permanent establishment exists may reduce New Zealand's tax take from New Zealand residents that have digital permanent establishments in overseas markets. It is unclear at this stage whether the fiscal effect of implementing any OECD recommendations to amend taxing rights in this way would be positive or negative.

We agree with the recommendation that the New Zealand Government should fully engage with the OECD but we are strongly of the view that it must proceed with caution with regard to its responses to specific BEPS issues.

If you have any queries regarding our submission please contact me.

Yours faithfully

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