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Inquiry into the Services Sector
New Zealand Productivity Commission
P O Box 8036
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Our ref 140307ProductivitySub

7 March 2014

Dear Sir or Madam

KPMG's submission on "Boosting productivity in the services sector - 2nd Interim Report"

KPMG is pleased to make a submission on the New Zealand Productivity Commission's (the "Commission's") second interim report (the "Report").

Our comments are in respect of the following tax-related recommendations, that:

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

Summary

The interaction of domestic tax rules and Double Tax Agreements ("DTAs") with employee transfer arrangements creates compliance and tax costs which inhibit the free movement of people. New Zealand should consider unilateral as well as bilateral changes to its tax policy and compliance settings to reduce those costs.

It is unclear to us that base erosion and profit shifting ("BEPS") contributes to productivity problems (such as poor quality of service and higher costs) in the New Zealand digital services sector. It is further unclear that implementing recommendations to address BEPS issues will solve those productivity concerns, if in fact productivity is a problem. The Commission should confirm that it has identified a real issue before proceeding with its recommendation.

Impact of the NZ and international tax rules on labour mobility

KPMG believes that domestic and international tax rules and, importantly, how those rules are applied and enforced by tax authorities can act as a significant barrier to the efficient mobility of

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labour and New Zealand employers being able to source the skills they need, at the time they need them.

Various tax barriers exist to both trans-Tasman labour mobility and attracting highly skilled personnel from further afield. We believe the appropriate response needs to be a combination of signing new, and updating existing, treaties to remove double taxation concerns (the Commission's recommendation), as well as unilateral measures to help New Zealand businesses attract and deploy talent.

We discuss the issues and recommended solutions below.

Short-term employee transfers

New Zealand, like most other countries, taxes individuals on their employment income if the services are performed in New Zealand.

However, under New Zealand's DTAs, employment income will not be taxed if, broadly, the person is in New Zealand for less than 183 days (either in a 12 month period, or during a fiscal or income year) and the employer is non-resident.

Similar protection applies for New Zealand residents exercising their employment in the DTA-partner country. This is to accommodate "short-term employee transfers".

"Economic employer" approach

In practice whether employment is being carried out for a foreign employer, or not, is open to interpretation. This is particularly the case under the New Zealand-Australia DTA.

The Australian Taxation Office will generally treat an Australian subsidiary as the "economic employer", under a 2003 Ruling[1], where the work is performed for that subsidiary's business but the employee remains legally employed by the New Zealand parent. Accordingly, the employee will not be allowed relief under the New Zealand-Australia DTA. The New Zealand Inland Revenue, in contrast, does not apply the economic employer approach. Because of the differences in approach, New Zealand may not allow a credit for Australian tax paid.

The New Zealand-Australia DTA does contain (in Article 14) a more limited 90 day rule in addition to the broader 183 day exemption. The 90 day exemption does not have regard to the status of the employer and therefore is not subject to the economic employer argument. However, this rule substantially limits the ability to use an employee on a project.

The concern is not limited to trans-Tasman short-term employee transfers. We note that a number of our key trading and investment partners also apply the economic employer approach. This impacts the ability of New Zealand businesses to transfer employees freely across their international networks without double taxation risks and concerns arising. This in turn affects

[1] The Ruling interprets "employer" to mean the entity that has the economic risk and reward in relation to the employee's activities in the work location. In that respect, it is the ability for the Australian subsidiary to "control" the employees' activities will be relevant, not necessarily who the employer is at law.

the cost of such transfers, e.g. if there is the need to "tax equalise"[2] such employees, and pricing of contracts.

Recommendation

New Zealand should seek to ensure that its DTA partners do not apply the economic employer approach when considering the availability of treaty benefits, when negotiating DTAs. If it is unable to do so, it should make clear that a New Zealand tax credit is available for foreign taxes paid.

Short-term contractor engagements

The issues are broadly the same as for short-term employee transfers, with additional obligations if a contractor is operating through a fixed base in New Zealand. This is reasonably straightforward where the contractor has their own office and facilities in the temporary work location, but may be less clear when the individual is at an engineering or project site, or visiting many different sites during the engagement. The complexity of these rules can lead to non-compliance in both countries.

New Zealand operates a withholding tax regime for non-resident contractors. While there are some exemptions from this regime – most commonly if the contractor will be present for less than 92 days in a 12 month period and would otherwise be exempted under a DTA – Inland Revenue approval (including payment of a bond) is required for longer contracts. Practically, it will be difficult for the New Zealand business to establish the contractor's total New Zealand presence, in a 12 month period, if they are/have been engaged in projects with other parties as well.

Recommendation

The New Zealand tax regime for non-resident contractors (particularly where the contractor is normally resident in Australia[3]) should be simplified. Any New Zealand tax costs from inadvertently breaching the 92 day short-term contractors' exemption should be able to be remedied prospectively.

Longer term employee transfers

There is also the need to ensure that the tax rules do not discourage longer term employee transfers, to fill New Zealand skills gaps.

An assignment in New Zealand lasting longer than 183 days (e.g. one or two year secondments) will result in a person acquiring New Zealand tax residence, which allows New Zealand to tax not only the local employment income of the individual, but also prima facie, their worldwide income.

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[2] Ensure employees do not suffer a reduction in their after-tax income as a result of an international assignment.

[3] Given the Closer Economic Relationship between the two countries and enhanced information sharing between Inland Revenue and the Australian Taxation Office, which should help mitigate the fiscal risks.

While the employee may be able to argue non-residence under a DTA, this will only offer limited protection from double taxation.

Under New Zealand's domestic law there is a transitional residents' exemption, which excludes from tax the foreign sourced income of new migrants and certain returning New Zealanders for a period of four years. However, this exemption can only be accessed once and is limited to a person's foreign passive income only – i.e. NZ and offshore employment and business income continue to be taxable.

The concern is the treatment of certain non-cash (i.e. fringe) benefits that may continue to be provided while the employee is temporarily present in New Zealand. Only the New Zealand-Australia DTA explicitly provides specific protection from the double taxation of such benefits. Employees resident in other countries may be double taxed.

An example is continuing superannuation contributions to a foreign superannuation scheme. These contributions are subject to FBT in New Zealand whereas the employee may be subject to income tax on the contributions in the other country (similar issues may arise in relation to the provision of motor vehicles and other in-kind benefits). As FBT and income tax are not cross-creditable, the cost of assigning employees to New Zealand will be increased as a result.

Recommendation

Any future DTA negotiations by New Zealand need to incorporate relief from double taxation for fringe benefits, to ensure the tax rules do not discourage longer term employee transfers.

Permanent establishment risk

A key concern for foreign companies without a fixed New Zealand place of businesses, from sending employees to New Zealand, is the risk that the employees' presence could create a "permanent establishment", and what this means practically.

Whether a permanent establishment will be created for a foreign employer will depend on the foreign company's country of residence. Under some DTAs, presence of more than 183 days in a 12 month period will be sufficient. Under others, a period of more than 365 days may be required.

While not only creating a New Zealand tax liability for the business, a permanent establishment can also create significant and retrospective New Zealand tax compliance obligations for a foreign employer, including PAYE, FBT and GST obligations, if their employee breaches the relevant threshold by even a single day. Further, the foreign employer will have been required to deduct the relevant taxes (PAYE, etc) from day one and will be subject to Inland Revenue's interest and penalties regime for non-compliance.

This acts as a significant barrier to New Zealand businesses being able to source key personnel from overseas, including their foreign affiliates. (New Zealand businesses may be required to indemnify the foreign company against local tax risk, which can drive up the cost of projects.)

Projects timelines can and do slip. The retrospective application of New Zealand tax rules is unfair where both the foreign employer (and employee) have a reasonable belief at the outset that relevant days count rule would not be exceeded.

Recommendation

Any New Zealand tax costs for foreign businesses, from breaching the relevant days count rule for a permanent establishment, should be able to be dealt with prospectively, without the risk of Inland Revenue penalties and interest.

Inland Revenue's operational approach

We have seen multiple instances recently where Inland Revenue's operational approach on employee issues, including the taxation treatment of employer provided accommodation and tax residence of individuals, has created significant uncertainty for business and individuals.

Our biggest concern is recent changes to Inland Revenue's view of the law having retrospective application. That is, requiring previous tax positions to be amended in favour of the Department's latest operational position. This has a considerable cost not only to the businesses (and individuals) directly affected, but also the wider business environment and the ability of New Zealand firms to have certainty about their tax affairs.

Recommendation

Changes to Inland Revenue's view or application of the law, other than in exceptional circumstances, should apply prospectively only to provide certainty. (Exceptional circumstances should be limited to those where Inland Revenue has previously warned against the position being taken and there is a material fiscal risk or a risk to the integrity of the tax system from allowing this to continue.)

Alternatively, the tax cost from any retrospective change in Inland Revenue's view of the law should be able to be "washed-up" in a future tax return (that is, without the need to re-file past returns or incur interest and penalties).

Profit shifting concerns

The Report references the OECD's base erosion and profit shifting ("BEPS") project and raises specific concerns around New Zealand's ability to tax the profits earned by international cloud computing providers in the New Zealand market. (We have taken cloud computing to be representative of digital services providers generally, who may have a virtual but not a physical presence in New Zealand.)

General approach to BEPS

We note that Government has committed to New Zealand's participation, including the involvement of senior Tax Policy Officials, in the OECD's ongoing BEPS deliberations. Therefore, there seems little risk that New Zealand will not actively participate in those discussions, even if the eventual outcomes may not necessarily be in New Zealand's best interests.

It is worth noting that OECD BEPS concerns encompass a variety of inter-related work streams, of which the taxation of digital service providers (which itself is part of a wider debate on the efficacy of the current "permanent establishment" concept) is only one. The outcomes in other key problem areas, including tax mismatches involving "hybrid" instruments and entities[4] and transfer pricing, particularly where cross-border funding is concerned, will be equally important to New Zealand.

There has been much debate to date on how and where profits from provision of digital services should be taxed.

That is, conceptually, should the allocation of profit be based on where the underlying "intangibles" are created or used, or where the services are consumed, or some hybrid of the two? (The place of legal ownership of the intangibles, which bears the development and other costs, could also be a place of profit attribution. However, this does not appear to be a favoured option as these countries are typically low or no tax jurisdictions, which is one of the concerns being addressed under BEPS.)

The place of creation would favour the country where intellectual property is generated or where the technology is applied, a "production" basis of taxation. A "consumption" basis of taxation would favour the place where services are consumed (i.e. the country of consumption).

New Zealand has an interest in taxing both tax bases. While there may be a current concern that New Zealand is missing out on taxing New Zealand's share of the "profit" of foreign digital services providers (i.e. profits attributable to New Zealanders consumption of those services), if our aspirations are to be a knowledge economy, we need to be cognisant that New Zealand firms will also be providing digital services globally. New Zealand will therefore want to preserve its ability to tax on a production basis.

Secondly, it is unclear what the appropriate taxing mechanism should be if there is no physical presence in New Zealand to establish taxing rights. The OECD's head of tax policy has suggested a "digital permanent establishment" may be the answer. Taxing digital services at point of sale may be another option. Both have inherent complexities.

Therefore, there is no "one size fits all" solution to the tax issues involving digital services, and these trade-offs will also be relevant for the design of international tax rules for non-digital businesses. For example, New Zealand's ability to tax its agricultural exporters will be compromised if the international tax landscape shifts to taxing based on where those exports will be consumed. The New Zealand Government needs to carefully balance these issues in determining its response to BEPS.

We discuss below the Commission's specific concerns around BEPS contributing to poor quality of services and higher cost of digital content, for New Zealand users. However, consideration also needs to be given to the market potential for New Zealand digital services

[4] These are transaction or entities which have different tax characteristics in different jurisdictions (e.g. instruments that are treated as debt in one country and equity in another) allowing for tax arbitrage opportunities.

providers. New Zealand firms will invariably need to look to overseas markets to grow. If key clients are based in the United States or Europe, for example, it makes commercial sense to base the supporting IT infrastructure nearer to those clients (and those clients will drive the cost/quality of service trade-off). This will not, and should not, be driven by the tax rules.

The Commission's specific concerns

We understand the Commission's specific concern is the international tax rules not only reducing New Zealand's ability to tax digital service providers, but also driving lower productivity for New Zealand firms in that sector by encouraging "off shoring" of IT infrastructure (i.e. relocation of servers and other IT hardware which supports cloud computing to low or no tax jurisdictions). The impact for New Zealand is said to be poor quality of service, increased data transport costs and reduced ability to apply New Zealand law to digital content.

We strongly recommend the Commission test the above concerns with New Zealand software service providers, as we are not convinced that the problem definition is correct.

Our understanding is that the IT infrastructure of New Zealand software services providers is likely to be located offshore for commercial, rather than BEPS, reasons. We would be very surprised if digital service providers are willing to compromise service quality and data security, to gain a tax advantage. More likely, off shoring of technology reflects the reality that offshore IT providers will have the required capacity at a lower cost than a New Zealand based provider of the same technology.

We are not in a position to comment on whether that comes with a quality/cost trade-off but it would appear that this trade-off is currently being made in the market. For example, a recent law change has reinforced the ability of accounting software providers to use offshore locations to store taxpayer information.

This acknowledges the reality that a number of key New Zealand software service providers already have IT hardware located offshore or use third party IT suppliers. We would expect that they have considered the cost/quality trade off in making that off shoring decision. And if a third party technology provider is used offshore, it is unlikely to be for BEPS reasons.

We appreciate that the cost/quality trade-off for this particular instance may be different from the desired/desirable trade-off for other sectors but it does not seem to us that the BEPS project will assist in making that trade-off, one way or the other. It is more likely that service quality/cost/other factors will be more influential than tax considerations. The New Zealand Government's position, that its data should not be stored offshore (presumably for privacy and sovereignty reasons) is an example of that.

Recommendations

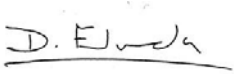
The New Zealand Government needs to carefully consider the BEPS project recommendations to ensure their fit with the New Zealand environment and objectives.

The Commission should review its recommendation that BEPS will assist in resolving the cost/quality trade-off in relation to the off shoring of technology.

Further information

Please do not hesitate to contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940 if you require any further information about our submission.

Yours sincerely



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