Will BEPS Allow New Zealand to Finally Tax Google?

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1.0 Introduction

Tax avoidance by major US multinationals has been extremely topical worldwide over the past decade since the great financial crisis of 2008. One company which typifies the tax avoidance issue is Google, now owned by US holding company called Alphabet Inc, has been at the forefront of this tax avoidance controversy. It has been able to snare a dominant share of the international online advertising market without paying significant amounts of tax in foreign countries where it obtains orders outside the US. For the latest fiscal year ended 31 December 2016 Alphabet Inc has reported revenues of US$90.3B (of which Google accounts for US$89.5B), and net income after tax of US$19.5B. It has disclosed an effective tax rate of 19% in its financial statements with the gap between this "effective rate" and the US statutory rate of 35% largely explained by a differential of 11% in the US and average foreign tax rate.[1] As foreign revenues for the period were US$47.5B out of US$90B and that the parent company disclosed that most of foreign earnings were earned by Irish subsidiaries[2] (Ireland being a country noted for offering low tax rates for multinational investors), it appears reasonable to conclude that the effective tax rate on Google's foreign earnings was very low.

Unlike many other US multinationals which have been accused of tax avoidance such as Starbucks and McDonalds, Google's primary tax avoidance strategy is relatively simple. It has gamed the world network of double tax agreements (DTAs) by securing orders for online advertising in a way that avoids the creation of "permanent establishments" (PEs) in the foreign countries in which their customers are located. In the absence of a PE in the foreign countries where it secures orders for advertising, these countries cannot tax Google on any profits secured from those orders. Instead the profits are taxed in jurisdictions where the orders are received such as Ireland and Singapore which are noted for attracting multinational investment by offering low tax rates.

In common many other countries New Zealand has been concerned whether foreign multinationals have been paying sufficient tax in New Zealand in respect of the business they obtain in New Zealand. Media reports have highlighted the very low amounts of tax some US multinationals have paid in New Zealand despite apparently profitable business obtained there.[3] Despite political pressure mounting for the New Zealand Government to take unilateral steps to

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1 2016 10-K filing, page 77.

2 Refer above note.

3 Refer Matt Nippert, "Top multinationals pay almost no tax in New Zealand", *New Zealand Herald*, 7 June 2017.

more effectively tax multinationals operating in New Zealand, the New Zealand Government resisted and instead decided that solutions should be developed on a multilateral basis in forums such as the OECD and the G20 economic grouping.[4] Presumably this was to ensure that the approach eventually adopted by New Zealand was based on solutions developed through international consensus and also that changes to domestic law might either be ineffective due to existing DTAs being held by NZ courts as overriding these changes or that if the treaty overrides were upheld, the risk of retaliation by treaty partners.

The majority of the work undertaken to address the problem of MNE tax avoidance has been done by the OECD under the title of “base erosion and profit shifting” (BEPS). A key part of this project was the development of an international convention (known as the “multilateral instrument” or MLI) which is designed to modify all of a nation’s DTAs at one go short circuiting a very lengthy process where a state would have to renegotiate all of its DTAs individually which could take many years. Part IV of the MLI contains provisions designed to address the tax avoidance strategy used by Google namely avoidance of the creation of permanent establishments. In June 2017 over seventy countries signed the MLI including low tax jurisdictions such as Ireland, Singapore, Hong Kong and the Netherlands. A few more countries have since signed, the United States being a notable exception and unlikely to do in the future.

This paper analyses the responses of some of New Zealand’s key DTA partners in respect of Part IV of the MLI dealing with PE avoidance to see if the New Zealand’s Governments reliance upon the BEPS project (and in particular the MLI) will enable it in future to tax Google on the profits it obtains from New Zealand businesses. Other options for dealing with the tax avoidance strategies adopted by Google will also be discussed including recent unilateral initiatives announced in New Zealand.

2.0 How Does Google Avoid Paying Tax In New Zealand?

Google maintains a physical presence in New Zealand through Auckland offices of two New Zealand incorporated companies. These companies are Google (New Zealand) Limited and Google Payments (New Zealand) Limited. Both companies are 100% subsidiaries of Google International LLC a hybrid entity incorporated in the United States.[5]

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4 Refer Smith, A; “Officials’ Report on the Taxation of Multinational Companies”, *International Transfer Pricing Journal*, Vol 20, No 6, November/December 2013, pp 412-416.

5 In filings with the New Zealand Companies office different addresses are given for Google International LLC. One address given is the head office of Alphabet Inc’s head office at Mountain View, California, while

The first of these companies employs local staff as “sales Googlers” which advise potential and existing customers how they can use Google to advertise and assist them in promoting their businesses online. The second company processes payments for advertising obtained from New Zealand customers on behalf of other Google overseas subsidiaries. Neither company will accept orders for Google products or services nor negotiate contracts on behalf of overseas Google subsidiaries.

Foreign owned companies are required to file annual accounts at the New Zealand Companies Office.[6] Typically these accounts disclose the minimum amount of information required under New Zealand law. In the account filed by Google (New Zealand) Limited its principal business is described as providing “services, consulting, advice, and assistance required in connection with marketing and support activities for the business of developing, marketing and web search services”. The revenue from its major business activities arise from a service agreement with Google, Inc for the provision of research and development services and another service agreement with Google Asia Pacific Pte Limited (incorporated in Singapore) for the provision of sales and marketing services.[7] Economic dependency upon these two Google companies is also disclosed in the accounts.[8]

For the year ended 31 December 2016 Google (New Zealand) Limited reported gross sales of $12.6m but a net loss after tax of NZ$604,000 after unusually providing for income tax expense of NZ$305,000.[9] Since most of its revenues arise from transactions with other Google companies it must raise the issue whether the company is charging an appropriate amount in these transactions especially since for financial reporting purposes losses are reported. Around 90% of the company’s assets are cash and cash equivalents plus trade payables owing to it from other Google companies.

Google Payments (New Zealand) Limited has not filed annual accounts with the Companies Office for financial years ending after 31 December 2014. It appears that is no longer required

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the other address is of a company incorporation service company located in Wilmington, Delaware, Delaware being a popular state for company incorporations in the United States.

6 Sections 207D and 207E Companies Act 1993.

7 Note 2(c)(i), 2016 financial statements at p9.

8 Note 2(c)(q), 2016 financial statements at p14.

9 The company appears liable to pay New Zealand tax despite declaring a pre-tax loss due to non-deductible expenditure. Note 6(b), 2016 financial statements at p15.s

to do so as it is not a "large company" falling within the definition of section 45(2) of the Financial Reporting Act 2013.[10] Its principal business is disclosed as performing "transaction processing on behalf of other Google companies" mainly Google Ireland Limited.[11]

For the year ended 31 December 2014 the company reported gross revenues of NZ$23,000 and net income after tax of NZ$783 after tax expense of NZ$123. Again all of its revenues are with other Google companies which raises the issue whether the company is charging an appropriate amount for the services it supplies to overseas Google companies but given that collecting and processing payments is a relatively simple and low risk activity, it may be easier for revenue authorities to determine whether the amount charged by this company for its services is appropriate (i.e. commensurate with arm's length prices which is the required standard for most countries' transfer pricing rules).

Unsurprisingly there is no public information available as to how much business Google obtains for internet advertising from New Zealand businesses. Given the absence of formal national borders on the internet it may be difficult to precisely determine. Professor Craig Elliffe from the Law School at the University of Auckland has made an estimation based on publicly available information from 2014.[12] Based on an estimated total online advertising market of around NZ$590 million in 2014 (obtained from the Interactive Advertising Bureau of New Zealand website) and that Google has around an 86% share of that market (based on Experian Hitwise estimates), it appears that Google obtained sales of around NZ$500 million from New Zealand advertisers that year. Based on worldwide consolidated accounts filed by Google in the US for 2014 fiscal year, it can be estimated that Google made around NZ$133 million net profit before tax on those orders (assuming a net profit to gross revenue ratio proportionate with Google's consolidated worldwide accounts) which would create a hypothetical New Zealand tax liability of NZ$35 million approximately. By way of contrast the two New Zealand incorporated companies paid income tax of less than NZ$400,000 for the same year. Of course these estimates are crude and overlook the internationally accepted transfer pricing method being the arm's length principle that MNE profits are taxable in particular jurisdictions according to the functions and risks assumed of each subsidiary there. Since realistically none of the activities that creates

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[10] The thresholds for an overseas controlled company being a "large company" for financial reporting purposes is that they either have assets exceeding NZ$20m or total revenue exceeding NZ$10m in each of the two preceding financial years.

[11] Notes 1 and 2(n), financial statements, at pages 6 and 9.

[12] "Taxing Digital Business: The Law and Policy", presentation by Professor Craig Elliffe, 2015.

Google's huge profit margins are located or based in New Zealand (they are in the US), substantially less than NZ$133 million could be justified as being earned in New Zealand.

How does Google avoid paying tax on orders it obtains from New Zealand advertisers? The answer lies in the fact that the orders are received by a Google subsidiary located in Singapore. As consequence of orders being received by a company resident in Singapore, the taxation of that company from customers located in New Zealand is governed by the provisions of the New Zealand-Singapore Double Tax Agreement signed in 2009. That agreement is based substantially on the OECD Model Tax Convention on Income and on Capital as are a majority of the world's DTAs. In common with virtually all other DTAs, a resident business located in one of the contracting states cannot be taxed in the other state on business conducted or obtained from the other state unless they have a "permanent establishment" there.[13] The definition of what constitutes a "permanent establishment" is found in Article 5 of most DTAs.

In the absence of an applicable DTA, New Zealand would be free to tax Google according to its domestic law provisions. New Zealand asserts very broad taxing rights in section YD 4 of the Income Tax Act (ITA) 2007 and it is likely that Google would have a liability to New Zealand tax on orders obtained from New Zealand advertisers as it could be argued that they were partly carrying on a business in New Zealand (section YD 4(1)(b) ITA 2007) or wholly or partly making or performing a contract in New Zealand (section YD 4(1)(b) ITA 2007). Even though it could be argued that Google has New Zealand sourced income under the ITA 2007, there remains doubts because of the nature of the product that Google offers. Where actually is internet advertising performed? Can it be actually attributed to one jurisdiction?

But in the end those arguments are irrelevant to the case of Google being examined here as the orders Google receives from New Zealand advertisers through a Singaporean company which is entitled to benefits under the DTA between New Zealand and that country. As all New Zealand's DTAs are superior to domestic law provisions (section BH 1 ITA 2007) those provisions are no longer relevant in taxing the Singaporean Google subsidiary receiving Google orders from New Zealand.

The definition of a "permanent establishment" in the New Zealand-Singapore DTA is unremarkable and largely follows Article 5 of the OECD Model Agreement. The basic definition

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[13] Article 7(1).

of a PE is a "fixed place of business…..". Specifically excluded are a range of preparatory or auxiliary activities which would appear to cover the work done by Google New Zealand Limited in advising customers about Google's products or services and thus prevents this company from being a PE of the Singaporean Google company. Under Article 5(5) a PE can also be created if someone is acting as dependent agent of an overseas principal and regularly obtains orders for that overseas principal. Google New Zealand Limited would definitely qualify as being a dependent agent due to the economic dependence it has for all its business from other Google companies but because it does not negotiate or conclude any contracts made on behalf of Google Singapore, no PE arises again. Consequently, in the absence of a PE, New Zealand cannot tax Google Singapore on any profits obtained from New Zealand advertisers. The same outcome would almost certainly arise if the Google subsidiary was resident in any one of the other 39 countries with which New Zealand has concluded a DTA with.

3.0 How Are Countries Constrained By DTAs?

DTAs constrain countries in several ways. Firstly because they are an international treaty they are accepted and treated as being superior to domestic law of a contracting state. For many countries this superiority is recognised and maintained under their constitution. In some countries (where the doctrine of parliamentary sovereignty applies for example as in New Zealand) this superiority of international treaties is not paramount but in practice such countries are loathed to depart from the principle that international treaties are superior because it is the accepted position under international law and failure to uphold may lead to retaliation by other countries and undermine a state's credibility in their international dealings.

Secondly, the way in which DTAs are negotiated also constrain states. Countries negotiate DTAs on one-by-one basis. Few have the capacity to negotiate more than a few each year which is also similarly constrained by the other party's capacity to negotiate DTAs. While DTAs can usually be terminated by giving a required period of notice (usually 12 months) most countries are loathed to terminate without a replacement DTA being negotiated as the termination of a DTA without any replacement leads to uncertainty as to how cross border trade and investment with be taxed in future. Many investments would have been made relying upon the certainty that DTAs provide foreign investors and the absence DTA protection is likely to harm cross border trade and investment.

It is theoretically possible that a country such as New Zealand could request that Singapore renegotiate its DTA to include provisions that would enable New Zealand to tax Google Singapore on business obtained from New Zealand advertisers. Assuming that Singapore would agree (unlikely since it would be conceding some of its economic strengths in attracting multinational investment) the revised DTA could easily be circumvented by Google restructuring its operations so that orders are then received by a Google subsidiary resident in another country with which New Zealand has concluded a DTA with. Countries such as Ireland, United Arab Emirates or Hong Kong are possible jurisdictions which would provide Google with equivalent tax benefits that Google currently obtains in Singapore. Could all those DTAs be simultaneously renegotiated? Highly unlikely. Quickly one can see how an established network of DTA constrains New Zealand in changing its tax rules applying to foreign businesses. Furthermore, a small country like New Zealand is dependent upon foreign investment and sudden or aggressive changes to its DTA policies are likely to be viewed negatively offshore and could undermine economic growth.

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4.0 The OECD and the BEPS Project

The Fiscal Affairs Committee of the OECD commenced its base erosion and profit shifting (BEPS) project in 2013. The objective of the project is to develop solutions on a multilateral basis to stem MNE tax avoidance. Originally only OECD member states and countries from the G20 were involved but in 2015 it was recognised that to be effective developing countries needed to be involved and eventually around 100 countries were involved in the deliberations.

In October 2015 a 15 point action plan was released each of which was a specific plan to deal with certain tax avoidance issue. Not all of the 15 "actions" were mandatory upon states, a number of them were mere recommendations for best practice[14] while others set standards for information exchange and disclosure.

The last of the 15 "actions" concerned the development of a "multilateral instrument" (MLI). It was recognised that many of reforms outlined in the 15 "actions" required amendments to existing DTAs if they were to be effective. With over 3,000 DTAs in force today, it was highly impractical to expect states to renegotiate their existing DTAs on a bilateral basis as it would take decades to achieve. As a result, the MLI was proposed as a multilateral international

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[14] For example Action 3 concerning CFC rules.

convention which would sit on top of a country's existing DTA network and modify them all at once.

While sounding conceptually simple, the MLI is a complex and lengthy convention. The MLI contains a limited number of minimum standards which all signatory states must adhere to. Even within these mandatory standards there are options for states to decide how they will achieve that standard. A great majority of the remaining articles in the MLI are not mandatory and states are free to opt out of them entirely but with one condition. That condition is that their position in respect of each article must be consistently adopted and enforced in respect of all their DTAs covered by the MLI.

For a provision of the MLI to apply to modify an existing DTA, there are a series of steps that need to be met:

(1) The contracting states to that DTA must both be signatories to the MLI. Around 80 states have signed so far, the US being a major omission. Some key Asian countries (Thailand, Malaysia) have also not signed.

(2) If (1) is met, then both states must then agree that the DTA is a "covered agreement" for the purposes of the MLI. New Zealand has specified that 36 of its 40 DTAs are covered agreements but interestingly some of those "covered agreements" are with countries that have yet to sign the MLI so not all of these 36 "covered agreements" will in fact be modified or subject to the provisions of the MLI.

(3) If (2) is met, both countries must have agreed to be bound by a particular article of the MLI. If there is no alignment between the positions of the two contracting states with respect to a particular article of the MLI, then that article will not apply to modify that covered agreement.

Thus, it can be seen to determine whether an existing DTA is modified in a particular way there is a complex process. Alignment under step (3) is far from certain as many of the signatories to the MLI have reserved their position to most of the articles of the MLI and thus are not bound by them in respect of their lists of "covered agreements".

The list of signatory states to the MLI contains several which are known benefactors of the current international tax environment (such as Singapore and Hong Kong) who offer tax incentives and low tax rates to attract MNE investment at the expense of many of MLI signatory

states. Unsurprisingly these jurisdictions have reserved their position on most of the key provisions of the MLI which suggests that have signed potentially for cosmetic reasons or to enhance their relationships with other OECD states when in effect they have agreed to little and are not prepared to undermine their economies by signing up to all parts of the MLI.

5.0 BEPS Provisions To Deal With PE Avoidance

As explained in section 2, a key strategy employed by Google in avoiding tax in the jurisdictions where it obtains orders for online advertising has been to ensure the orders are taken in such a way that a PE is not created. This achieved by not taking orders through any fixed place of business in those jurisdictions and also by ensuring that there is no person who could be regarded as a dependent agent in those jurisdictions how habitually concludes contracts on behalf of Google. To deal with this method of avoidance would require almost every DTA to be revised so that a new definition of PE is incorporated to catch such arrangements where Google has staff located in the jurisdiction to undertake sales and promotion work which ultimately results in Google received orders offshore for its online services. Thus, the MLI is a useful vehicle for a state to have all its DTA revised at the same time to incorporate a revised definition of PE.

There are two articles in the MLI that deal with the definition of a PE. Article 12 applies to deal with situations where a PE has been avoided through the use of commissionaire arrangements which are found in civil countries being similar to agency arrangements found elsewhere. Under Article 12(1) of the MLI, a PE is deemed to arise where:

> *a person is acting in a Contracting Jurisdiction [i.e. state] to a Covered Agreement on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:*
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> *a) in the same of the enterprise; or*
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> *b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that enterprise has the right to use; or*
>
> *c) for provision of services by that enterprise,*
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> *that enterprise is deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that person undertakes for that enterprise unless these activities, if they were exercised by a fixed place of business.... would not cause that fixed place of business to be deemed a permanent*

establishment under the [revised] definition of a permanent establishment included in the Covered Tax Agreement.

Again, excluded are agents of independent status from creating a PE. But there is an exception to this exclusion where a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related.

Thus Article 12 extends the boundaries of the activities which a dependent agent may undertake which will give rise to a PE. The previous wording in the OECD Model Tax Agreement only applied to dependent agents who "habitually exercise, in a Contracting State an authority to substantially negotiate or conclude contracts on behalf of the enterprise".

Article 13 of the MLI deals with situations where there has been artificial avoidance of a PE through the specific exemptions found in the definition of a PE in Article 5(4). Article 13 offers two options how to deal with this type of avoidance. Option A in Article 13(2) of the MLI excludes from the definition of a PE:

a) activities listed in the Cover Tax Agreement [prior to modification by the MLI] deemed not to constitute a PE whether or not those activities are dependent on being of a preparatory or auxiliary character;
b) the maintenance of a fixed place of business solely for carrying on, for the enterprise, any activity solely for the purposes of carrying on, for the enterprise, any activities not described in a) above;
c) the maintenance of a fixed place of business for solely for any combination of activities mentioned in a) and b) above,

provided that such activity (or overall activity of the fixed place of business) is of a preparatory or auxiliary nature.

Option B in Article 13(3) of the MLI is largely similar except of slightly different wording to paragraph a) above.

Irrespective of whether Option A or B are selected, under Article 13(4) of the MLI the specific activities which are excluded from being an PE do not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries

on business activities at the same place of at another place in the same Contracting Jurisdiction and:

a) that place or other place constitutes a PE for the enterprise or the closely related enterprise under the provisions of a Covered Tax Agreement defining a PE; or
b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two place is not of a preparatory or auxiliary character,

provided that the business activity carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprise at the two places, constitute complementary functions that are part of a cohesive business operation.

A definition of what constitutes a "closely related enterprise" is found in Article 15 of the MLI.

6.0 Will the MLI Allow New Zealand to Tax Google on Profits it Earns From Orders for Online Advertising From New Zealand Advertisers?

Google Singapore currently accepts order from New Zealand advertisers for online advertising but in a way that a PE is not created. The two New Zealand based Google companies cannot fall within the dependent agent provisions of Article 5(7) because they are not habitually concluding contracts in the name of Google Singapore. Will Article 12 of the MLI apply so that a broader definition of dependent agent PEs apply and hence open the opportunity for New Zealand to impose tax?

Firstly both New Zealand and Singapore have signed the MLI on 7 June 2017. Both countries have also specified in their Status of List of Reservations and Notifications at the Time of Signature made pursuant to Articles 28(7) and 29(4) of the MLI that the New Zealand-Singapore DTA signed in 2009 is a Covered Tax Agreement for the purposes of the MLI.

New Zealand has opted for Article 12 of the MLI to apply to its 36 Covered Tax Agreements. It is required pursuant to Article 12(5) of the MLI to identify which of its Covered Tax Agreements have provisions equivalent to Article 12(3)(a) which will be modified by Article 12 (1). In that regard it has specified Article 5(7)(a) of the New Zealand-Singapore DTA. Similarly, pursuant to Article 12(6) it is required to identify which of its Covered Tax Agreements have provisions equivalent to Article 12(3)(b) which will be modified by Article 12 (2). It has specified Article 5(8) of the New Zealand-Singapore DTA.

Singapore has exercised its right under Article 12(4) of the MLI for the entirety of Article 12 not to apply to its Covered Tax Agreements. Consequently, modifications contained in Article 12(1) and (2) will not apply to the New Zealand-Singapore DTA and the definition of a PE contained in that DTA will continue to apply as it was originally negotiated. Therefore, it appears that New Zealand is no better position to tax Google Singapore on the profits it derives from orders obtained from New Zealand advertisers than it was prior to the MLI being signed. At this stage one might conclude that the BEPS project has failed New Zealand (and probably many other countries) in dealing with PE avoidance techniques used by MNEs such as Google.

Would it made much difference if Singapore had agreed for Article 12 of the MLI to apply to it Covered Tax Agreements? Probably not. Many signatories have made a similar election in respect to Article 12 (Hong Kong, UAE etc) suggesting either they are not prepared to accept the OECD's solution to the problem of PE avoidance or that they are not prepared to suffer loss of their tax bases through adopting Article 12. Thus, if Singapore elected for Article 12 of the MLI to apply, Google could simply restructure its affairs so that orders for online advertising were taken by another Google subsidiary resident in another state which had elected for its Covered Tax Agreements not to be bound by Article 12.

The next issue to consider is, assuming that all signatory states to the MLI had agreed for Article 12 to apply to their Covered Tax Agreements, would the revised definition of a PE found in Article 12(1) necessarily capture the type of activities carried out by Google New Zealand as "playing a principal role leading to the conclusion of contracts". That wording is open to interpretation. Some guidance can be obtained from the draft commentaries written in regard of the 2017 version of the OECD Model Agreement. In the 2017 edition of the OECD Model, Article 5 has been revised to reflect the modifications to that article arising from the adoption of Article 12 of the MLI. Thus, future DTAs negotiated from the 2017 edition of the OECD Model will have equivalent provisions to existing Covered Tax Agreements which have been modified by Article 12 of the MLI.

The key issue is whether the revised wording of Article 5(5) whereby a person "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" creates a PE in New Zealand for Google. Paragraphs

89 and 90 of the draft Commentaries to the 2017 Model Agreement are interesting in that regard. Paragraph 89 states:

> *The phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" therefore applies where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise approves those transactions. It does not apply, however, where a person merely promotes and markets good or services of an enterprise in a way that does not directly result in the conclusion of contracts. Where, for example, representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs, the marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraphs does not apply even though the sale of these drugs may significantly increase as a result of that marketing activity.*

Paragraph 90 appears to explain a situation closer to the way Google markets its business in jurisdictions such as New Zealand:

> *The following is another example that illustrates the application of paragraph 5. RCO, a company resident of State R, distributes various products and services worldwide through its websites. SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO's employees send emails, make telephone calls to, or visit large organisations in order to convince them to buy RCO's products and services and are therefore responsible for large accounts in State S; SCO's employees, whose remuneration is partially based on the revenues derived by RCO from the holders of these accounts, use their relationship building skills to try to anticipate the needs of these account holders and to convince them to acquire the products and services offered by RCO. When one of these account holders is persuaded by an employee of SCO to purchase a given quantity of goods or services, the employee indicates the price that will be payable for that quantity, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO's contracts, including the fixed price structure used by RCO, which the employee is*

not authorised to modify. The account holder subsequently concludes that contract online for the quantity discussed with SCO's employee and in accordance with the price structure presented by that employee. In this example, SCO's employees play the principal role leading to the conclusion of the contract between the account holder and RCO and such contracts are routinely concluded without material modification by the enterprise. The fact that SCO's employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to 96 accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and RCO.

But does the above scenario in paragraph 90 provide guidance to an enterprise such as Google how to make minor modifications to its manner of marketing and promotion in New Zealand which would enable them to escape the revised definition of a PE?

The other issue is that while the Commentaries to the Model Agreements illustrate in more detail how the Fiscal Committee of the OECD sees the various Articles applying to specific situations, their conclusions sometimes show a bias of revenue authorities of member states and are not necessary the conclusions that other commentators might concur with. Additionally, commentaries are not in themselves binding law (at least in New Zealand). They can be regarded as "soft law". Although their special status in interpreting and applying DTAs based on the OECD Model has been recognised by the New Zealand Court of Appeal, it does not necessary follow that any New Zealand court is required to follow the Commentaries – refer *CIR v. JFP Energy Inc*.[15]

Even if one accepts that the current structure Google has adopted to conduct its business in New Zealand does give rise to a PE in New Zealand as a result of the MLI, how much income could be attributed to the New Zealand PE? After all that is the only income New Zealand is entitled to tax in respect of the transactions Google obtains from New Zealand advertisers.

The taxation of PE income is governed by Article 7 of the OECD Model. Under Article 7(1) only those profits attributable to the PE can be taxed in the state where the PE is located. In

[15] [1990] 3 NZLR 536.

determining the profits of the PE under Article 7(2) the PE must be treated as a "distinct and separate" enterprise dealing with its head office on an independent basis. That principle can be difficult to apply in practice as income is being determined on a hypothetical basis assuming that one homogenous enterprise is capable of division into two separate entities. Lastly under Article 7(3) in determining the profits of the PE deductions should be allowed for administrative and head office costs of the enterprise whether incurred in the state where the PE is located or elsewhere.

Applying Article 7(1) to (3), it would be likely that the income that Google Singapore might derived in respect of a PE in New Zealand would be relatively small in comparison to the total profits Google might derive from orders obtained for online advertising from New Zealand advertisers. Firstly, the key driver of profitability for Google in its online advertising business is its intellectual property which was developed in the US and is either located there or in low-tax jurisdictions. Secondly, the functions that Google New Zealand performs in the overall Google operations are very small, have low risks and require very few assets. Applying transfer pricing principles these factors would mean that very little profit could be attributed to the New Zealand PE which only undertakes sales and marketing functions for on offshore enterprise.

7.0 Domestic Law Changes in New Zealand

In December 2017 the New Zealand Government introduced a bill titled the Taxation (Neutralising Base Erosion and Profit Sharing) Bill to make amend the Income Tax Act 2007 (and other related revenue legislation such as the Tax Administration Act 1994) to make various BEPS measures effective from a domestic law prospective. These changes are necessary because even though the MLI may serve to amend parts of New Zealand's DTA network, unless taxing rights exist in domestic law the MLI changes are unlikely to be effective on their own. A DTA cannot establish a tax liability on its own but merely serves to relieve double taxation that arises under domestic law.

PE avoidance is clearly one issue that the above bill is intended to address. The bill will introduce an anti-avoidance rule for large MNEs (being MNEs with consolidated global turnover of more than Euro 750 million). A non-resident company that is part of that MNE group will be deemed to have a PE in New Zealand if a related entity (i.e. Google (New Zealand) Limited) carries out sales related activities for it under an arrangement which has a merely more than incidental purpose of tax avoidance. This PE will be deemed to exist for the purposes of any of New

Zealand's DTAs unless the DTA incorporates the latest version of the PE definition article found in the OECD Model Agreement. Additionally, any amount of income attributed to that deemed PE will also be deemed to have a New Zealand source so that New Zealand can establish primary taxing rights under its domestic law.

Specifically, the bill proposes to introduce a new section GB 54 in subpart GB. This subpart contains many specific anti-avoidance provisions relating to many income tax matters and its inclusion here is notable as it is being presented as an anti-avoidance provision.

Section GB 54 will apply when a non-resident:

- Is part of a large MNE group (consolidated turnover exceeding Euro 750m); and
- The non-resident makes a supply of goods and services to a person in New Zealand; and
- A person (termed a "facilitator") carries out an activity in New Zealand for the purpose of bringing about that particular supply; and
- The facilitator is associated with the non-resident or is commercially dependent upon it; and
- The facilitator's activities are more than preparatory or auxiliary; and
- The non-resident's income from the supply is subject to a DTA than does not include the OECD's latest definition of a PE; and
- A more than incidental purpose of the arrangement is to avoid New Zealand tax, or a combination of New Zealand and foreign tax, for the non-resident.

If all these conditions are met, the non-resident will be deemed to have made any of the supplies that are subject to the rule through the deemed PE. Any income attributable to a PE in New Zealand will be deemed to have a New Zealand source under a new subsection to be found in section YD 4(17C). In addition, New Zealand will adopt the Australian approach and any income which New Zealand is authorised to tax under a provision of a DTA will be deemed to have a New Zealand course - section YD 4(17D).

The bill also contains a provision to enact a new section which will define what a PE is for domestic law purposes. This is new because the current ITA 2007 does not contain any domestic law definition of a PE although in some cases a domestic law definition of "fixed establishment" currently in ITA 2007 applies which is simplified definition of the PE definition found in DTAs. A proposed section YD 4B will define a PE where a person or enterprise makes in New Zealand a supply of goods or services.

Under proposed section YD 4B(2), a PE for an enterprise which is resident in a country or territory which New Zealand has concluded a DTA with shall be defined by either the meaning given to it in the DTA, or proposed section GB 54 if the enterprise meets the requirement of that section. If the enterprise is from a jurisdiction with which New Zealand has not concluded a DTA, it will be given the meaning for a PE found in proposed Schedule 23 of the ITA 2007. This schedule will contain the definition of a PE as found in the 2017 version of the OECD Model Agreement which reflects amendments arising from the BEPS project. The definition of a PE where Schedule 23 will apply, is also expanded to consistently apply to the guidance given by the Commentaries to Article 5 of the OECD Model as published by the OECD "from time to time". The wording "from time to time" clearly implies an ambulatory approach to defining what a PE is for domestic law purposes where a DTA does not apply.

In section YD 5 there is an apportionment rule which applies to certain limited categories of income which are partly earned in New Zealand and offshore. It is proposed that this apportionment rule will not apply in determining any income of a permanent establishment and instead a proposed section YD 5B will apply. Under proposed YD 5B(2), any income earned by a person with a PE in New Zealand "is the amount that the PE might be expected to derive if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions dealing wholly independently with the person". This is the accepted basis by which the profits of a PE are to be ascertained under a DTA in Article 7 Business Profits.

It is hardly a secret that these domestic law changes seek to override existing DTAs which contain older definitions of a PE. Theoretically New Zealand can do that because it is a jurisdiction where the doctrine of Parliamentary sovereignty applies. But this point has not previously be considered by a New Zealand court in respect of DTAs and any future New Zealand court will the cognisant of the sensitivities of that issue. Based on an earlier UK case *Collco Dealings Limited v. IRC*[16] they are likely to uphold a domestic law override of existing treaty obligations only where the New Zealand Parliament clearly intended to do so which appears is the clear intention of Parliament here. There also some grounds for New Zealand to argue that such a treaty override would be acceptable because the OECD has stated that provisions which override DTA obligations in order to prevent tax avoidance are acceptable as

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16 [1962] AC 1.

anti-avoidance provisions.[17] Here the intention of the New Zealand Parliament is clear that these provisions are to be viewed as anti-avoidance provisions given the wording in the proposed section GB 54(1)(h) which is almost identical to the definition of "tax avoidance" in section YA 1 of the ITA 2007 and also of inclusion of wording about incidental purpose of an arrangement which mirrors wording found in section BG 1 ITA 2007 containing New Zealand's GAAR.

Using domestic law enactments to override existing DTA obligations even though it can be justified in terms of the OECD's recommendations that such overrides are acceptable, are unlikely to be appreciated or accepted by many of New Zealand's DTA partners. In particular New Zealand can expect as a minimum some pushback or protest from those DTA partners who have signed the MLI but not elected to adopt Articles 12 and 13 of the MLI or have not signed the MLI at all (e.g. the United States). It might also lead to retaliation again New Zealand not necessary in the income area but in some other area which hits this country hard such as its export trade in fresh produce. New Zealand would be wise to tread carefully deeming PEs of US resident entities given that country's opposition to much of the BEPS project and the MLI. What power Singapore (or say Ireland) have in retaliating against New Zealand in respect of deemed PEs is uncertain.

8.0 But Even With a PE in New Zealand Will Google Be Liable to Pay Much Tax?

Even if New Zealand succeeds in deeming Google's operations in New Zealand a PE, that on its own may not necessarily result in substantially more New Zealand tax being paid as outlined earlier.

Firstly, assuming that Google does not restructure its New Zealand operation (locally and offshore) as a result of the MLI (and related domestic law amendments) the next issue is how much income can be attributed to that PE. In a nutshell probably not very much. New Zealand is required to tax the PE as if it was an independent business which of course is a fiction. To attribute profits to the PE transfer pricing methodologies need to be applied. This involves analysis of the whole Google enterprise to determine what parts of it contribute to its profitability, where actual risks are borne and where key assets are located and employed. Any

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[17] Refer Nash, Hon Stuart, *Taxation (Neutralising Base Erosion and Profit Sharing) Bill: Commentary on the Bill, Policy and Strategy*, Inland Revenue Department, December 2017 at p 44. At the same point the relationship between the proposed section GB54 and the general anti-avoidance rule (GAAR) (section BG 1, ITA 2007) is also discussed. Also at p 46.

simplistic formula apportionment as was attempted in section 2 of this paper would not be acceptable.

The Google online advertising model is highly profitable because of proprietary intellectual property which was developed in the United States and will be located there or in another low tax jurisdiction. The value of that intellectual property is very substantial. The sale functions that are effectively carried out in New Zealand are not high risk, do not require many assets and operate in a way which is hardly unique to Google. So relatively little of Google's overall profits derived from business obtained from New Zealand can be taxed here using the accepted arm's length transfer pricing methods and PE attribution principles.

Secondly, it is unrealistic to assume that if the changes arising out of New Zealand adopting the MLI including domestic law amendments are effective, that Google will not restructure its operations in some way to still avoid New Zealand tax. How that might progress is uncertain, but it is almost certain international tax advisers will be developing new methods to avoid tax if the BEPS/MLI project results in a client paying more tax under their existing arrangements.

9.0 Are There Other Options For New Zealand to Tax Google?

Three countries Australia, the United Kingdom and India have adopted strategies to deal with the tax avoidance methods adopted by Google before the BEPS project had arrived at the MLI solution. Australia and the UK have enacted domestic law provisions which are intended as anti-avoidance provisions where avoidance of the creation of a PE in those countries by a major MNE is deemed to have occurred. Despite these categorising their enactments as anti-avoidance ones and therefore justified overriding existing DTA obligations, both countries have been criticised for "going it alone" outside the consensus approach of the OECD with its BEPS project, even though both countries did actively participate in the BEPS project. There were concerns that their unilateral actions might undermine the international tax order and multilateral institutions leading to a tax war and increased international double taxation. At this stage assessments of additional tax under each countries' enactments have not yet been tested in their courts of law. Hence it remains uncertain how their courts may view these enactments vis-à-vis their existing DTA obligations and how their DTA partners may react to additional tax assessments upon their MNEs.

India has imposed an "equalisation levy" in 2016 which is a flat rate tax on consideration for digital services.[18] It is not entirely clear whether it is a type of withholding tax on the incomes of non-residents providing digital services to Indian customers or some type of transaction or excise tax on the consideration paid for digital services supplied by non-residents which is paid and borne by the Indian customers in addition to the consideration paid to the non-resident suppliers. This would act in much the same way that the Approved Issuer Levy applies to interest paid to non-residents which is gross-up tax and from the non-resident's perspective is paid free of any New Zealand tax. Such an approach would sidestep any problems with the BEPS measures may produce and is likely to be acceptable to DTA partners (there has been no adverse reaction from DTA partners from the Approved Issuer Levy) but will raise the cost of online advertising for New Zealand based businesses. Such a levy in the range of 5% to 10% would produce much greater revenue that the BEPS measures are likely to produce in the end from Google's business obtained from New Zealand.

Another option might be for consideration for online advertising services to be reclassified under domestic law as a royalty. When a royalty is paid to a non-resident it is subject to non-resident withholding tax at 15% on the gross amount as either a minimum tax or final tax. If payments for online advertising services were defined as a royalty the non-resident withholding tax would more likely be a minimum tax under New Zealand domestic law as it more related to industrial or commercial activities rather than royalties to use artistic works subject to copyright. Under all of its DTAs New Zealand has retained the right to tax royalties at source at rates from 5% to 15% as a final tax. If the royalty is earned in conjunction with a PE then the withholding tax cannot be imposed by instead the royalty is assimilated to the PE's income and taxed on a net basis.

Such an approach would also meet the same problems as the BEPS provisions of DTA override, but it could be effective for amounts paid to non-DTA countries. Issues over treaty overrides are likely to be more acrimonious because such an approach as not been suggested nor endorsed by the BEPS project nor the OECD.

10. Conclusions

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[18] Refer Shreya Rao, "The Indian Equalisation Levy: Inelegant But Not Unexpected", *NLS Business Law Review*, Vol 2, 2016, pp 25-48. Ganesh Rajgopalan examines whether the levy might contravene India's obligations under the WTO agreements and concludes that it probably does and that modification of it should be made. Refer Rajgopalan, G; "Equalisation Levy – Applicability of Non-Discrimination Rules in International Agreements", *Journal of the Chamber of Tax Consultants*, July 2016.

The Google methods of obtaining orders from foreign countries in a way that does not result in them creating a PE in those countries has been a simple but successful method for Google to avoid tax in many countries. Clearly the BEPS project and the resulting MLI have Google well within their sights with several provisions designed to combat this method of tax avoidance.

It remains to be seen whether the MLI and the domestic law changes contained in a bill recently introduced to the New Zealand Parliament will achieve the desired result. Not all of New Zealand's DTA partners have signed the MLI, and many that have signed have not agreed to adopt the new PE provisions in Articles 12 and 13 of the MLI. Therefore, New Zealand proposed domestic changes may well be viewed by its DTA partners as a domestic law override. It is not totally certain that a future New Zealand court would uphold those domestic law changes in the context of a treaty override and if it does so, how DTA partners may react if they do not agree with the changes New Zealand has adopted.

Even if the MLI and the domestic law amendments proposed are valid, the next issue to consider is how much income could be attributed to a deemed New Zealand PE under current transfer pricing norms. It is likely that relatively little income could be attributed to any such deemed New Zealand PE in Google's case. New Zealand Governments would be wise to not assume huge amounts of tax will be collected as a result of adopting the MLI and enacting domestic law amendments until the tax has been received and avenues for judicial challenges have been exhausted. Initial suggestions are that NZ$200 million[19] might be collected from the BEPS initiatives overall, which is not a huge amount of tax even in the context of small country such as New Zealand. At least New Zealand can have some comfort it will not be going it alone in adopting measures to deal with the type of tax avoidance practiced by Google and that the measures it has adopted have been developed in a multilateral forum and will be adopted by other OECD members.

[19] Refer Nicholas Jones, "$200m extra a year from closing multinational tax loopholes: Government", *New Zealand Herald*, 3 August 2017.